Transcription – 2T23 Results

[Renato Lulia]

Hello. Good morning, everyone! My name is Renato Lulia, and I'm the Head of Investor Relations and Market Intelligence at Itaú Unibanco. Thank you very much for attending this conference to discuss our earnings for the second quarter of 2023, which we are broadcasting directly from our office here at Faria Lima Avenue, in São Paulo.

Today's event will be divided into two parts. In the first part, Milton will detail our quarterly performance and earnings. This will be followed by a Q&A session, during which analysts and investors will have the opportunity to interact directly with us.

I'd like to give you some instructions so that we make the best use of our time today. For those who are watching on our website, there are three audio options on the screen: the entire content in Portuguese, the entire content in English, or in the original audio. In the first two options, there is simultaneous translation. To choose your option, just click on the flag that is in the upper left corner of your screen. As always, questions can also be sent via WhatsApp. To do this, just click on the button on the screen for those who are watching on our website, or alternatively send a message to the number (11) 97825-5798. Our presentation today is available for download on the website screen, as well as on our IR website.

I will now hand over to Milton, who will start the earnings presentation, and I will be back later to moderate the Q&A session. Milton, the floor is yours!

[Milton Maluhy]

Good morning, everybody! Welcome to our earnings presentation for the second quarter of 2023. Thank you, Renato. I'll get straight to the figures. We have a very direct presentation today in order to give you an overview of the figures, pick out some highlights, and at the end we'll talk about guidance.

So, let's get started. This quarter we've delivered R$8.7 billion in earnings, which represents growth of 3.6 percent, with a very strong ROE profitability of 20.9 percent, 21.5 percent in Brazil. In our opinion these are two very strong results. The Margin with clients grew by 3.7 percent to reach R$24.9 billion, and as you will see from the figures, this is a core result, with little impact from working capital. In terms of margin with the market, this was yet another very strong quarter. You are aware of the challenges faced in this area, but despite these we've been able to continue to deliver quarter after quarter, seeing 65 percent growth.

The delinquency ratio is stable, with a growth of 0.1 percentage points, as we've been anticipating for several quarters, meaning these are entirely in line with our expectation, and consistent with the information we've provided to you in the past.

The efficiency ratio is 39.6 percent on a consolidated basis, and in Brazil we reached the lowest ratio ever, which is great news, and was driven by key topline growth and cost control. We'll get into a bit more detail on both of these agendas a little later.

As for our loan portfolio, I've set out to you on past calls that the adjustments that have been made to this portfolio, such as de-risking in some segments, which were significant for our delinquency ratio and cost of credit. As such, it is only natural that we're seeing the portfolio's growth decelerate somewhat. We managed to obtain 0.6 percent growth in the quarter in the Individual Loans portfolio, and 8.9 percent year-on-year, only slightly below double digits. In the SMEs portfolio, the volume was virtually flat, given the impact of foreign exchange rates on this portfolios, especially in the Middle Market. Year-on-year, growth was 4.4 percent.

In Latin America, the figures reflect the impact of changes in foreign exchange rates, and if not for this impact the consolidated figures would have grown by 1.3 percent quarter over quarter, and by 7 percent year over year.

So the key point we can take from the portfolio figures is that we've never stopped growing, at any point in the cycle, in terms of both number of clients and target segments.

We also did all of this while de-risking the portfolio. To give you an example, we saw a reduction in the credit card portfolio during the quarter, which was very much by design. We decided to make a key intervention in the portfolio, especially in those channels we call "the open sea", where we noticed accelerated delinquency rates, over-offering of products, and a very high level of debt service burden. Digitalization had also driven an expansion in the number of credit cards.

Until recently, we had an average of 1.7 cards per individual, whereas currently we have 4 cards per individual in the market, which indicates an oversupply. Despite all this effort, and I'll talk more about delinquency rates in a while, but suffice to say that during this quarter we've started turning things around. We don't show a breakdown by portfolio, but note that the credit card NPL has already reduced by 20 basis point this quarter, with the portfolio decelerating. This shows how important it was to make these adjustments in a timely manner.

Now, in other segments such as middle and high income, and higher revenue businesses, both in retail and wholesale, with more resilient clients in the cycle, we have continued to grow at well above double digits, and in the more affluent segments, at more than 20 percent. So clearly growth has not gone away.

Obviously, we're coming from a more challenging credit environment, but we're starting to see positive signs, and we will continue to react to and anticipate these cycles, so we can continue to deliver sustainable results and good profitability.

In terms of financial margin with clients, the key message is that most of the result came from our core business. As you can see, working capital accounted for R$2.8 billion last quarter and R$2.9 billion this quarter, representing only a slight change, so most of these earnings are consistent with the core margin with clients.

So, this is great news for our margin, with yet another quarter of growth. When we look at the annualized average margin rate, we see a quarter-on-quarter expansion, to 8.8 percent in this quarter from 8.4 percent in the second quarter of last year. And even adjusted for risk, we managed to remain at the same level. I would also remind you that in the fourth quarter of 2022, considering everything we said about credit costs and ratios, we had the impact of that large retailer, of which you are already aware.

When we look at the margin in Brazil, the story is similar. We saw quarter-on-quarter NIM growth, to 9.6 percent from 9.2 percent in the second quarter of 2022. And in terms of the risk-adjusted margin, we also see a recovery. This is great news, since despite all the challenges and portfolio adjustments, we kept increasing our margin with clients.

As for the margin with the market, as I had already anticipated, we had a very good quarter, since in both the last quarter and the preceding ones, we have been running at an average of

R$600 million per quarter. In the current quarter we reached R$1.1 billion, with growth both in Brazil and Latin America, and at a slightly lower hedging cost of our capital ratio, as the interest rate gap closed a little, we ended up having a slightly lower hedging cost.

So, another sound quarter, and despite the existing interest rate challenges, we've been able to take advantage of the opportunities.

I'd like to spend some time on this slide, since here we need to explain and detail some assumptions. The main message here is a discussion of Itaú Unibanco's sensitivity to interest rate cycles. There are those who understand exactly how our sensitivity changes throughout the cycle, there are those who have questions, and there are those who think that we could be more sensitive in an interest rate cut cycle than in a hike cycle, there are several views.

What we have sought to do here is provide a summary of how our NIM evolves during a long interest rate cycle.

We've normalized certain impacts. First, we matched the NIM, that is, we brought together the margin with the market and our margin with clients, because after all the interest rate cycle affects both. Second, we've eliminated some effects from this historical perspective to get a comparison basis. We've normalized the overdraft cap, eliminated the impact of the over-hedge, which is important, and the hedging cost of the capital ratio, which I was talking about just now, is also gone. It may have some sensitivity to interest, but this has nothing to do with the bank's core business.

We made two further adjustments.

One was in the fourth quarter of 2019, since this was the last pre-pandemic quarter where we had a 100 baseline, and we adjusted to fixed mix. That's because as we change the mix over time, this naturally changes our NIM. If we have a more secured portfolio, we get a lower NIM, and if we have a clean portfolio, a higher NIM, then what we wanted to show was the sensitivity to interest in our NIM as a function of the interest rate cycle. By locking in a 100 baseline, you will see that when we go back to 2016, we see reasonable stability. We go from 105, we go to 102, we go through 99, 102 again, and we get to 100. Interest went from 14 percent to 6 percent, and kept reducing to reach 3 percent.

Here in 2020, we introduced the program called *Travessia*, which naturally had a strong impact on the NIM because of renegotiations with our clients. So, this helps understanding that the main impact comes from the *Travessia* program. As we can see, interest rates continue to fall, then they go back up, but our NIM remains pretty stable.

What is the message we want to get across here? It is about our ability to manage risk and the risk factors to which our balance sheet is exposed and is sensitive. We use this type of risk management across all our business lines, whether in the margin with clients or the management of our products and commercial portfolios, and above all in the management of risk factors within the treasury department, in the margin with the market, and as you've seen, we have been able to manage risks very well.

Therefore, we do not go long only in our positions, regardless of whether we are in an interest rate hike or cut cycle. We actively manage risk factors at the bank.

We have a very dynamic approach to risk management, and these are the results produced throughout the cycle. I think I have made this clear, but of course the IR team is available to answer any questions, and to clarify details. But I hope this material has made a little clearer how interest-sensitive our NIM is.

In Commission and Fees and Result from Insurance operations, we expected a slightly more robust performance fee from capital markets activity in the first half of 2023 than we actually got, and I'll talk a little bit about that in the guidance later. Nevertheless, we were able to grow quite strongly in the credit and debit cards, with a year-on-year increase of 10.9 percent, with a 22 percent in the acquirer earnings.

Our acquiring business reached a volume of R$208 billion and a 22 percent growth in revenue, so we are having a very special year in the Rede business.

