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CREDIT OPINION
16 December 2020

Update

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# Banco do Estado de Sergipe S.A.

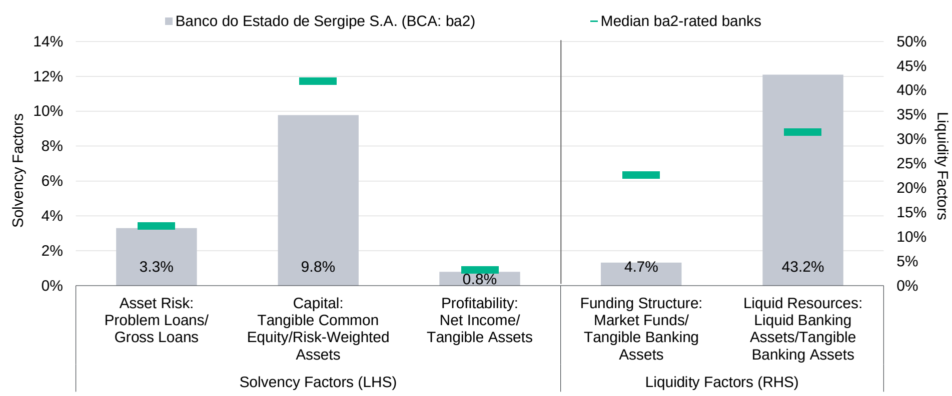
## Update following upgrade of foreign-currency deposit rating to Ba2


## Summary

On 11 December 2020, Banco do Estado de Sergipe S.A.'s (Banese) foreign-currency (FC) deposit rating was upgraded to Ba2 from Ba3, following the raise in the FC ceiling for Brazil (Ba2 stable) to Baa2, announced on 7 December 2020. The outlook on the bank's FC deposit rating was changed to negative from stable. The previous stable outlook was driven by the fact the entity's FC deposit rating was constrained by the country ceiling and, therefore, carried the stable outlook of the sovereign, despite the negative outlook on the remaining ratings. The rating upgrade followed the publication of the updated Country Ceilings Methodology.

Banese's ba2 Baseline Credit Assessment (BCA) reflects the bank's entrenched retail franchise in its regional market, which is supported by its stable market share of core deposits in excess of 30%, largely sourced from the state government's civil servants. Banese's ratings and assessments incorporate strong liquidity metrics, as well as recurring earnings generation, which ensures the replenishment of its capital. The negative outlook on the ratings reflects the challenges to Banese's asset quality and profitability, arising from rapid loan growth and exposure to business segments that are more vulnerable to the coronavirus pandemic-related downturn.


Exhibit 1
**Rating Scorecard - Key financial ratios**




*Source: Moody's Financial Metrics*

**RATINGS**

**Banco do Estado de Sergipe S.A.**

| | |
|---|---|
| Domicile | Aracaju, Sergipe, Brazil |
| Long Term CRR | Ba1 |
| Type | LT Counterparty Risk Rating - Fgn Curr |
| Outlook | Not Assigned |
| Long Term Debt | Not Assigned |
| Long Term Deposit | Ba2 |
| Type | LT Bank Deposits - Fgn Curr |
| Outlook | Negative |

*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.*


**Contacts**

Theresangela Araes +55.11.3043.7306
*VP-Senior Analyst*
theresangela.araes@moodys.com

Alexandre Albuquerque +55.11.3043.7356
*VP-Senior Analyst*
alexandre.albuquerque@moodys.com

Vincent Detilleux, CFA +55.11.3043.7312
*Associate Analyst*
vincent.detilleux@moodys.com

M. Celina Vansetti +1.212.553.4845
*MD-Banking*
celina.vansetti-hutchins@moodys.com

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Americas 1-212-553-1653
Asia Pacific 852-3551-3077

## Credit strengths

» Small retail franchise, with an entrenched footprint that supports a stable and granular core funding base

» High share of payroll loans, which reduces credit losses during market downturns

» Well-managed state-owned franchise and adequate governance guidelines, which reduce the risk of political interference

## Credit challenges

» Capital buffer is an important component of Banese's financial profile because it supports the bank's competitive position in the local retail banking segment, in which competition is intensifying.

» Earnings will likely be challenged by growing competition from large retail banks and slow operational growth.

» Asset-risk profile could be strained as the bank expands its operations beyond its regional footprint and to riskier segments to compensate for limited expansion prospects in its home market.

## Outlook

All the ratings were affirmed on 10 July 2020 and the outlook on Banese's Ba2 long-term local-currency deposit rating was maintained at negative. The negative outlook reflects the challenges to Banese's asset quality and profitability, arising from rapid loan growth within Small-and mid sized (SMEs) companies and exposure to business segments that are more vulnerable to the pandemic-related economic downturn.

The outlook on the bank's FC deposit ratings was changed to negative from stable. The previous stable outlook was driven by the fact the entity's FC deposit rating was constrained by the country ceiling and, therefore, carried the stable outlook of the sovereign, despite the negative outlook on the remaining ratings.

