

**CREDIT OPINION**

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Update

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**Contacts**

**Farooq Khan** 55-11-3043-6087  
*Analyst*  
 farooq.khan@moodys.com

**Alexandre Albuquerque** 55-11-3043-7356  
*AVP-Analyst*  
 alexandre.albuquerque@moodys.com

**Thiago Scarelli** 55-11-3043-7347  
*Associate Analyst*  
 thiago.scarelli@moodys.com

# Banco Cooperativo Sicredi S.A.

## Update Following Outlook Change To Stable

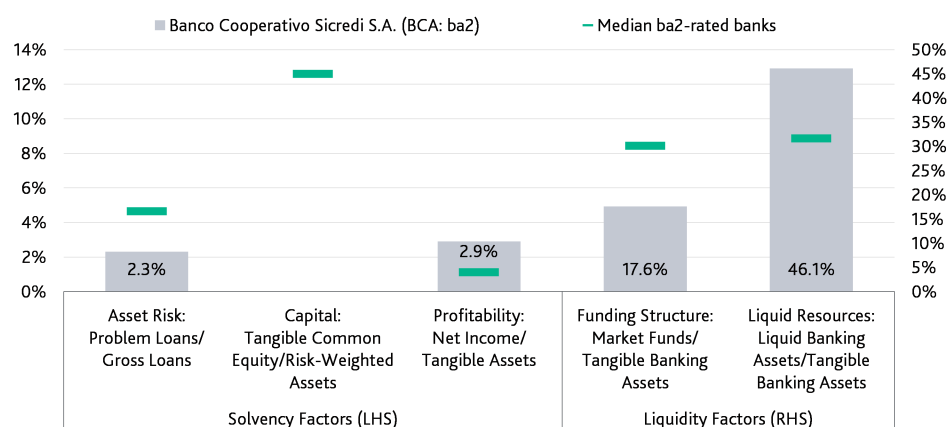
### Summary Rating Rationale

Moody's assigns a corporate family rating of Ba2 to Banco Cooperativo Sicredi (Banco Sicredi), reflecting its adequate capitalization, good profitability and granular funding structure. The rating also acknowledges the challenges the banks' asset quality faces in light of the ongoing recession in Brazil over the medium term and the intrinsic limitations to business flexibility and expansion imposed by the cooperative model. Banco Sicredi is the central entity of Sistema de Crédito Cooperativo Sicredi (Sicredi), which congregates 121 financial cooperatives with over 3.3 million associates in 20 Brazilian states, and offers traditional financial services to associates (such as lending, credit cards, insurance and investments) under the same brand and common risk policies. Moody's assesses the Sicredi group as if it operated as a single entity, taking into consideration its strategic and operational cohesion, common policies for credit risk, liquidity risk and capitalization; and the principle of solidarity within the group.

The outlook on Banco Sicredi's long-term deposit ratings was changed to stable from negative on 16 March 2017 following the change in outlook on Brazil's bond rating announced on 15 March 2017.

Exhibit 1

### Key Financial Ratios - Banco Cooperativo Sicredi S.A.



Source: Moody's Financial Metrics

## Credit Strengths

- » Adequate capitalization, both at the combined group and at each individual entity of the Sicredi network
- » Good profitability, largely driven by high margin lending operations and low cost of funding
- » High liquidity and granular funding structure, largely composed of cooperative associates' deposits

## Credit Challenges

- » Delinquency pressures due to the challenging operating environment in Brazil despite conservative risk management and below system average problem loans
- » Intrinsic limitations to franchise business flexibility and growth, due to cooperative model

## Rating Outlook

The outlook on all ratings is stable, in line with the outlook on Brazil's sovereign rating.

## Factors that Could Lead to an Upgrade

At this point, there is limited possibility for an upgrade, given the prospects of weak economic environment in Brazil and the challenges associated with it. Banco Sicredi's BCA is constrained by Brazil's sovereign rating.