But when we look at asset management, we see a drop in the quarter and year-on-year, while reminding you that typically the effects of performance fees are recognized in the second quarter, but this was a weaker six-month period in terms of performance fees for the industry as a whole, and for us it was no different.

We're already starting to see stronger activity for the second half of the year, with an expectation of recovery, but it may not be enough for us to make up for what weren't able to capture in the first half. And here I'm talking about the whole industry, which went through a tougher market this year.

On the Advisory Services and Brokerage front, we kept on performing very well in terms of investment banking, leading most of the transactions that came to the market, with huge transactions, primarily follow-ons. We also maintained a key leadership role in the DCM market.

However, it is very important to make clear that during this first half year, volumes in the fixed income capital market fell by 45 percent, in effect showing much weaker activity in the market than we had anticipated. Looking at the second half, we can already see a rebound, but perhaps not enough to offset the market volume drop in the first half. As for ECM, activity was also resumed, and we have been discussing this with the market, so we have positive expectations going forward.

The last item I wanted to address are the earnings from our Insurance, Pension and Premium Bonds Operations, which grew by 2.9 percent in the quarter, and 17.5 percent year-on- year.

When we look at premiums earned, we grew by 12 percent, and the recurring results, in our core insurance business, showed less volatility, with a very satisfactory loss ratio in the segments that represent less volatility and bring more profitability overall, posted year-on-year growth. Last year our recurring insurance results grew by 50 percent, and this year we've already grown 24 percent.

This shows that our strategy has been successful, in that we've found a way to expand our insurance operations, which have been a major contributor to delivering and creating value.

Finally, in terms of fund management, we posted growth of 4.7 percent both in the open platform and in our own products. We have continued to expand our funding. I think that was the headline message here.

I'll spend a few minutes talking about credit. First, when we look at the NPL 15-90 days, whether in Brazil, in Latin America, or overall, we see similar figures.

But more important than the 2.5 percent obtained, is the trend, since we don't see any big impact on short term delinquency, either in Brazil or in Latin America, which is great news.

The overview for Brazil illustrates a key point I mentioned to you last quarter, which is that we did expect this increase, since there is a seasonality effect in the first quarter, which historically tends to drive delinquency ratios, while the second quarter tends to see a recovery. In the last couple of years that hasn't happened because of the pandemic, which is something we had already talked about. But the key issue here, which I mentioned on the last call, is that we expected to recover about 10 basis point in the short term delinquency, and that's what ended up happening.

I've already mentioned several times, but I'd like to stress again, the extent to which we have been able to predict and anticipate the bank's cycles, and to make projections using the tools we have available. I think this is very important, not only in terms of transparency to you, but also for our management and decision-making ability.

We have great news regarding the NPL 15-90 days in Brazil for SMEs, which remained stable. We have no specific concerns in this regard. As for the Large Corporate index, the changes are small, and I don't think this is a fair indicator for Large Corporates.

When we look at the consolidated figures here in the NPL 90 days, we see a slight increase of 10 basis points in Brazil and an increase of 10 basis point on a consolidated basis, and also a decrease of 10 basis points in Latin America, as I mentioned in the first slide. The key thing here is how we break down this information.

We've been telling you for a few quarters, since the end of last year, that at the start of the year we were going to stabilize the 90-day NPL of individuals. And in the first quarter of this year, we'd already have stabilized this delinquency ratio. As you can see here, in fact, the NPL 90 days was stable, and this implies two further effects.

First, I had said that we could expect a change of about 10 basis points, and we've been able to work within that estimate. Our expectation going forward remains the same, more or less 10 basis points, which is a more positive expectation compared to this, especially in the fourth quarter. The second effect, which is particularly important and which I've just commented on, is a natural slowdown in portfolios due to decisions that were made several quarters ago. Thus, the denominator effect of the ratio does not favor us. Still, we've been able to stabilize significantly the delinquency ratios of individuals.

The NPL 90 days for SMEs in Brazil shows an increase that is totally within our expectations. We have no concerns on this front, and I wanted to make this very clear to you. When we project what may come in the next two quarters, our best expectation is stability, with a more positive than a negative outlook. This means that, looking to the future, I believe we have more chance of surprising you positively than negatively. To give you a good overview of this trend, stability is a good goal for us to pursue, especially since the short term delinquency rate is stable. We are very comfortable with our delinquency ratios among SMEs, and while in Large Corporates, as I've just said, this isn't the best indicator, it's still at its lowest level in the NPL 90 days series. As shown in the previous slide, especially for individuals in Brazil, the credit card portfolio has already reversed its trend, despite the drop in its balance. We saw a drop of 20 basis points in the delinquency rate, which is quite a positive development and is very much in line with what we'd have hoped to see, given the number of interventions we've made in this portfolio throughout the cycle.

The cost of credit came highly in line, totaling R$9.4 billion and a cost of credit over portfolio ratio of 3.3 percent. I would remind you that the fourth quarter of 2022 was affected by the retailer event already mentioned. Thus, we continue to operate at levels very similar to pre-pandemic, and in line with the expected stabilization we've been talking about for a long time.

The Coverage Ratio did not show any variation, and remained very stable at 212 percent. In the retail segment, our coverage ratio was far above what we were operating at on average, looking back at the pre-pandemic time. Accordingly, our balance sheet shows a very healthy coverage and protection level. Our Balance Sheet, our Provision for Loan Losses and our Portfolio are very well protected, as you can see here. And we have continued to make a provision for our NPL Formation, as you may have noticed. We do not manage our balance sheet based on our NPL Formation, but our expected-loss models have led us to recognize a provision of approximately 100 percent of the NPL Formation, which also shows that we have been delivering significant results, with, in our opinion, an adequate level of provision.

Our non-interest expenses grew by 7.5 percent year over year. I would remind you that the last quarter was a more difficult one, and is usually a quarter with lower costs. As a result, total non-interest expenses grew by 4.1 percent in Brazil. I would draw your attention to the efficiency ratio, as we remained within the margin by reducing our efficiency ratio, which saw performance of 39.6 percent on a consolidated basis and 37.7 percent in Brazil. Based on the same logic I've been talking about a lot, which involves a focus on the topline, a focus on costs, higher productivity, and more investment in technology, we were able to achieve these results.

Looking now at investments, our challenge has always been to come in well below inflation in the core costs of the bank, and we have been able to do this quarter after quarter. And in terms of investments, we continue to invest in our platforms, while upgrading and expanding our businesses. Basically, what we are not going to do is stop investing in the future because of worries about the outcome in the next three or six months. We will keep investing heavily in the franchise, strong in the experience of our clients, and in all business expansions that will bring long-term results to Itaú Unibanco.

We talk a lot about digital transformation, cultural transformation, and efficiency. We've found a way to try, perhaps make it perceptible to you, what has been our journey in these areas. I think this table pretty much summarizes the message that I'm trying to get across. Maybe it makes it a little clearer. This is a vision of how we serve our clients proactively and reactively. When clients get in touch and there are 30 million interactions per month, you can see that it grows, but it grows much less than proactive services. What is the message here? Firstly, our ability to predict, to anticipate, to record everything that our clients actually say. Our artificial intelligence models and our ability to retain these interactions or have them through digital channels is already at 92 percent. We talk to clients much more proactively, while trying to help them on a journey, trying to spell out a need or a security event, and trying to anticipate any problems. And we've been able to do this with the significant increase in volume. We've already managed to reach a degree of stability between quarters, but with a material drop in the cost per unit. If we look at the index 100 graph, we saw a 52 percent drop in the period from 2020 to today, which shows the results of the huge technological effort and investment we've been making here at the bank to improve the client experience.

Our NPS was 71 points, which is an increase of 9 points compared to 2020 and reflects the digital and cultural transformation, client-centricity, and the delivery of very powerful results so far. We recorded 210 million proactive calls made per quarter. Currently 100 percent of our contacts are recorded and qualified on our modernized platform, where we can centrally read, using robots, consisting of both artificial intelligence and models, to understand the client's risk of problems or suitability for business. This has generated a lot of business for the bank. So, these proactive interactions are not only service, they are everything that generates earnings in digital channels.

Currently we can perform 90 percent of account approvals via branches automatically. In addition, we perform 95 percent of automated approvals through our digital channels, without any type of intervention, and we posted a 99.9 percent decrease in the time required to open an account. Previously, it took us 28 hours, which didn't make any sense. But this has had a lot to do with our installed structure and legacy systems. After upgrading these, we were able to open an account in four minutes. So this is a key change, especially in terms of client experience and perception. And here, we've also chosen a very important journey, which is the mortgage loan journey, the degree of digitalization increased by 87 percentage points. And speaking of experience and client centricity, we've been able to make at least half the volume of private credit production, of mortgage loans, with the best NPS in the market. This shows that, once again, this investment, this vision, and this transformation have generated and produced material outcomes.