## Factors that could lead to an upgrade

Banese's rating outlook could return to stable if the bank is able to preserve its profitability in its regional market, maintaining adequate capital and improving asset-risk metrics.

## Factors that could lead to a downgrade

The BCA and ratings could be downgraded if the bank's asset quality weakens significantly, along with a decline in profitability because of higher provisioning needs as new loans will season under a more difficult economic scenario.

## Key indicators

Exhibit 2

**Banco do Estado de Sergipe S.A. (Consolidated Financials) [1]**

| | 09-20[2] | 12-19[2] | 12-18[2] | 12-17[2] | 12-16[2] | CAGR/Avg.[3] |
|---|---|---|---|---|---|---|
| Total Assets (BRL Billion) | 7.0 | 6.0 | 5.5 | 5.1 | 4.4 | 13.6[4] |
| Total Assets (USD Billion) | 1.3 | 1.5 | 1.4 | 1.5 | 1.3 | (1.9)[4] |
| Tangible Common Equity (BRL Billion) | 0.5 | 0.5 | 0.4 | 0.3 | 0.3 | 12.2[4] |
| Tangible Common Equity (USD Billion) | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | (3.1)[4] |
| Problem Loans / Gross Loans (%) | 3.3 | 3.5 | 1.6 | 2.6 | 3.2 | 2.8[5] |
| Tangible Common Equity / Risk Weighted Assets (%) | 9.8 | 10.2 | 9.6 | 8.8 | 9.3 | 9.5[6] |
| Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%) | 16.0 | 17.2 | 8.0 | 13.3 | 16.6 | 14.2[5] |
| Net Interest Margin (%) | 8.3 | 9.0 | 8.6 | 9.6 | 9.1 | 8.9[5] |
| PPI / Average RWA (%) | 6.1 | 5.9 | 6.0 | 7.5 | 7.9 | 6.7[6] |
| Net Income / Tangible Assets (%) | 0.8 | 1.6 | 1.3 | 2.0 | 2.1 | 1.6[5] |
| Cost / Income Ratio (%) | 66.8 | 66.1 | 66.1 | 62.4 | 63.3 | 64.9[5] |
| Market Funds / Tangible Banking Assets (%) | 5.0 | 4.7 | 6.9 | 7.5 | 10.2 | 6.9[5] |
| Liquid Banking Assets / Tangible Banking Assets (%) | 51.9 | 43.2 | 47.0 | 42.4 | 40.1 | 44.9[5] |
| Gross Loans / Due to Customers (%) | 55.1 | 68.9 | 62.3 | 64.7 | 74.2 | 65.0[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*

## Profile

Founded in 1961, Banco do Estado de Sergipe S.A. (Banese) is owned by the state of Sergipe, which holds 89.8% of its total shares, while the remaining 10.2% are free float. The bank is part of the Banese conglomerate, which primarily comprises the bank and the credit card issuer and acquiring company, Sergipe Administradora de Cartões e Serviços Ltda. Because Banese is a regional local government bank, its activities are restricted to the state of Sergipe through its 63 branches.

Although small, Banese's defensible position in the local market stems from its focus on providing banking services to the state's civil servants, as well as small and medium-sized enterprises (SMEs), which are intrinsically connected with Sergipe's economy. Most of the bank's executives are career professionals or former employees who retired and decided to return to the bank, but the appointment of directors is subject to changes in the local government every four years.

## Detailed credit considerations

### Historical asset-risk levels reflect Banese's focus on secured lending, but asset risks are increasing as the bank diversifies into unsecured lending products

Banese's asset quality has always been supported by its focus on its core business of offering secured household loans to civil servants of the state of Sergipe. According to our calculation, the ratio of problem loans to gross loans was 3.30% as of September 2020, in line with that as of December 2019, but above the 1.62% as of year-end 2018. The worsening from 2018 was mainly because of a conservative change in the risk classification of retail operations, without differentiating products and collaterals. This ratio was above the industry average of 2.43% as of September 2020. Reserves for loan losses were high at 5.11% of total loans as of September 2020, above the problem loan ratio. The level of loan charge-offs as of September 2020 (annualized) was 1.8%, slightly higher than the 1.3% of September 2019. In recent years, Banese's management has increasingly focused on collection. Recoveries until September 2020 were at BRL17.9 million, compared with BRL13.4 million during the first nine months of 2019.

With a 42.2% share of the total credit market in the state of Sergipe, Banese's consolidated loan book decreased slightly by 0.6% in Q3 2020, but recorded a more moderate 8.5% expansion in the 12 months that ended September 2020. Overall credit growth in the period was pushed by SMEs loans, a riskier segment considering the bank's traditional focus on payroll loans. Individual loans accounted for roughly 76% of its total portfolio. Although the wholesale portfolio is made up of loans to SMEs and accounted for only 7.2% of total loans as of September 2020, it incorporates some degree of borrower concentration, which was responsible for the bank's asset risk and credit cost volatility in the past, as well as the recent deterioration. The bank's 10 largest borrowers accounted for 5.1% of its total loans and 33% of its tangible common equity (TCE) as of September 2020.