## Factors that Could Lead to a Downgrade

Negative pressure on Sicredi's ratings would derive from significant weakening in its loan portfolio performance. Should a potential deterioration become more than currently anticipated - and in turn, putting Sicredi's profitability and capital generation at risk - the ratings would face downward pressure.

## Key Indicators

Exhibit 2

### Banco Cooperativo Sicredi S.A. (Consolidated Financials) [1]

	6-16 <sup>2</sup>	12-15 <sup>2</sup>	12-14 <sup>2</sup>	12-13 <sup>2</sup>	12-12 <sup>3</sup>	Avg.
Total Assets (BRL billion)	62	52	46	38	31	19.1 <sup>4</sup>
Total Assets (USD billion)	19	13	17	16	15	6.5 <sup>4</sup>
Tangible Common Equity (BRL billion)	9.6	7.8	6.5	5.1	4.2	22.7 <sup>4</sup>
Tangible Common Equity (USD billion)	3.0	2.0	2.4	2.2	2.1	9.7 <sup>4</sup>
Problem Loans / Gross Loans (%)	2.3	1.8	1.6	1.3	1.3	1.7 <sup>5</sup>
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	6.3	5.8	5.7	4.7	4.6	5.4 <sup>5</sup>
Net Interest Margin (%)	11.4	11.1	10.7	10.3	9.5	10.6 <sup>5</sup>
Net Income / Tangible Assets (%)	2.9	2.8	2.8	2.4	2.4	2.6 <sup>5</sup>
Cost / Income Ratio (%)	55.1	55.1	55.9	54.1	55.3	55.1 <sup>5</sup>
Market Funds / Tangible Banking Assets (%)	17.6	20.4	22.9	22.6	28.6	22.4 <sup>5</sup>
Liquid Banking Assets / Tangible Banking Assets (%)	46.1	38.8	33.6	33.4	39.5	38.3 <sup>5</sup>
Gross loans / Due to customers (%)	84.2	102.2	112.8	110.9	111.0	104.2 <sup>5</sup>

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; LOCAL GAAP [3] Basel II; LOCAL GAAP [4] Compound Annual Growth Rate (%). Any interim period amounts presented are assumed to be fiscal year end amounts for calculation purposes [5] Simple average of periods presented

Source: Moody's Financial Metrics

## Detailed Rating Considerations

### GRANULAR BORROWER EXPOSURE IS POSITIVE, BUT POOR ECONOMIC ENVIRONMENT WILL WEIGH ON ASSET RISK

Moody's assigns a ba2 score to Sicredi's asset risk, reflecting its granular, geographically diversified loan book and conservative provisioning policies. At the same time, the score incorporates our expectation that the currently low nonperforming loan ratio will

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continue to deteriorate over the medium term, due to the persistence of very weak economic conditions in Brazil. In addition, the score also takes into consideration the above market average growth of Sicredi's loan portfolio during the past two years, which we see as higher asset risk.

As of June 2016, Sicredi's nonperforming loan ratio was 2.3%, following a persistent upward trend since the end of 2013, as asset risks have increased at the majority of the individual credit unions. This negative trend will likely continue, as a consequence of the lagging effects of Brazil's recession.

Each one of the 121 credit unions within Sicredi's cooperative system provides loans and other traditional financial services to its own associates, mostly individuals from low to mid income classes and small farmers. As of June 2016, agribusiness was the dominant segment in Sicredi's loan book (39%), followed by loans to individuals (33%).

According to Sicredi's internal by laws, the highest borrower cannot exceed 15% of the total regulatory capital of the credit union. Since individual credit unions are modest in size - with an average common equity Tier 1 of BRL70 million - and distributed over 20 different states in Brazil, Sicredi's asset exposure is more granular than other Ba rated commercial banks.

The group's internal regulation states that a credit union cannot provide new loans if it does not comply with the minimum liquidity, capital and asset risk thresholds established centrally by risk management, and a recovery plan must be implemented. In addition, each credit union must hold allowances in the amount of 2.5x its problem loans, providing a relevant loss absorption buffer.