In Capital, I think we have great news to share with you. Our Tier 1 Capital Ratio was 12.2 percent, which represents a growth of 20 basis points, as you can see here. For this quarter we are bringing *pro forma* figures. The *pro forma* table has two columns. First, I think you've heard a lot about the new Basel models, credit risk, new weightings. We did an extensive job here at the bank, from which we 've already benefited at the beginning of the month, in 80 basis points of capital. This is a very relevant effect for us. We were talking about 50 basis points, and that was our best estimate. Of course, when we introduced the weightings, when we managed to understand the standard in detail and could dive into the processes, we found 80 basis points of opportunity here, which is very significant news. Another highlight is that we have continued evolving our internal models and this, also at the beginning of the month, resulted in a benefit of 0.2 percent. This shows that we are growing by 1 percent in the CET 1 core capital, from 12.2 to 13.1 percent.

Our core capital is 13.1 percent, and our total capital is 14.7 percent. What we do not have yet, and will be a negative issue for capital and for the industry as a whole, not only in Brazil, but worldwide, it is Basel III, operational risk, for which the Central Bank is currently writing the applicable standard. We've already looked into the public consultation, and carried out simulations, but our best expectation is that we have to wait until the end of the year for further details. Possibly the new standard will be implemented in 2025, but we still don't know if it will be phased in, although we hope so. Naturally we will share the expected impacts with you, but I think overall the news in terms of capital is quite positive, as we have really completed a cycle of continuous evolution in our capital ratios.

Last but not least, I'd like to pass on a few messages about our guidance. The first is that we maintained our guidance on almost every line. This means that the ranges that were previously stipulated still meet our current best projections. This shows the predictability, transparency, and the ability to "look through the cycle" in terms of every kind of impact, and how we are managing the bank's balance sheet.

This way, pretty much everything is kept unchanged in the Guidance. What we are reviewing here is the best information available to date, and it indicates that we in fact had a higher degree of optimism that didn't materialize in terms of service and insurance revenue. We expected stronger activity in the first half of the year, both in performance fees and in the investment banking operation. As I told you just now, the volumes were little lower, and we thought it would be better to revise the growth forecast, which we previously estimated at between 7.5 and 10.5 percent, to between 5 and 7 percent, which represents our best estimate today. We've made a smaller adjustment to the effective tax rate, which we expected to be between 28.5 and 31.5 percent and now we expect between 27 and 29 percent. We are very thorough, and we thought that, for transparency's sake, it was worth making this adjustment, to make our best expectations clear to you.

In the second half of the year, in the Commissions and Fees and Result from Insurance Operations line, we expect an increase in activity. Not enough to recover what was in the guidance, but we expect a better second half with more activity. And despite these changes and the structure, our expectation is that what was implied in our net income for the bank wouldn't change from what we're looking at in our best projections today. Accordingly, our best earnings expectation remains the same, just with a slightly different structure, but with the bottom line still very much in line with our expectations at the beginning of the year.

Before I join Renato for the Q&A, I'd like to thank you on behalf of Itaú Unibanco, myself, of course, and on behalf of all our teams, for the recognition you have given us at Institutional Investor. We were very honored by that recognition, both on the buy-side and the sell-side. We came first in all eight categories, which was very nice for us. We were in those positions last year, and achieved them again this year. I would like to tell you that this naturally fills us with pride, and only increases our sense of responsibility. Of course we are happy, but it is our nature to be down to earth, humble, and without any type of conceit. What we really want is to continue delivering, managing the bank in the best possible way and, more than that, to maintain a very close relationship with you, investors and analysts, our clients, and all stakeholders. But I would especially like to thank you, our investor base, and our base of analysts, who do an exquisite job. So, all the feedback that comes from you, who are in contact with the Investor Relations department, the feedback that we receive on calls or on a daily basis, is very valuable for us to continue evolving. We've always wanted you as partners in this evolution, and I think we are succeeding in that. So once again, a special thank you to all of you, and also to my Investor Relations team, who also do a really excellent job.

I'd like to finish by saying to all the stakeholders who are watching us that I think this was yet another sound quarter, and we had the opportunity to share our earnings with you. We've talked here about clients, about culture, about digital transformation, which we've tried to make just a little more tangible. We want to say again that for us it is a never-ending game. It's not just one quarter, it's the next, and the next, and the next... We're here for the long term. These are long-term decisions, and we are not trying to optimize just the next quarter's earnings, what we want is, in fact, to build a platform, a bank, a capable bank, as we have done throughout our whole history, to deliver sustainable earnings and strong performance in our view, given the existing scenario and challenges. So thank you again. I will now join Renato for the Q&A and then we will be able to discuss a little more about your questions, challenges, and considerations.

Again, thank you very much and we'll see you shortly.

Q&A

[Renato Lulia]

Well, we're going to start now, Milton just got here and is next to me.

Thank you, Milton. We'll start with the Q&A session.

I remind you that this is a bilingual Q&A, i.e., Milton will answer the question in the language in which it is asked. But, if you want to have some support in translation, as always, we will have the audio in both Portuguese and English; just click the option you want here on the screen.

Questions can also be sent via WhatsApp, reminding you that the number is 97825-5798.

Well, we already have a lot of questions, Milton, we actually have 13 analysts here with us waiting, but I'm going to take the mic for myself and ask you a first question that has to do with yesterday's operating event. So, a lot of our clients, a lot of our partners, were affected by this intermittent systems unavailability, the unavailability of the client service channels throughout the day yesterday. Therefore, I thought it would be interesting to start the Q&A by putting you on the spot and ask you what happened? How did we solve it? And what did we learn from this incident?

[Milton]

Cool, thanks.

Great question to get things going. Anyway, let's start there.

I think the word that defines what happened is already an apology.

We have to start with this for you, investors, clients, partners, affected stakeholders. Evidently, we're working every day so that incidents like these do not happen or, if they do happen, make sure we have a sizeable recovery capacity. It was a very specific incident, in a bank's internal platform, that ended up damaging the rest of the environment.

We took longer than we would obviously like to recover and reboot the environment. We were able to do it throughout the day but it was something very limited and specific. I think we are left with the learning curve as this is part of the bank's development, part of our transformation to learn how to handle this type of situations. We have to be very resilient, calm, cool-headed and, again, acknowledge that no one is perfect and we need to keep moving forward and assimilate these learnings. So, I think this is a glass half full situation and that it was important to start the call with an apology to all of you who were affected

[Renato Lulia]

Thank you, Milton. Let's start with the analysts. We have on the screen Henrique Navarro from Santander. Hi Henrique, good morning, how are you? Welcome to our call.

[Henrique Navarro]

Good morning! Thank you for the opportunity and congrats on the earnings. In fact, Milton, I'd like you to help to shine a light on 2024. Here at the bank, we've updated our models with the second quarter figures and what you delivered was almost like clockwork. It didn't take us a lot of work for us to update them and we kind kept the figures the way we use them before. And the point is, looking at 2024, I can see between 10 to 15 percent profit growth. This growth is a figure that some of the investors we talk to are not so sure about. People are doubtful of how the margin with the market will behave in the interest rate cut cycle. We saw that the margin with the client for the second quarter was affect by a small credit slowdown by I imagine you have a provision buffer. Banking fees were a little weaker.

I think the first question, Milton, is if you—without asking for guidance beforehand—if you more or less agree that Itaú would actually be able to deliver between 10 and 15 percent profit growth for 2024? And where would it come from? From what lines, specifically, do you think the bank can make a difference for 2024? Thank you.

[Milton]

It's fine, thank you, Henrique.

Let me start by saying that we remain positive about the bank's development, optimistic about the outlook. I think the margin outlook has improved and, as you know, face challenges in the first half in capital markets, challenges to the loan portfolio and these are decisions that have been made over the last few quarters. It has affected insurance, it has affected the performance fees business, and, of course, the portfolios as a whole grew much less, as you can see, and this was by design. So, when we look at the portfolios' earnings, we are quite comfortable because we are coming out of a very important post-pandemic adjustment cycle, a gradual normalization of delinquency, and I think we knew how to place and position the bank at a key moment. I always say, but just to give you an idea, that if it weren't for this de-risking that we did in the portfolio, our delinquency ratios would be 180 points higher than the numbers that we've been disclosing.

The strategy was actually correct.

We do bottom-line management, of course, so we don't look at a line separately. The top line is, of course, important and shows our strength, engagement, ability to extract value, but we need to work on the other two lines also with the same emphasis. Our expectation is that the cost of credit may have peaked and we already expect a more stable ECL expense for the next two quarters, nominally stable, I'm not talking about a delinquency ratio. Of course, it's always subject to wholesale events, you know it well, it's an event-prone segment. And then, on the cost side, there is an efficiency work and agenda that we have been pursuing a lot and we will continue to pursue, naturally, seeking so that we can have a balance between the cost of serving and the ability to generate value.

