

CREDIT OPINION

27 October 2020

Update

✓ Rate this Research

RATINGS

Banco Regional de Desenv do Extremo Sul

Domicile	Porto Alegre, Rio Grande do Sul, Brazil
Long Term CRR	Ba2
Type	LT Counterparty Risk Rating - Fgn Curr
Outlook	Not Assigned
Long Term Issuer Rating	Not Available
Type	Not Available
Outlook	Stable

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

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Asia Pacific 852-3551-3077

Japan 81-3-5408-4100

EMEA 44-20-7772-5454

Banco Regional de Desenv do Extremo Sul

Update following rating affirmation, stable outlook

Summary

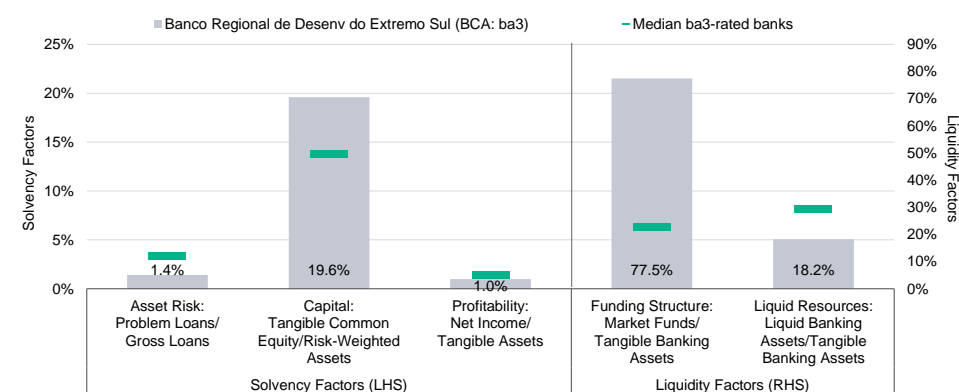
BRDE's BCA of ba3, reflects the bank's established role in fostering development in the relatively prosperous southern states of Brazil, the position as one of the largest on-lender of [Banco Nac. de Desenv. Economico e Social's](#) (BNDES, Ba2/Ba2 stable, ba2¹) funds to the agricultural sector, and sound capitalization levels. BRDE' stable, but highly concentrated, funding structure, composed of funds predominantly sourced from BNDES, is a key factor supporting its ratings. The BCA also incorporates BRDE's loan book concentration by sector and borrower owing to its footprint in the southern states whose economies have relevant contribution from agriculture, in addition to a moderate profitability due to its development bank role.

BRDE's Ba3 issuer rating is derived from its BCA of ba3 and does not receive any uplift from our assessment of moderate affiliate support from its owners. The A2.br Brazilian national scale issuer rating assigned to BRDE maps from its Ba3 issuer rating.

On 21 October 2020, all ratings and assessments privately assigned to [Banco Regional de Desenv do Extremo Sul](#) (BRDE) have been affirmed, including the Baseline Credit Assessment (BCA) at ba3 and issuer rating in local currency at Ba3. The ratings outlook remained stable.

Exhibit 1

Rating Scorecard - Key financial ratios



Source: Moody's Investors Service

Credit strengths

- » Established role as a regional development bank, with steady loan growth and focus on the agricultural industry
- » Sufficient capitalization levels
- » Limited susceptibility to political influence because of its three-state ownership

Credit challenges

- » Concentrated funding structure, with high reliance on funds from BNDES
- » Asset risk and profitability challenges stemming from adverse economic conditions and the low interest rate environment in Brazil

Rating outlook

The outlook on BRDE's ratings is stable and reflects our expectation that the bank's capitalization will offset potential asset risk and profitability challenges over the next 12-18 months

Factors that could lead to an upgrade

- » BRDE's ratings could face upward pressure if the bank's asset risk sustains at low levels and its profitability recovers. Significant diversification of the bank's funding sources would also be positive, particularly if this funding is lower cost and stable.

Factors that could lead to a downgrade

- » A significant weakening of BRDE's financial fundamentals, resulting from a larger-than-expected deterioration in the quality of the loan book and an ensuing reduction in capitalization levels, could have a negative effect on the bank's ratings.