#### **ADEQUATE CAPITALISATION SUPPORTS SICREDI'S CREDITWORTHINESS**

We score Sicredi's capital as baa1, given that Sicredi's credit unions report core capital ratios comfortably above the Brazilian average and above the ratios reported by groups with similar business model globally. Our assessment for capital also notes the gradual increase in the capitalization across the multiple credit unions over the past two years, placing the network in a better position to weather the challenging environment. Looking at nominal leverage, as of June 2016, the aggregated loan book of the group was 3.2 times its equity, which compares to a leverage of around 6 times for the system.

According to internal regulation, each credit union must report capital ratios at least 300 basis points above regulatory minima, which ensures a solid position at the network level. The ratios are centrally monitored and noncompliant entities are only allowed to originate new credit operations under the supervision of regional centers. Credit unions whose capital ratios remain below internal thresholds must present plans to replenish capital; while those with ratios below regulatory minima are prohibited from originating loans. The group also benefits from regular reinvestment of net income in its capital structure.

In line with its cooperative nature, each of Sicredi's individual associates is a shareholder of the group and new joiners must make an equity injection to be entitled to membership. These contributions and the systematic earnings retentions are key sources of capital for the group and therefore its capital is almost exclusively made of loss absorption common equity. In the first half of 2016, Sicredi's common shares increased by BRL393 million, comprised of BRL230 million as retained earnings, BRL163 million as shares issued to new members. Withdrawals from members who left the group amounted to BRL120 million in the same period.

Besides members contribution and internal earnings generation, a minor addition to regulatory capital comes from subordinated Tier 2 notes with the IFC (BRL109 million, due in 2021) and additional Tier 1 (BRL158 million, only at Banco Sicredi).

In terms of ownership, the local credit unions and the four regional centers are the shareholders of Sicredi Participações - the holding entity that controls Banco Cooperativo Sicredi. The Dutch group Rabobank and the International Finance Corporation (IFC) also have minority interests in the bank, with around 20% and 3% of its capital - respectively - which improves Sicredi's technical expertise and its incipient access to international markets.

#### **OVERALL PROFITABILITY REFLECTS LOW COST OF FUNDING, BUT PERFORMANCE DIFFERS AMONG CREDIT UNIONS**

Although profit maximization is not Sicredi's main objective, given its cooperative model, the system has strong returns on its assets reporting a ratio of net income to tangible assets was 2.9% as of June 2016, slightly up from the ratio reported in 2015. The key driver for this performance is the sizeable net interest margin on lending, twice as large as the average of Moody's rated banks in Brazil, as credit unions generate loans at market rates while benefiting from low-cost core funding (at 91% of the benchmark rate, on average). Sicredi also provides insurance broker and credit card services, but these products represent little more than 5% of revenues.

Sicredi is present in 1,056 cities and is the sole financial institution in 20% of them, which provides geographical diversification to earnings. At the same time, this characteristic weighs on Sicredi's operating expenses, as individual credit unions lack operational scale and must comply individually with regulatory demands from the Central Bank, including the report of audited financials. Nevertheless, the system as a whole has adequate efficiency, with a cost to income ratio around 55%.

We also note that individual performances vary within Sicredi's network, with credit unions in Rio Grande do Sul, Mato Grosso and Mato Grosso do Sul reporting stronger results than other domiciled in Para and São Paulo. Looking ahead, we expect current performance to be negatively pressured by high provision expenses, as delinquency increases throughout the country, which rose by 27% in the first half of 2016 versus the same period a year before. Our score of baa1 for profitability incorporates this negative trend.

#### **GRANULAR FUNDING BASE SUPPORTS ADEQUATE LIQUIDITY**

Moody's assesses Sicredi's liquidity as ba1, incorporating ba1 score for funding structure and baa2 for liquid resources, given its stable, granular funding base and the conservative liquidity management across the cooperative system.