In the portfolios, we have grown in several core segments for the bank, growing above 20 percent, so the number in the aggregate does not help because, if you look only at the card portfolio, it is 130 billion—any adjustment impacts the whole. But even in the card business, we have grown in the target segments, in the target clients, which shows our ability to really choose at what point in the cycle we are and how to move forward. Moving forward, I think we can have a pretty good second half. As activity resumes, there will be more capital market activity, which has an important weight, more activity involving assets, funds, etc. And we can see a major pipeline in the wholesale, with structured operations that can help us a lot throughout the second half. And we have done a very important strategic review job of retail as a whole by separating individuals from businesses, in the business model we post an ROE for each business line. We have already reversed the situation, two quarters ago, and I believe that we will continue to improve gradually by increasing the profitability of retail within the cycle.

So I think retail profitability will be higher than we've seen so far and it's growing, wholesale will continue to be very strong, delivering earnings; it's a stable cost of credit agenda. I think that, anyway, this cost of credit level is already staying behind us, nominally, and, of course, the lever is always wholesale. On the one hand, there's uncertainty, the margin with the market, earnings... and the cost of credit is always a variable, but we already see a more benign cycle, including for wholesale credit than we initially foresaw at the beginning of the year.

I think we're in a position to continue delivering adequate profitability; I think we'll be fine when we get to 2024. If we'll grow 10, 15 percent, we'll see, we don't have the precise number yet but we are working on the numbers. We're entering the bank's budgeting phase in the coming months and we'll have a better view of our capacity. But, in terms of direction, we expect to be well positioned when we get to the next year, regardless of the cycle and, again, I think we know how to make good use of the cycles. So, despite this view that we are more sensitive to one cycle level or another, I think the margin with the market, through the cycle, and all the changes in the interest curve, we have always been very able to deliver earnings regardless of the curve moment in which we were.

We are not long only, we do not believe in one direction alone, and I think that this ability to actively manage risk factors and the balance sheet is what has managed to make us deliver a solid profitability. We're going to continue to pursue this with a lot of emphasis.

[Renato Lulia]

Thank you Milton, quite clear. We go directly to the second person, Renato Meloni, from Autônomos, who is already here with us. Renato, good morning and thanks for being here. You are on mute, Renato.

[Renato Meloni]

Good morning, guys, sorry about that. Thinking here about the capital position, which is very comfortable, and growth, which has not yet got back to speed, what are your thoughts about payout?

[Milton]

All fine, Renato? Thanks for the question.

It's as follows, to be very clear here, in fact the level of capital recovery was pretty good, throughout all these quarters, so we posted very sound organic growth, while improving profitability and at this turn of the six-month period, we reaped the benefits that we disclose there: Basel credit risk at 80 bases points and the improvement of internal models.

Our Board's risk appetite is CET1 of 11.5 and AT1 of 1.5, so we are talking about 13 percent. What's missing, and more importantly, now in the second half, is for us to know the details of the Basel 3 operational risk standard. Everything suggests that we will have this information in the second half and we are waiting for these data to be able to have a better projection. In terms of direction, yes, we expect to increase the payout, it is not our goal to retain earnings or capital beyond what is necessary and what's necessary, has to do with the forward looking views of growth opportunities, capital allocation opportunities. We're always looking at it, making our plans, looking at the longer scenario for capital. But yes our expectation is an increase in the payout and we will work and disclose to you this information as soon as we have more data.

Operational risk, in our best estimate, could impact something like 100 basis points on the bank. It may be more, depending on how the operational risk standard comes out, and even if it has a *phasing* process, we anticipate this in our projection. But, we are optimistic and the idea is to review our payout. We should do this throughout the second six-month period, as soon as we have the data, we'll share it with you.

[Renato Lulia]

Thank you, Milton.

And for the next question, we have Jorge Cury from Morgan Stanley. Hi, Jorge good to see you and thank you for joining our call today.

[Jorge Cury]

Good morning everyone and congrats on the figures. I want to ask about the tax reform. Right now people are discussing the elimination of the IoC tax, as well as the possible reduction of corporate tax and dividend taxation. IoC, according to your disclosures, represented on average a tax reduction of approximately 10 percent for you in the last five years. In a scenario where IoC is in fact eliminated and the corporate tax doesn't change much, what can you do to offset this 10 percent reduction in your profitability from the elimination of IoC?

[Milton]

Good to see you again Jorge, thanks for your questions.

Our current view on IoC is constructive. We still don't know how the second phase of tax reform will be designed and discussed in Congress, especially in Congress. However, we are aware and understand that IoC plays an key role, particularly for our industry, which pays the highest tax, not only locally, but also globally compared to other banks and other industries. So I think the Government understand very well the impact of IoC specifically for the banking industry, because of the minimal capital we need. This is not tax planning but the point is that the level of capital required to retain the operation has to do with regulatory issues. That is why we have a very intense capital activity in Brazil.

Our opinion is to wait and see, of course; what we've heard is that the idea is to make a neutral reform in the context of IoC. So if there's any change in IoC, we also know the ACE, which is a European methodology as you know. There are other ways to work out this, such as reducing the corporate tax, for example. Otherwise, I think it will produce an effect that is not positive, at the end of the day, for society since you must pass on the risk to prices and the costs of credit may be affected by the tax increase or tax withholding on IoC. I believe it plays a key role in our tax payments at the end of the year and the Government knows that. That is, it will not be possible to pass on the SELIC decrease if we have a major impact on IoC and I believe that there'll be a repricing by the industry as a whole. But, we're constructive and if you ask me, I think the Government is going to try to do something very balanced and neutral in terms of tax impacts for us and the industry, in this case, I'm talking about the financial industry in the context of the impact and the level of tax that we already pay, as the corporate tax that we pay is 45 percent in addition to other taxes, which increases overall taxation above 45%. I believe that IoC generates an important benefit, specifically in terms of price of credit and the impact on consumption and operations, and so on, so we remain constructive on this issue.

[Renato Lulia]

Thank you, Milton.

And for the next question, we already have Daniel Vaz from Credit Suisse on the line with us. Hi Daniel, good morning, thanks for coming.

[Daniel Vaz]

Good morning, Renato, good morning, Milton, thanks for the opportunity to make a question.

I'd like to take this opportunity to address retail credit. Despite the slowdown we're seeing, the portfolio continues to grow almost 9 percent per year. We could conclude that the middle- and higher-income focused portfolio should be growing at double digits, given this mass credit acceleration. I'd like, therefore, to understand the curve's profile in these different segments. That is, is it possible to keep this double digit growth in the middle- and higher-income segments next year? And as regards mass credit, if there is an improvement in risk indicators, what would be Itaú's strategy to regain share in this segment or even not to win market share? So, give me a bit of these two prospects if you can explain it to me. Thank you.

[Milton]

Thank you, Daniel, for the question.

I think we've put your finger on some key issues. Yes, we are growing in the double digits in middle- and higher-income target clients. Obviously, at the current interest rate level, demand is a little lower than it could be and as we enter a rate-cut cycle, demand tends to grow since it would come from more informed clients, with less credit demand in general and who end up taking credit in more specific lines. I think the increase in demand will come and it there'll be a natural interest rate-related elasticity. We're already seeing this happening and we can grow not because of credit but because of the engagement. It is very important that we get out of the credit lever because, in the end, for us stand-alone credit is a penetration, client engagement lever. What really creates value is the client vision, it's the relationship as a whole. We see retail as an opportunity to keep growing, whether in the corporate or individual lines. We see an opportunity to grow a client base that we've always explored, or explored very little, the full bank vision. We've always looked at this client base as an offer that is not part of the full bank. Our proposal used to be to serve each client either by product or by a variation of a product in respect to that client. But without upgrading our platforms and without using the solutions that we've been working on, we wouldn't be able to reach this engagement and this key cross sell. To provide a full bank experience to a client base that already has a relationship with us and that has a history that we know and the behavior of whom we also know. So, we see a great opportunity, we are working hard on this. We talked about this on Itaú Day, we've provided a good overview of what it means and we'll get back to this issue as soon as we, eventually, have the results, which we'll share with you, when we have something relevant to share.

We are at a very important implementation and execution phase.

I think so, credit will be a lever, there is an opportunity to expand it, while we have to be careful with the simplification that we end up doing in the higher-, middle- and lower-income even segments. Because there is a way to serve each client segment, there is a way to serve them, and there is a way to seek opportunities, even in the lower-income segment.

It's not that we went away, I mean, it still has an key role in our portfolio. We've carried out a material de-risking and, as I've explained, this released 180 delinquency points from the bank's balance sheet, the cost of credit could have been much higher and have significantly impacted our earnings. But still, we have 20-25 percent of our portfolio still consists of lower-income clients, with whom we have a very close relationship, through our joint ventures with the financial companies, with the retailers. And, obviously, there are ways to work with this type of client by offering the right product, with the right risk, and we continue to believe that.