Key indicators

Exhibit 2

Banco Regional de Desenv do Extremo Sul (Consolidated Financials) [1]

	06-20 ²	12-19 ²	12-18 ²	12-17 ²	12-16 ²	CAGR/Avg. ³
Total Assets (BRL Billion)	16.6	16.9	17.3	17.2	16.5	0.1 ⁴
Total Assets (USD Billion)	3.0	4.2	4.5	5.2	5.1	(13.8) ⁴
Tangible Common Equity (BRL Billion)	3.1	3.0	2.7	2.5	2.5	6.7 ⁴
Tangible Common Equity (USD Billion)	0.6	0.8	0.7	0.8	0.8	(8.1) ⁴
Problem Loans / Gross Loans (%)	0.7	0.4	1.4	3.0	1.0	1.3 ⁵
Tangible Common Equity / Risk Weighted Assets (%)	19.6	19.2	17.8	16.3	16.2	17.8 ⁶
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	2.6	1.7	6.0	13.6	4.4	5.7 ⁵
Net Interest Margin (%)	4.0	4.3	4.6	4.9	5.6	4.6 ⁵
PPI / Average RWA (%)	2.9	3.0	3.8	3.3	4.3	3.5 ⁶
Net Income / Tangible Assets (%)	1.0	1.6	1.0	0.7	0.7	1.0 ⁵
Cost / Income Ratio (%)	32.3	37.7	30.7	42.5	33.2	35.3 ⁵
Market Funds / Tangible Banking Assets (%)	76.2	77.5	77.2	79.9	79.7	78.1 ⁵
Liquid Banking Assets / Tangible Banking Assets (%)	17.6	18.2	20.0	17.5	17.9	18.2 ⁵

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

Sources: Moody's Investors Service and company filings

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Profile

Founded in 1961, Banco Regional de Desenv do Extremo Sul (BRDE) is owned by the states of Rio Grande do Sul, Santa Catarina and [Parana](#) (Ba2 stable), which together contribute around 17% of Brazil's GDP. The bank lends directly to private-sector companies, largely agricultural producers and to cooperatives, as well as to infrastructure projects.

According to its mandate to foster development in the south of Brazil, BRDE's operations are focused on the relatively prosperous states of Parana, Santa Catarina and Rio Grande do Sul. From 2012 to 2016, the bank's loan operations expanded at a compound annual growth rate of around 14% and remained flat after this period. The bank has acted as a conduit for growth in the agricultural industry in the region, and the loan book remained flat in June 2020 compared with June 2019. However, loan disbursement increased 34% in H1 2020 compared with H1 2019, reaching BRL1.3 billion, supported by BRDE's strong relationships with regional credit cooperatives, which channel resources to smaller producers and provide strong loan guarantees.

Detailed credit considerations

Focus on the agricultural industry in the south of Brazil

As a result of its importance in southern Brazil, the agricultural sector represents more than 60% of BRDE's loans and is split among cattle breeding, protein production, multiple crops, warehouse services and transformation companies. Among the main credit lines offered by the bank are loans to finance machinery acquisition, investments to improve production plants or construct new plants and some working capital financing. For the most part, the bank provides long-term loans, with an average maturity of more than five years, and also lends to infrastructure projects, mostly in the energy industry.

Similar to other regional development banks, BRDE is also involved in managing funds for federal and state governments. Alongside BNDES, the bank is an agent of the Fundo Setorial do Audiovisual (FSA) fund, which supports film-making and small-scale television industries. BRDE also manages a development fund that channels loans to municipalities in Santa Catarina (FUNDAM). The bank is responsible for the origination of these loans and for monitoring credit allocation, but it does not share credit risk with public funds and receives around 3% of disbursements as management fees.

Low problem loan level will be strained by the adverse economic conditions

As of June 2020, BRDE's problem loan² ratio was 0.7%, slightly higher than 0.6% twelve months earlier. The bank's volume of problem loans remains low, significantly below that of retail-oriented government-owned banks and in line with that of BNDES, its main source of funding.

The challenges faced by BRDE because of the unexpected downturn in economic activity caused by the coronavirus pandemic, will likely have a negative effect on bank's asset quality in the coming 2-3 quarters. As of June 2020, BRDE loan deferrals accounted for 22.8% of its loan book, or BRL3 billion, which benefited problem loans and potentially delayed some loan loss provisions by June 2020. After government emergency measures to support the economy expire by YE2020, asset quality could deteriorate in H1 2021, however BRDE has traditionally maintained a high reserve coverage of 414.5% of problem loans as of June 2020, up from 386.2% a year earlier, which will partially alleviate the pressure from a problem loans increase. Net charge-offs represented a gain of 0.4% of gross loans in June 2020, from a loss of 1.5% a year earlier, reflecting the bank recoveries in the period. Most of the bank's operations are backed by guarantees, which does result in higher recovery ratios of its charge-offs.

BRDE's loan book also shows credit risks associated with relatively high geographic and sector concentration, as well as by borrower type. The bank's focus on the southern states, despite their stronger economic growth than that of other states, constrains its operations to a single region, which also results in a less diversified revenue structure than that of its peers with nationwide coverage.

Similarly, the bank's loan book also features a high concentration in the agriculture segment, leading to higher credit risk than if its operations covered a variety of segments, such as BNDES. The exposure to agriculture, however, has been positive for BRDE in light of the sector's recent good performance, which has propped up regional and national economic growth.