As of June 2016, total deposits were its major funding source accounting for 83% of Sicredi's total funding. The second most important source are domestic onlendings operations from government-owned development bank BNDES - BRL6.5 billion - which are channeled through Banco Sicredi to the credit unions, and represent 13.4% of the system's liabilities.

As of June 2016, the majority of the credit unions held sufficient liquidity to cover more than 2 months of operations. According to internal regulations, the minimum amount of liquidity established for each entity depends on the volatility of its funding availability, being higher for unions with higher deposit concentrations and noncompliant entities cannot disburse new loans. We understand such measures help to address the challenges imposed by the complex and heterogenic network and reinforce the cross guarantee in place.

#### **QUALITATIVE ADJUSTMENTS**

Sicredi's cooperative model results in intrinsic limitations to its franchise in terms of business flexibility and growth. In addition, the cooperative system as a whole presents higher structural complexity, which derives from the heterogeneity of individual cooperative entities, than rated commercial banks. The comprehensive and timely risk monitoring by Banco Sicredi counterbalances this complexity. Nonetheless, in order to reflect this increased complexity, we assign a qualitative adjustment of -1 for opacity and complexity to Sicredi.

#### **SICREDI'S RATING IS SUPPORTED BY THE MODERATE MACRO PROFILE ON BRAZIL**

Brazil's Moderate macro profile reflects the country's large and diversified economy, while the combination of ongoing economic recession, persistently high inflation and the difficult political scenario increases challenges to Brazilian banks' operating environment. The pace of loan growth has reduced significantly in the last year and tightening monetary policy allowed banks to raise lending rates, which has relieved part of the earnings pressure arising from asset risks. Public banks hold a 56% share of Brazil's loan market, which is reflected in the adjustment for industry structure. Capital and funding remain adequate, and exposure to international capital markets will remain low. External vulnerability is also limited by Brazil's sizeable international reserves, which reduce the country's sensitivity to external shocks, such as sudden stops in capital flows.

## **Notching Considerations**

#### **ADDITIONAL NOTCHING GUIDELINES**

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

#### **GOVERNMENT SUPPORT**

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

#### **ABOUT MOODY'S BANK SCORECARD**

Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard

may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

## Rating Methodology and Scorecard Factors

Exhibit 3

### Banco Cooperativo Sicredi S.A.

Macro Factors						
Weighted Macro Profile	Moderate	100%				
Financial Profile						
Factor	Historic Macro Adjusted Score Ratio	Credit Trend	Assigned Score	Key driver #1	Key driver #2	
Solvency						
Asset Risk						
Problem Loans / Gross Loans	2.32%	baa1	← →	ba2	Loan growth	Expected trend
Capital						
TCE / RWA	—	—	—	—	—	—
Profitability						
Net Income / Tangible Assets	2.69%	a2	← →	baa1	Expected trend	
Combined Solvency Score		ba2		baa3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	20.40%	ba1	← →	ba1	Deposit quality	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	38.80%	baa1	← →	baa2	Expected trend	
Combined Liquidity Score		baa3		ba1		
Financial Profile				baa3		
Business Diversification				0		
Opacity and Complexity				-1		
Corporate Behavior				0		
Total Qualitative Adjustments				-1		
Sovereign or Affiliate constraint:				Ba2		
Scorecard Calculated BCA range				ba1-ba3		
Assigned BCA				ba2		
Affiliate Support notching				0		
Adjusted BCA				ba2		
Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating

Source: Moody's Financial Metrics

## Ratings

Exhibit 4

Category	Moody's Rating
<b>BANCO COOPERATIVO SICREDI S.A.</b>	
Outlook	Stable
Baseline Credit Assessment	ba2
Adjusted Baseline Credit Assessment	ba2
Corporate Family Rating	Ba2
NSR Corporate Family Rating	Aa2.br
Issuer Rating -Dom Curr	Ba2
NSR Issuer Rating	Aa2.br
ST Issuer Rating -Dom Curr	NP
NSR ST Issuer Rating	BR-1

Source: Moody's Investors Service

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