And the more benign scenario going forward, if it materializes, and we're here to make these decisions every day, we're obviously going to grow our business. Anyway, we never stop growing, we'll accelerate growth where we have to accelerate, but carefully so that we're able to deliver a sustainable performance during the cycle.

So we're optimistic and I think the individuals BU is a business where we're going to see steady profitability increases going forward.

[Renato Lulia]

Thank you, Milton. We're going immediately to the next question, which comes from Yuri Fernandes, from JP Morgan. Hi Yuri, how are you? Welcome.

[Yuri Fernandes]

Hi Renato, hi Milton, thank you and congrats on the earnings. I have a question about REDE. I think now you're market leaders but we still don't have your market share because industry data is missing. But, I think you ended up becoming leaders in this market. I'd like Milton to give some color of your strategy for REDE. We've even seen revenue going up a little bit this six-month period but we know it's a very competitive industry and I know you a client centricity position, mixed a little with the bank's. It's hard for us to try and look only to the products acquisition standpoint as we have to consider the SELIC cuts, which should benefit the industry. So, trying to be very practical, what's your price prospect, Milton? Should REDE be aggressive? No, that's not how you see it? Just a little color about this operation. Thank you very much!

[Milton]

Thanks Yuri for your question.

I think about the figures, ABECS releases the figures now, on August 10th, and the data is public, we will know the results. But I'd like to make a few points here. First, I think that looking at REDE's balance sheet separately lost its comparability because, for some time, the Network has ceased to be an absolutely separate vehicle, independent of the bank, to become a line fully integrated and coupled with our strategy. We've even talked on itaú Day about the fact that currently REDE is reporting directly to the corporate BU, under André Rodrigues, and is completely integrated into the structure and that is the challenge.

Client centricity yes but being at the top, being the leader or the runner-up, that's not what moves us, market share for market share sake. I know what I'm talking about since I sat on REDE's chair many years ago, more than ten years ago, I was there, and I know this dynamic, I know how much large companies' revenue affect it. Our strategy has not been to gain market share or rent market share, which is the term I like because, if this is the fight, it is a fight for price, it is a fight for negative margin of contribution, the only goal of which is to reduce, I mean, increase market share. That's not the goal, that's why we talk about and put emphasis on the disclosure of revenue growth rather than the issue of market share per se.

I think market share is the result of our ability to penetrate, to be close to clients and deliver value. We've carried out an important review of the REDE's strategy, which has proven to be very correct. We do have an integration with the retail banking business that has been efficient. And it's not brute force, I think that's the whole point of the discussion, it's not putting in more people, more effort all the time that you solve the issue because we are not talking about that. I think we have to have a value proposition, we have to understand the clients' need and then REDE will cease to be, and in our case it's no longer a stand-alone product, a monoliner that is neither a company nor it is listed, it's not an independent group company, and it becomes yet another value proposition in our relationship with the clients.

It has a super important role for several other business lines and I think the fact that we own 100% of the acquirer is a comparative advantage, and I think few players can do this integration the way we've done it. So we are optimistic about the progress. This year will surely be a great year for REDE, with a major growth in earnings, which is important for the bank as a whole. Naturally, we don't see any cannibalization. If it were a dispute for market share, of course, we would see the renting of market share in the market and we won't do it. This is not our essence. Our essence, in fact, is to create long-term solutions that are sustainable and always integrated into a value proposition for the client. I'm very optimistic, we've also been able to penetrate the target segment, which is what we've been aiming. We were able to reprice our products despite all the surrounding events, such as interest rate hikes and revisions that were made over time, and at an NPS level way above what we used to see. I also think it was a good fit doe us and we are quite optimistic about how REDE will evolve moving forward.

[Renato Lulia]

Great Milton. And the next person is already here with us, it's Rafael Frade from Citi. Hi Rafael, how're you doing? Good morning.

[Rafael Frade]

Good morning, Milton, good morning, Renato. Milton, I think you've made a very clear case with respect to your ability throughout the cycle to always manage very well the issues arising from interest rate cuts and hikes on the financial margin. But on the other hand, more recently, quarter after quarter we have seen the margin with liabilities being pointed out by you as benefiting from the spread increase and possibly this line we should start to see in the opposite direction because of the cuts in interest rates. So given the portfolio today, how should we think about it? I mean, is it something that's going to prevent improvements in NIMs as the interest rate is cut? Will it perhaps have a little bigger impact? So, specifically are regards the liability margin, I believe that it's been quite significant throughout this cycle and possibly it can be a ready win with the rate cut.

[Milton]

That's great, Rafael, thanks for your question.

Liabilities are an integral part of our operation. Our ability to attract funds, as we've always been a bid fundraising bank in the form of investments and funds from clients. And here I think it has a double impact, it's not only SELIC, but it also has a volume effect to the extent that we've been able to expand our offer platform. It's a fact that there's a migration of products to fixed income in an interest cycle like what we've been observing in recent months and this ends up bringing, without a doubt, more fixed income products to the bank. But, the most important thing is that we are prepared to have the client AUM, AUC, regardless of the scenario, without any kind of conflict due to the product profitability. The second aspect is that the way we hedge our liabilities also does not leave us exposed to short-term movements, neither on the long nor on the short position. We didn't have to pass through this interest rate increase to the investments; we did not capture this in the line automatically because we make a dynamic, long-term hedging, with several peaks in which we look at stability, which we've been managing throughout the cycle. So, for the increase side, we did not capture 100% of the increase, as this is a process that is still happening, and when we enter an interest cut cycle, it also takes time, it is a reasonably longer cycle for us to be able to capture these effects. What this allows us to do is provide flexibility and time to do an active management. And the moment interest rates start to fall, on the other hand, we keep going and we start to increase credit granting, we start to have other opportunities brought by the cycle. Cross sell with insurance, for example, as if we look at lender insurance, which is a product that is absolutely associated with credit, then the more credit is granted, the more the lender insurance segment is penetrated. As we come from a portfolio reduction and adjustment cycle, obviously, the insurance business—despite it 25 percent per year growth—also suffered a certain downturn involving the lender insurance activity in this first half. So, opportunities come from one or the other side and that's why you look at this long series, during which we've had interest rate hike and falling interest rate cycles, and still we were able to efficiently protect our business. And then the adjustment is in the mix, a mix of wholesale and retail, a mix within retail, it's the credit adjustment, it's the adjustment that gradually comes as a result of hedging that we make both to liabilities and working capital. Then, I think the bank can anticipate these events and protect itself in situations where cycles are more heightened, either on one side or the other. Then again, it always increases the pressure, it's always an additional challenge because if it's not on one side, it's on the other. This is the tradeoff that we are doing in portfolio management.

[Renato Lulia]

Thank you, Milton. The next question comes from Mario Pierre of Bank of America. How are you, Mario, good morning.

[Mário Pierre]

Good morning, guys, congrats on the earnings. My question will also be on the regulatory side. We keep hearing about the Government's dissatisfaction with credit card interest. I know the banks have already been talking about but it but seems like the news never leave the newspapers. Every week, we see the government's dissatisfaction. I'd like to understand on the potential cap side of credit card interest, how are the discussions going? How do you expect this to develop? And also, I'd like you to elaborate a little bit on the impact of the Desenrola program; how do you see it impacting your operations?

[Milton]

Great, thank you, for the kind words, it's good to see you again.

Allow me to make some comments, first on the issue of the card cap, which is not a cap on the card but on the revolving credit, the credit card interest rates. In recent times, most of our time has simply been invested in being able to share and discuss our positions with the market, and the market is not the banks, the market is the Government, the Central Bank, the retailers, in short, it's all our stakeholders, the credit card companies... so that we all have a common start point. So the diagnosis was very important. We did the work via FEBRABAN and some banks within FEBRABAN have clearly been part of this process by discussing the topic very openly, and I think this was very positive and constructive.

Congress, the Government, the regulator, retailers, the card companies, everyone is fully aware of the challenges we are facing. Some numbers are very important as we are talking about 400-percent interest on revolving credit. First, revolving card in the individuals portfolio of the national financial system accounts for 3 percent of the balance, three percent. If we include interest-bearing installments, we add two percent. So we're talking about five percent and we're discussing three percent of the portfolio. Second, no client stays subject to this rate for twelve months because the Central Bank's own regulation defines that after 30 days you have to offer something better, extended due dates, better terms. So, a client is in revolving credit during 18 days on average—this is the period that a client stays is in revolving credit, which shows that that rate is virtual. It's simply annualized, but it is not the actual rate charged.

That's what makes the headlines, it's what generates uneasiness.

