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DPGE II Favorable for Banking System as Long as it Does Not Lead to Dependence

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NON-RATING ACTION COMMENTARY

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Fitch Ratings-Rio de Janeiro/New York-16 August 2012: Fitch Ratings considers the recent changes on the rules of Special Guaranteed Time Deposits (DPGEs) favorable for the Brazilian banking system. The agency's opinion reflects the positive aspects that stem from the creation of a permanent contingent liquidity line with a simple structure and less bureaucracy, which will relieve some of the pressures on the liquidity of small and medium-sized institutions especially in times of higher economic volatility.

In recent years, Banco Central and Fundo Garantidor de Credito (FGC, Credit Guarantee Fund) have played a key role in the maintenance of a healthy Brazilian banking system and in reducing systemic risk despite growing market discussion about moral hazard. One of their recurring concerns is the small and medium-sized banks' restricted access to longer-term funding sources or adequate funding structures, mainly in times of increased volatility and uncertainties within the macroeconomic scenario.

The DPGE net protection scheme was created in April 2009 with an aim to provide a stable long-term funding alternative for banks. DPGE's major attraction for investors stemmed from FGC's larger guarantee coverage, of up to BRL20 million per depositor, against BRL70 thousand for regular deposits.

The recent action by the FGC consists of the creation of a new funding line, the DPGE II, now a permanent line, with lower costs due to the pledging of guarantees to FGC through the fiduciary lien on the receivables of credit and leasing operations originated by the issuing bank. The pledging of these guarantees allows the reduction of the insurance amount paid to FGC to 0.3% per year, against the 1.0% required by the DPGE I line. This results in a more attractive funding cost for small and medium-sized banks and mitigates immediate concerns as to the impact of the end of DPGE I which is expected to be completely phased out in 2016.

One other purpose of this new measure is to reduce FGC's high exposure to the DPGE I program (BRL26.4 billion in December 2011 and BRL19.3 billion in December 2010), as its exposure is unsecured in nature. The timetable previously set by the FGC for banks to reduce the usage of DPGE I has been maintained and the repayment of those outstanding balances may come from the use of regular funding sources and/or deposits issued under the new program.

Additionally, Fitch believes that these actions will be more effective for banks with a less robust financial profile than the program announced back in December 2011 by the Central bank, which encouraged the release of compulsory deposits from large banks to smaller banks. The benefit of such a program was captured by medium-sized banks that had a stronger financial profile and were the main recipients of those funds.

At the same time, Fitch also highlights its concern with the possible effects of this new DPGE II program. An excessive use of this new limit especially in a scenario of resumption of economic growth could represent an even higher risk for depositors and investors not protected by an FGC guarantee scheme in a downturn scenario. If banks become heavily reliant on the new modality, a meaningful portion of their assets will be pledged as guarantee to the FGC, which could reduce the potential of recovery for other unsecured depositors/investors in an eventual default. In general, high levels of encumbrance on the balance sheet not only suggest severe funding weakness, but also reduce the appetite of unsecured creditors to keep providing funds to any given entity - resulting, in the extreme, in a magnification of the original funding weakness.

In Fitch's view, the DPGE must be used as a contingency line to be accessed only in times of increased volatility and economic uncertainty, rather than merely as a recurring funding source, or as part of a bank's business model. However, the experience with DPGE I shows that several small and medium-sized banks have used their entire limit available and leveraged their credit position, exhausting their limits and ending up without this long-term funding alternative in times of liquidity squeeze. The market, in general, has also considered as negative the higher use of the DPGE I limit, which made these banks' access to other traditional funding sources difficult.

Despite the possible benefits explained with this comment, Fitch reiterate its view as to the challenges of some small and medium-sized banks to sustain a healthy funding base that matches the tenor and characteristics of their assets. Such weakness has resulted in recurrent liquidity squeezes for the aforementioned segment in the last few years and, in general, a relatively weaker financial profile of these banks. The need to find sustainable and proper sources of funding and not rely on external aid from special programs such as DPGE remains a challenge for those banks; a weakness already reflected in the agency's ratings for a number of years.

Fitch also considers important for improved transparency that information on the use of DPGE lines and related guarantees pledged to FGC be disclosed to the market and detailed in the banks' financial statements. Thus, market players will be able to evaluate to what extent the use of DPGE II affects the payment capacity and risk profile of each institution.

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Additional information available at 'www.fitchratings.com' or 'www.fitchratings.com.br'.

Applicable Criteria and Related Research:
--2012 Outlook :Brazilian Banks,Well Positioned, but Credit Slowdown

Expected, Dec 16, 2011;
--Fitch: Reserve Requirement Changes Generally Positive for Mid-Sized Brazilian Banks, March 08, 2012.

Applicable Criteria and Related Research:
2012 Outlook: Brazilian Banks (Well Positioned, but Credit Slowdown Expected)

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