High capitalization buffers to remain adequate following previous dips

BRDE's capitalization, which we measure as tangible common equity/risk-weighted assets (RWA)³, increased to 19.6% as of June 2020 from 18.6% in June 2019.

BRDE reported a regulatory Common Equity Tier 1 capital ratio of 18.6% as of June 2020, well above the minimum regulatory level of 7.0%, which has declined to 5.75% since 1 April 2020 as part of the Brazilian central bank's measure to alleviate capital pressure on the banking system during the adverse economic conditions.

We expect BRDE to maintain its sound capital levels, particularly because of low loan growth and no dividend distribution in 2020.

Profitability will still be strained by Brazil's recession

Although BRDE's mandate is not focused on profitability but on increasing lending with the objective of development to ensure economic prosperity and job creation in the south of Brazil, the bank's recurring earnings generation has historically been adequate to maintain capital at sound levels. Net income decreased 24.2% in H1 2020 compared to H1 2019, reducing net income to tangible assets ratio to 1.0% from 1.3% in the same period.

Loan loss provisions increased 185% in H1 2020 compared to H1 2019, representing 1.1% of gross loans in H1 2020 from 0.4% in H1 2019, however it is still below the peak of 3.9% during the Brazilian economic recession in H2 2016. Net interest income decreased only 0.9% in the same period, because BRDE operations are concentrated in BNDES onlending, therefore not highly exposed to policy rate, which was cut from 4.25% pre-pandemic to 2% in August 2020. On the other hand, operating expenses declined 9% in H1 2020 from a year earlier, mainly due to a lower contingent liabilities provisions related to labor claims.

We expect profitability to be constrained by the adverse economic conditions that will likely increase loan loss provisions and reduce business volume.

A still concentrated funding base leaves BRDE susceptible to BNDES' lending policies, despite efforts to reduce funding concentration

Because of its policy role as a development bank, BRDE is not allowed to take deposits from individuals and companies. As a result, of the bank's total funding of BRL13.1 billion as of June 2020, BNDES funds accounted for 77.5% of total loans. BRDE was the 4th largest disburser of BNDES' credit lines in the south region of Brazil in H1 2020, despite the bank operates only in the south region of Brazil. The rest of BRDE's funding base is composed of resources from [Caixa Economica Federal \(CAIXA\)](#) (Ba2/Ba2 stable, ba3), Fundo de Garantia do Tempo de Serviço (FGTS), [Banco do Brasil S.A.](#) (Ba2/(P)Ba2 stable, ba2) and the federal government, including Financiadora de Estudos, Projetos (FINEP) Fundo Geral do Turismo (FUNGETUR), Fundo de Defesa da Economia Cafeeira (FUNCAFE) and Fundo Constitucional de Financiamento do Centro-Oeste (FCO). In 2018, BRDE raised foreign funding for the first time with multilateral agencies such as the Agence Francaise de Developpement (AFD) and the [European Investment Bank](#) (EIB, Aaa stable). BRDE has also been using its own capital to finance its new loans.

As part of BRDE's efforts to diversify its funding, BNDES' resources represented 51.9% of new loans in H1 2020 compared with 94.0% in 2017. The bank is also using its own resources for lending, which accounted for more than 27% of new loans in H1 2020. However, the high concentration of funding remains and weighs negatively on BRDE's creditworthiness. While funding from BNDES is relatively long term and, hence, more stable than market funding, the pending elimination of BNDES' subsidized lending rates will cause BRDE's spreads on new loans to remain compressed. Although management is attempting to diversify its funding sources, we expect the lion's share of funding to continue to come from BNDES.

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

Brazil's Moderate- Macro Profile incorporates its large-scale and highly diversified economy amid a low interest rate and inflationary environment, despite modest growth prospects. However, Brazil's economic rebound has been weaker than expected, still reflecting a degree of uncertainty surrounding economic growth in 2020, in the face of the downturn triggered by the coronavirus outbreak. The global spread of the coronavirus is resulting in simultaneous supply and demand shocks. We expect these shocks to significantly slow economic activity, particularly in the first half of 2020. The full extent of the economic impact remains uncertain. The fear of contagion will dampen consumer and business activity. The longer it takes for households and businesses to resume normal activity, the greater the economic impact.

In Brazil, the government and the central bank have announced some measures to mitigate the economic impact and to provide support to businesses and vulnerable segments of the society. However, the fiscal deficit and relatively high debt are constraining the government's ability to provide a stronger fiscal response. We, therefore, expect a significantly negative effect on employment and

growth. Therefore, we expect GDP to contract 6.2% in 2020 and grow 3.6% in 2021, still remaining below Brazil's potential growth rate according to our forecasts. The coronavirus outbreak will have a direct negative impact on banks' asset quality and profitability, in some cases in a pronounced manner, for example, for undiversified banks with material exposure to high-risk sectors and small and medium-sized enterprises. We also view risks as elevated for business models that rely on spread income, equity indices and rates.