Another important news, in Brazil, is that 75 percent of the Card Portfolio does not pay interest but 25 percent does and when you go to other economies in the region, or developed countries, you will see that the ratio is absolutely inverse, 70 percent pays interest and 30 percent does not pay interest. So there is a cross-subsidy, and I insist on that because, in the end, each business will want to make its own interpretation. We want to move from an unstable balance to a stable balance as regards cards. So, what we want to talk about and I know very well, which I addressed a little as regards REDE and yourselves said that we've assumed, are the numbers, while assuming that we are the largest acquirer, the largest issuer in Brazil, I mean, which we have no qualms to talk about. This is our field, why? Because in fact, we want to solve something that is structural. I will not defend interest-free installment sales because REDE factors installment receivables interest free and I have an financial interest in this. I'm not going to defend the revolving credit rate because the issuer... we need to build a solution that is good for everyone, that in the end is good for consumption, is good for employment, that is sustainable, that is good for retail, that is good for everyone. I think this is the guiding principle; yes, we have succeeded in holding good discussions and we are working in this direction.

We do not believe that the cap is the best solution, its impact would be quite significant. It's not good for anybody, it's not good for the regulator, it's not good for the Minister, the Ministry of Finance, it's not good for society, it's not good for retailers, it's not good for banks, because it's an artificial lever.

We will attack the root cause and this is what we believe; currently, our best information is that we will work over the coming 90 days in a multidisciplinary group to deliver a solid proposal to the Central Bank, the Ministry of Finance and Congress, and we will surely make progress in this issue. Anyway, I'm being constructive too; it's not an easy issue to solve but we're quite optimistic that there are mechanisms to make a smooth transition and move forward. That's what we stand for, it's the stable balance, not an unstable balance. I'm being constructive; I think we'll be able to come out of this process well.

[Renato Lulia]

Perfect, thank you Milton. Next question comes from Bernardo Guttmann of XP. Hi, Bernardo, good morning and welcome.

[Bernardo Guttman]

Hello, good morning Milton, good morning Renato, thank you for the opportunity to ask and congrats on the earnings. As regards the guidance, this fee and service revision seems fair, given the starting point in the first half. However, I think Milton made some good points regarding the recovery prospects of the capital market activities, so could this guidance be revised to include a possible stronger reacceleration as ECM and DCM activities are resumed? If you can, please comment a little about the prospects for the Investment Bank in the second half. Thank you.

[Milton]

Of course, thanks to you, Bernardo, thank you for joining our call. Thanks for the question.

We have already done a sensitivity test during the revision of the guidance, so our best information today is that we can navigate the next two quarters within this new range, already considering that the activity will be resumed.

We expect a good level of activity in the second half but not big enough for us to offset the first half. There are basically three lines that ended up suffering the most: the investment banking market activity, the capital market activity, in short, all that you've talked about right now. It's the funds' performance fees, so we've been going through a more difficult activity process in the fund industry, as it is increasingly difficult to secure gains in a market with this degree of volatility. And then, already in the second half, we expect to resume activities, but the performance fee depends on the market, depends on the funds' positions, the managers, it is very difficult to predict.

And it has a third effect, which has to do with credit, which is the lender insurance that I was just talking about. It is intrinsic, it is very involved in the credit operation, so as credit activity resumes, we have an expectation that the lender insurance segment will grow as well. That said, we don't think it's going to be big enough to offset the downturn in the first six months, so I don't foresee a change in guidance for the next two quarters. I'd love to come back here and say we're revising the guidance upward, but that's our best information today. I think this is the information which should use now, within the geography to which it refers, between five and seven, which is the figure we've disclosed; I think it is reasonable to imagine that the bank will be able to sustain these levels. Should there be any positive surprise, I think this range will accommodate it.

[Renato Lulia]

Milton, before moving on to Gustavo Schroden, who is next, Mario asked two questions about the revolving credit cap and one about Desenrola.

Could you please answer the Desenrola question, and then I'll move on to Gustavo.

[Milton]

Oh sure. Mário, back to this issue, let's get back to the point. I see two key elements in Desenrola. The first is that I think the level of client engagement has been quite good, the level of *awareness* that's been created is quite sound and we have noticed a growing demand in our various channels, seeking settlements, etc. We've already negotiated more than 200,000 contracts, and growing, and we've already upgraded the credit rating of more than 620,000-630,000 individuals, also growing. Here, when we start looking at all the transactions, I think this number already exceeds 700,000 as we speak. As we gauge the effect on the bank, we will start to really know the program's dynamics in September, how will tier 1 auctions go. The tier 2 stimulus is already in place, so we do expect some impact on tier 1 and I don't think it's going to be big enough from the bank's standpoint to move the needle of the cost of credit, or the delinquency ratios; I don't think it's going to have a material impact. But without a doubt, it is very positive for society, has a material impact for all clients and helps clients facing a more difficult cycle after the pandemic. I think again, yes, we expect some results. I don't see materiality in the result to the point of giving any financial highlight here. And it is very uncertain still because we will know the dynamics of the auctions from September onwards. Maybe in the next quarter, I can give a greater economic sensitivity, in addition to the impact in number, volume of clients, contracts. But let's wait another quarter to see what this means economically and I think I'll have more data to share with you.

[Renato Lulia]

Thank you, Milton. Now yes, we go to the next question which is from Gustavo Schroden of Bradesco. What's up, Gustavo? Welcome, good morning.

[Gustavo Schroden]

Good morning, Renato, good morning, Milton, thanks for the opportunity.

I'd like to change the subject a little and talk about efficiency. I think the bank has done an excellent job in this regard. If we look at the number 37 percent efficiency, for a bank of the size and soundness of Itaú, it draws a lot of attention. I'd like to understand here, Milton, if there is any target or any, let's say, any goal that we can work on in the next 2, 3 years in terms of efficiency index? I guess you can think that here at 35 percent or something along those lines? I understand that it has the revenue side, but assuming current revenue, thinking only about the cost side, if you can still do something to get the 35 percent or some even lower figure. Thank you.

[Milton]

Thank you Gustavo.

I think deep down our goal is to keep increasing. If you ask me if it's going to be 35 or 36 percent, where it stabilizes, it's going to depend a lot on this cost and revenue dynamic, something that we've been talking about a lot. So, we're working really hard, I think revenue have been tracking our performance throughout the cycle and the cost schedule as well. That's why we insist on disclosing the core cost, where we show—and we we've been absorbing all the inflation in the run the bank—the bank's transactional cost. A little while ago we looked at the service cost, i.e., the highly important reduction. Then, the digital investment that is being made in the bank aims, of course, to deliver the best value proposition, a better experience for our clients, and an increasingly customized offer. But, it also has a goal of reducing the service cost, in a market that will increasingly be more competitive. So, we need to move forward. I'm not talking about a remote bank because that's not what it's about, but a digital company and being able to serve your clients at a very optimized service cost, and currently technology allows you to do it. What sort of progress do I see here: we are still at a stage of some operational redundancy; as we migrate to the cloud you still have systems running in the old datacenters, so we have an operational efficiency to capture. We continue to see opportunities, here, to advance the business model itself, the structure, the client service model. So, I'm optimistic; this is an agenda that we're going to continue to pursue with a lot of emphasis, with a lot of emphasis, quarter after quarter, and we will, regardless of the top line; cost is an agenda that has to be present every day and that's what we're discussing here at the bank. So, I'm again constructive I don't know if it's going to stabilize at 35/36 anyway, where is it going to stay, but we're going in that direction. Time will tell and it will depend a lot on this top-line dynamic. And another point that

I think is relevant, is that when we provide our cost disclosure, first we put all the costs, inside. So there are no expenses and other expenses, they are expenses. The second element that I think is very important, I think the numbers are there to be checked, since within our cost agenda we do not relinquish all the adequate provisions, the whole PRO portion, labor and civil expenses, and all this is still cost to the organization, but always covered by a level of provisioning that is quite adequate. If you look at our balance sheet lines over time, this cost delivery has nothing to do with the reduction of structural provisions, which we understand are important for the bank's balance sheet. So, despite that we continue to deliver very powerful results and advance a lot, so I think it's super important to understand our provisioning in the various lines and follow the evolution of these lines over time. We do not relinquish soundness and long-term vision, although this may adversely affect the efficiency indicator in one quarter or another.

[Renato Lulia]

Perfectly clear, Milton, thank you. The next question then comes from Thiago Batista of UBS. Hi, Thiago, good morning.

[Thiago Batista]

Good morning everybody, congrats on the earnings.

My question is about credit card lines. You've already commented here, Milton, that the NPL fell 20 basis points this quarter. We can track it using the EAH that you disclose; it was the first drop in the last two years and something, also of 20 basis points. I'd like to understand if this drop was due to the change of mix by aiming more at a higher-income segment or if you took the existing base would also obtain this improvement. And in addition, when I look at the profitability of your credit business, this quarter it was in the single digits, I think the six-month period is at 10 and a little bit, it drops a little bit quarter over quarter, so it was single digit in this quarter. If this profitability improvement has to do with the card business, if the card business is still a significant detractor of this profitability of credit lines.

[Milton]

Well, first, several issues here, included in a single business. First, we see here in the national financial system an expansion of delinquency to over 90 days. And when we look at our own lag, we see that it has already dropped 20 basis points, so we've detached from the market's behavior that has a falling portfolio in nominal terms. So, as the funded portfolio dropped, the total portfolio also dropped in the quarter. This shows that the denominator effect here has a role but despite that we've to reduce the lag. I think it has a major mix effect. I think we've done a de-risking of the portfolio and we've been growing in the segments naturally, where there's a healthier expected level of return for the portfolio. So, the new loans that have been granted over time take time to have impact because it's a large portfolio. It's very difficult for anyone to change a portfolio overnight with new loans. But, all the loans that are being granted in our business are being granted with Over 30, MOB3 delinquency ratios, i.e., all showing very healthy indicators. The mix does play a much more important role in the de-risking of the portfolio than simply looking at the same base and imagining how it would have behaved. Also, in the end, as our lower-income operation has a role to play and as one of the levers is the credit card, as I've said just now: had we kept the mix constant, and credit cards have a key role in this mix, we would have worsened our delinquency ratios by 180 points, a much higher cost of credit and a much lower profitability.

The card business needs to be separated. Our card business is very large, the current account business is soaring, keeps growing, with a high level of engagement and a perfectly adequate level of profitability, and thus we are very happy with the results of the operation. In the market that I call the open sea, we actually made an adjustment to the portfolio. It's a portfolio that ends up suffering less, suffering more, and the financial companies a little bit in the middle, but both businesses are below the cost of capital. Not the current account business, but these two are separated. Then, we expect and are working to recover, so that we can get back to the capital hurdle, at least with these portfolios. It takes times and, therefore, this business was a big detractor of our cost of credit, given the size of our portfolio, which is disproportionate to the market. It is much larger compared to the individuals portfolio since if we include the Carrefour bank it has a market share of almost 30 percent. That's a very material number, which ends up having greater impacts. The figure we've disclosed for credit activity this quarter, in the business model, was 10 percent, so, it's not within single digits, but it was within the 10 percent photochart. On the other hand, we had a major expansion in the service and insurance revenue line that shows that the card credit for the monoliner or for the business without a full bank offer, naturally depends a lot on credit, while for other businesses, credit is a key lever for cross sell and for us to be able to capture all the rest of the value creation from the service and insurance revenue. And I think this is also the big opportunity, Thiago. As I've just said, we expect to be able to work on this basis from a non-full bank standpoint to a full bank standpoint with clients with whom we already have a history and know, that are already clients and have a CAC close to zero because they are already our clients. And what we have to do is really keep working and increasing the business. Anyway, I think there is also an opportunity here, I don't just see it as a challenge from a credit standpoint. I think it's a very strong business opportunity and it's possible that we have the untapped largest base of existing bank clients, and with work supported by technology and an upgraded, integrated platform, we might be able to seize such opportunity.

[Renato Lulia]

Thanks, Milton. Well, next question then comes Rosman from BTG. Hi, Rosman, good morning.

[Rosman]

Good morning everyone!

My question, I think, is a follow-up of Thiago's question, and also Milton's answer, about this general market client. I think we saw banks in general suffering a lot in the open market client segment, financial companies as well. So far, there was a digital bank performing better. I'd like to understand a little bit what is, today, the relevance of this so-called open market client on Itaú's earnings. I think it's small, but it would be nice if you could quantify it a little bit. And how are you're working to turn this type of client into a full bank client? In particular, would there have to be a migration to the app? Is this system ready for that? The entire tech backbone, it would be nice too if you guys could talk a little bit about this topic. Thanks.

[Milton]

Cool, of course, nice to see you again, Rosman. Thanks for the question.

I think the first message here, I think, that it's important to break down that this client, if we look at the bank's bottom line, is a client who added very little value to the bottom line. Such clients added much less RGO than we've seen in the past. Typically in the past, these operations always returned close to cost of capital, so a detractor of ROE, but it helps and generates value from the standpoint of earnings, scale to the operation. And obviously withing this cycle, the external channel turned out to be more challenging. This is not only for cards, it goes for vehicles, other businesses that depend exclusively on the external channel. So, we saw a decrease in the clients' contribution to the bank and, in particular, from the standpoint of profitability. So, even if with a positive RGO or profit, profitability becomes a detractor.

Despite that, we were able to absorb all these effects in the balance sheet, as you've seen. On the other hand, I see that we have an opportunity to transform a single-view client, many times involving a single product, and built up engagement. Engagement is you becoming the primary bank of such client, not the secondary bank. Because as the secondary bank, you feel a lot an effect from credit cards, in particular, the so-called sudden death. You have there a client, who's using your credit card until the day he no longer can pay, when he puts that card in the drawer and starts using the other six cards he holds. Then, his relationship and engagement with the organization makes a huge difference.

If you are the bank where he centralizes his main transactions, where he centralizes his daily affairs, a bank that even debit account mechanisms that foster a more integrated, complete relationship with each client, you also benefit from the cost of credit. You tend to be the last bank where the client won't naturally make a payment. The client tends to preserve, as far as possible, of course that the client's income is the client's income, but such client tries to preserve the relationship with the organization, with the bank that is his or her main bank. So, for me, this issue is being the main bank. In need a technological solution? Absolutely. You don't do it by brute force, it's not call center, it's not using the app to try to phish that client. Phishing in the sense of trying to originate a transaction with that client; it doesn´t happen like that. Now, if you build an integrated experience, and that's the work that we're doing, it doesn't matter if the client came through a channel or a product, or what is the product that they chose to have a relationship with the bank. You end this logic that the current account is the only center of relationship with a client, because it isn't any longer. It can be the checking account, it can be the payment account, it can be the credit card, in short, the client is the one who chooses where he wants to start the relationship. But, if you can, within a super app, you should make an integrated and complete offer to that client to change the dynamics. Experience changes, efficiency changes, and that's what we really believe. We're not there yet, there's important work going on, but we'll be there soon and I think it could be a gamechanger. We never had the tool and the technology that would allow this capture and this integration, and I think that finally now we have a much better solution to be able to generate this engagement with our clients. From a well-known client, with a behavior score, people who already have enough data to make good credit decisions; in short, I am optimistic and I think that the contribution from clients that today contribute very little can become important, especially in the bottom line due to the cost of credit. Such client ended up having a much bigger role in the cost of credit overall and that's the biggest detractor. The portfolio was the biggest detractor of cost of credit in the bank's balance sheet; it was the credit card portfolio. That's why we're disclosing a cost of credit of this size, with the largest portfolio in the market, perhaps twice as big as the runner-up, i.e., a huge difference, and yet, we're working with a cost of credit that the operation is able to absorb. So, this shows how much opportunity there is on the other hand for us to move forward.

[Renato Lulia]

Thank you, Milton.

I'm going to go back to speaking English since we have here with us Tito Labarta from Goldman Sachs. Hello, thanks for joining the call.

[Tito Labarta]

Hi, thanks Renato, hi Milton, how are you. Thank you for the call and taking my question.

My question is if you could give just a little more color on NII, you a very good performance on both the market and NII and the client NII this quarter, I think in the context of rates coming down. Now, how should we think about the market NII and how that'll evolve in this lower rate environment but also the client NII as you potentially accelerate loan growth into the next year. If the client's NII grows or benefits from a lower rate environment, as you grow the loan book more, maybe the mix could help if asset quality begins to improve, just to think about both the market and client NII in the context of a lower rate environment next year.