ESG considerations

BRDE's exposure to environmental risks is low, consistent with our general assessment for the global banking sector. See [Environmental risks heat map](#), for further information.

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

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

Support and structural considerations

Notching considerations

In the absence of a bail-in resolution regime framework in Brazil, the ratings follow the additional notching guidelines, according to our Banks rating methodology. In these cases, the approach takes into account other features specific to debt classes, resulting in additional notching from the issuer's Adjusted BCA.

Affiliate support

We believe there is a moderate probability of affiliate support to BRDE from its owner states. Therefore, in applying our Joint Default Analysis based on the State of Parana's rating, BRDE's Adjusted BCA of ba3 receives no uplift from its ba3 standalone BCA.

Government support

We believe there is a low likelihood of government support for BRDE's liabilities. This reflects the bank's reduced market share of deposits in Brazil.

Counterparty Risk (CR) Assessment

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

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

BRDE's CR Assessment is positioned at Ba2(cr) and Not Prime (cr), which is one notch above the bank's Adjusted BCA of ba3.

Counterparty Risk Rating (CRR)

Counterparty Risk Ratings are opinions of the ability of entities to honor the uncollateralized portion of non-debt counterparty financial liabilities (CRR liabilities) and also reflect the expected financial losses in the event such liabilities are not honored. CRR liabilities typically relate to transactions with unrelated parties. Examples of CRR liabilities include the uncollateralized portion of payables arising from derivatives transactions and the uncollateralized portion of liabilities under sale and repurchase agreements. CRRs are

not applicable to funding commitments or other obligations associated with covered bonds, letters of credit, guarantees, servicer and trustee obligations, and other similar obligations that arise from a bank performing its essential operating functions.

BRDE's CRRs is are positioned at Ba2/NP

BRDE's global local-currency CRRs are positioned at Ba2 and Not Prime, one notch above the bank's Adjusted BCA, reflecting the lower probability of default of CRR liabilities and our expectation of a normal level of loss given default.

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 Regional de Desenv do Extremo Sul

Macro Factors						
Weighted Macro Profile	Moderate	100%				
Factor	Historic Ratio	Initial Score	Expected Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
Problem Loans / Gross Loans	1.4%	baa2	↔	b1	Sector concentration	
Capital						
Tangible Common Equity / Risk Weighted Assets (Basel III - transitional phase-in)	19.6%	a3	↔	baa3	Expected trend	
Profitability						
Net Income / Tangible Assets	1.0%	ba1	↔	b1	Earnings quality	
Combined Solvency Score		baa2		ba2		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	77.5%	caa3	↔	b2	Extent of market funding reliance	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	18.2%	ba3	↔	ba3		
Combined Liquidity Score		b3		b1		
Financial Profile						
Qualitative Adjustments				Adjustment		
Business Diversification				0		
Opacity and Complexity				0		
Corporate Behavior				0		
Total Qualitative Adjustments				0		
Sovereign or Affiliate constraint				Ba2		
BCA Scorecard-indicated Outcome - Range				ba2 - b1		
Assigned BCA				ba3		
Affiliate Support notching				-		
Adjusted BCA				ba3		
Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency Rating	Foreign Currency Rating
Counterparty Risk Rating	1	0	ba2	0	Ba2	Ba2
Counterparty Risk Assessment	1	0	ba2 (cr)	0	Ba2(cr)	

Senior unsecured bank debt	0	0	ba3	0	Ba3
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[1] Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.

Source: Moody's Investors Service

Ratings

Exhibit 4

Category	Moody's Rating
BANCO REGIONAL DE DESENV DO EXTREMO SUL	
Outlook	Stable
Counterparty Risk Rating	Ba2/NP
Baseline Credit Assessment	ba3
Adjusted Baseline Credit Assessment	ba3
Counterparty Risk Assessment	Ba2(cr)/NP(cr)
Issuer Rating -Dom Curr	Ba3
NSR Issuer Rating	A2.br
ST Issuer Rating -Dom Curr	NP
NSR ST Issuer Rating	BR-1

Source: Moody's Investors Service

Endnotes

- 1 The bank ratings shown in this report are the bank's domestic deposit rating, senior unsecured debt rating (where available) and Baseline Credit Assessment.
- 2 We consider as problem loans the loans overdue rated between E and H under Brazilian Central Bank's resolution 2,682/99.
- 3 Our preferred measure of capitalization, which deducts from capital the intangible assets and a significant portion of deferred tax assets that do not provide significant loss absorption, and we adjust the bank's RWA by applying a risk factor of 100% to its significant holdings of the Brazilian government securities, weighted 0% by local regulations.

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