[Milton]

Thank you, Tito, good to see you. Thinking a little bit in what I was mentioning before, I think you have to look at both sides, okay. The investment side and also the credit side and we've been able to deliver a good performance throughout the cycle because we've been balancing a lot the portfolio with these decisions like that. So, in one way you have some positives from the investment side, with interest rates going up, you have more volumes with the interest rate going up, but, when you go in a cycle when you have a reduction of the interest rate, you'll see an opportunity in credit coming in front of us, where you can equilibrate, bring more balance to the mix of the portfolio, you can take more risks, you can go to products and the mix of retail can change, the mix of wholesale can change, so it's always a play of taking a little more risk in a scenario that allows you to do so, with better spreads. The, on the other side, we may lose a little bit the benefits on the investments, on the liability side. So, this is the balance that we've been pursuing. I think that in the mid to long term it's better for us to work in an environment where we have a lower interest rate. So it's not true when they say that a high interest rate is good for the banks. It's good in the short term, you have some benefits in the short term, but the cost of credit and the capability to increase portfolio, reduces decreases strongly as the cost of credit increases and capabilities decrease. Then, at the end of the day, on the balance of that you have more negatives than positives. We have fewer projects, the wholesale market is not so active. We are optimistic and I think in the downturn we'll see more activity in the downtrend of the cycle, in the reduction of the interest rate, and in the economy evolving in the coming quarters, we will see more positives than negatives. An then we'll have to adjust the structure, the cost, the portfolio, we will do so to whenever we feel comfortable to improve our performance. I'm positive about that and then we have to look the adjusted NII or adjusted NIM to understand how to we can manage throughout the cycle. In the NII, there are two impacts, especially for this year. One of them is the average balance of the portfolio, so we cannot look at the picture at the end of the cycle, at the end of the quarter, because you still have a higher aggregate balance than what we see, especially when the portfolio reduces. In the second half, we expect more activity in general, we see a good pipeline on the wholesale side where we can bring more economics to the operation and this will also benefit our NII. That's why we keep comfortable in our NII, even though the mix may change a little bit.

[Renato Lulia]

Thanks Milton. For the next two questions as well, we keep speaking English as the next question comes from Nicholas Riva from Bank of America. Hello, Nicholas.

[Nicholas Riva]

Hi, Renato, hi, Milton, thanks for the change to ask questions.

I have two questions, the first on capital. Milton, you alluded to this positive impact you're getting on capital from July 1, due to changes in operational risk, lower operational risks, and you estimated the positive impact at 100 basis points. If you can provide a little more color on what actually in changing regarding operational risks? That was my first question and then my second and I know I've been asking this and I think Nathalia has also asked this in past earnings calls, but I wanted to ask, I wanted to confirm if the strategy around call options in tier 1 and tier 2 bonds you still hold in the sense that in the tier 2 bonds, the 2029s and the 2031s, we should still expect that it what's most likely to happen is that you would call these bonds since they start to lose capital treatment if they're not called. And also with the AT1 bonds, we should expect that in that case you would only call then once you could issue new coupons, very similar to those you are currently paying, thank you.

[Milton]

Thank you. On operational risk, which is your first question, I think there was a public consultation done by the public regulator telling us how... and this is not a Brazilian discussion, this is a Basel discussion, and of course there are some items specific to Brazil and some discussions that we're having with the regulator as well also to avoid double accounting for some specific topics. To give you an idea, when we make labor provisions and we make tax provisions, at the end of the day we have some operational risk. But as these are two very relevant lines for the bank, we make on an expected loss provision. We provision on the balance sheet. So there is a discussion in the Central Bank with the ILM index that can be 1 or more than 1, depending on how the Central Bank regulates it, that we say it's double accounting because when I provision and I use the expected loss model, I take from the capital. So, If I take that into consideration when I look at my statistical loss, going back, then I'd be making a double accounting and that's why we discussed this ILM equal to 1 and then the Central Bank can regulate the level of provisions in the Basel pillar 2, ensuring that we have enough capital for those lines and those specific provisions. I think this is the biggest impact, it's an evolution in the regulation, it has to do with one's history, it has to do with the new models. I think it's an evolution that's happening worldwide and it makes sense, and we believe so, but we've had some comments, of course from the industry and within FEBRABAN and also the banks have had very constructive conversations with the regulator.

So let's wait and see. Our baseline is 100 basis points, in the worst case it could be 180, this could be a number, but we work more with 100 basis points as a baseline due to all the discussions and the logic behind this evolution in Basel 3 operational risk.

And speaking about bonds, we're keeping the same strategy. That is, whenever we approach the call option we understand if it is better to access the market or if, from an economic perspective, it is better not to exercise the call option. This is what we've been communicating to the market and even anticipate the communication, thus ensuring we're very transparent about this. And the Tier 2, it's same, as you've just mentioned, if we start losing the capital benefit because of the five years close to maturity, where we start reducing 20% per year, then we'll decide if it's an expensive Tier 2 or not. We don't have a material capital issue, as you can see from our figures. We are very comfortable with our level of capital, so in the economic side this'll be the key decision making lever. We'll keep tracing, it's difficult to say that we will anticipate, the market may change, the interest rate may change, but today it is worth not exercising the call, we can do it at least 200 basis points lower than if we went to the market. Especially in a troubled market after Credit Suisse's AT1 event, so we don't see a very open market for that, and we don't know what the new pricing level will be, at which level the new instruments will be priced. Then, we'll be monitoring the market and, if so, we will or will not exercise the call. It will depend on many issues, many levers, but the cost is the most relevant one.

[Renato Lulia]

Thanks Milton. And just before we move to the next and last question, I just want to acknowledge that we got a question via WhatsApp from Alexa Huether from Jefferies. She was asking the same question about the AT1s, so since Nicholas has already made this question, let's take that as already answered. Exactly efficiency, so last but not least, we have with us Carlos Gomez Lopez from HSBC. Hi, Carlos good to see you again. Thanks for joining the call.

[Carlos Gomez Lopez]

Thanks for extending the call and taking my question.

My question is about taxes. Can you comment on the possible effects of the first tax reform? The reform of indirect taxation. And whether this reform changes how you manage the bank or in terms of possible structural change in cost; do you see anything tangible there? And also related to taxes, as part of the tax discussion, is there a possibility that they will review the way your foreign subsidiaries are taxed and, therefore, what would be the results for your foreign business?

[Milton]

Thank you, Carlos, good to see you again and thanks for your question.

On the VAT reform, we have to separate the bank into three main business lines. In terms of service fees, we are in the general provisions, that is, if the rate is 25 percent, we don't know, the numbers have not been defined, we'd pay 25 percent on services and fees and it will be exactly like any other company, a drugstore, for example. However, we have two other provisions, in special regime, which will be regulated, and one of them is the spread. As you know, no country where VAT has been implemented, spreads are not taxed. And today, the cost of credit, the rate we charge our clients, 20 percent of that is explained by PIS and COFINS, which are the current regime in which we pay 4.65% on spreads. So what we've heard is that the idea would not be to increase that through VAT because imagine what would happen if the 4.65 increases to 25 percent. Even in a non-cumulative regime, the increase would still be huge. That's not the idea, as we've been hearing, because this would produce the worst possible effect that would increase prices and impact activities very strongly. This is the second one. The third is payment ecosystems, in a special regime as well, and it's very easy to explain. We were discussing interest rates on credit cards, but imagine if VAT impacts the interchange. We don't have any passed-through but the interest rate in the credit card business. That's why we want to have special discussions because there is no pass-through throughout the cycle in the VAT chain over the interchange. The idea is to take a look at this, otherwise we'll have to gross up on the brands and have new interchange fees published. Or, we will go to the interest rate of the revolving, on the interest-bearing installments, which could produce a very strong impact. This is why it's separate. So, let's see, we still have the discussion on the Senate, if there's any change it goes back to the lower chamber, so we have to way and see to understand the real impact. It may be that the activities get a little more expensive, there is no other way to do so. Most of that goes to price, there's a pass-through.

Right now we don't have a deep knowledge of what'll be the second chapter of tax reform. We have to wait and see, there are a lot of discussions going on. I think the focus and priority is to approve the text approved in the lower chamber. Let's wait and see so you can have a little more color. There is a bill that is in Congress, but it is old so we imagine some changes will be made by the technical team and many discussions will take place in the coming months and will involve all segments and industries. So let's wait and see.

[Renato Lulia]

Thanks Milton. As I've said already that was the last question, there were 14 questions from 14 analysts today and with that then we close the Q&A session and also our earnings call. But first I'd like to say goodbye to the everyone. And first, we're going to answer all the questions we've received via WhatsApp, and there were several. The IR team will answer them directly to you. Thanks for the participation of all of those who attended our call here today. Milton, you have the floor for your final thanks. Thanks Milton.

[Milton]

Thank you.

Look, as always it's a pleasure, thank you once again for being here. I think we have finally managed to ensure we have a very open, very transparent communication. I made my thanks just now about the recognition we get and, anyway, with a lot of humility, which is the watchword we keep using here at the bank. Everyone is being very practical and is aware of the challenges. Everyone is working willfully, with a lot of energy, with a lot of focus to continue delivering good earnings, to continue surprising our clients, to continue advancing our transformation agenda. Thank you for your time and for the questions. I always thank our 100,000 itubers, who really do an exquisite job, with the very high levels of energy. And I think we're in a very special moment, quite happy with what we've been able to deliver, but, aware, as I've just said, that this is a never-ending game, it doesn't end this quarter. So, in the next and the next, we'll come back to discuss new prospects. Provocations are always welcome. We will move forward with a lot of focus, discipline, and a lot of energy to continue delivering this level of profitability, in short, performing above the market average.

Thanks guys, see you at the next earnings call and see you around at our bilateral meetings. All the best.