Because of its recent rapid annual loan growth and despite low-risk payroll loans constituting more than a third of its portfolio, Banese's loans will season under more adverse credit conditions, causing nonperforming loans to increase, including in its SME loan book, which is already experiencing some delinquencies.

Overall, the b1 Asset Risk score is three notches below the Macro Adjusted score of ba1 and reflects the balance between the bank's various types of secured consumer loans and the growing participation in unsecured loans, such as credit cards, personal loans and SMEs loans. It also reflects the negative effect of the pandemic-related downturn on Banese's asset quality, which may worsen after the end of loan holiday payments programs. Additionally, the assessment incorporates the inherent business concentration in the state of Sergipe, which limits Banese's ability to diversify its risks geographically.

### After a period of stress in 2019, capital has returned to and stabilized at previous averages

In June 2019, Banese had to recognize an actuarial liability on its employees' pension fund (Sergus) and its TCE ratio at the time, as calculated by us, had dropped to 6.60%. Since then, the bank has recovered its capital, both by partial reversion and profit reinvestment. As of September 2020, Banese's TCE was 9.78%, in line with the 10% average maintained by the banks we rate in Brazil, and the bank's 8.9% average over the past three years. From a regulatory perspective, the Common Equity Tier 1 capital ratio increased to 12.94% as of September 2020 from 9.97% in Q3 2019, and is now well above the 8.5% regulatory minimum requirement.

Historically, Banese's dividend distribution policy has strained the bank's capital replenishment capacity. However, as part of its strategic approach to enhance its capital position, Banese has reduced its dividend policy to a 25% payout. Overall, we assign a b1 Capital score, in line with its current ratio. The score also reflects the direct effect that a prolonged economic disruption will have on the bank's asset risk, and, consequently, capital.

### Margins and funding cost pressures will increase in the next 12 months

Over the past three years, Banese's performance has benefited from higher-margin loans that resulted from the contraction of competitive pressure from other public banks in its local market (Sergipe); its fee income activities, including the credit card businesses controlled by the bank; a decline in the cost of risk since 2017; and low funding costs. The bank's bottom-line result for the first 9 months of 2020 was 37.5% lower than that for the year-earlier period, mainly because of higher credit costs and operational expenses more than offsetting higher revenue from credit operations and services, and lower funding costs. The 20% increase in credit costs is due to the effects of the pandemic. The ratio of net income to tangible assets was 0.80% as of September 2020 compared with 1.54% as of September 2019 and 1.61% as of December 2019.

Banese has also been working to enhance the culture of technological innovation to maintain its competitive positioning in retail banking in its regional market. As a consequence, the bank's operating costs increased on the back of higher investments in technology and digitalization.

The small size of the local economy and the limited expansion in Banese's franchise are intrinsic constraints to the bank's profitability.

### Stable and granular core funding is a key strength of Banese

The combined score of baa3 for Liquidity reflects the fact that Banese has a strong regional identity and defensible presence in its regional market, with a one-third share of the local market's time deposits. Banese has low dependence on market-based funding because it benefits from its local identity that facilitates its access to a granular deposit base in its core region, with proven stability in times of stress. In September 2020, 66% of Banese's funding comprised demand, savings and judicial deposits, primarily from individuals and local companies, which are core resources that are stable, granular and low cost, while an additional 28% constituted time deposits and letras de credito imobiliarias, which are bank notes linked to real estate loans, mainly sold to individual investors.

Government-related resources, including the cash position of the state government and the municipalities, accounted for 3.0% of total funding in September 2020, and long-term funds provided by federal banks Banco Nac. Desenv. Economico e Social - BNDES (Ba2 stable, ba2[1]) and Banco do Nordeste do Brasil S.A. (Ba2 stable, b1) accounted for only 1.9%. Core resources from individuals accounted for 44.0% of total funding, while judicial deposits accounted for another 18.1%, ensuring cheap and very stable funding for the bank.

In September 2020, the outstanding senior bank notes totaled BRL49.1 million, about 1.0% of total funding, with a short-term maturity profile between June 2020 and June 2021, while the outstanding subordinated bank notes totaled BRL104 million, all maturing in July 2023.

Banese maintains adequate cash, with a significant share of government securities. The liquidity ratio, measured as liquid banking assets as a percentage of tangible banking assets, was 51.92% in September 2020. The trading portfolio mostly comprises government securities, which accounted for 87%. The remaining 13% of securities were largely invested in investment funds and certificates of deposits issued by tier 2 banks in Brazil.

### Banese's scores are influenced by Brazil's Moderate- Macro Profile

Brazil's Moderate- Macro Profile incorporates the country's large-scale and highly diversified economy, despite the sharp decline in growth in 2020 because of the negative effect of the pandemic. We expect Brazil's economy to contract by 5.7% in 2020 before rebounding in 2021 with a 3.3% growth. The pandemic will have a direct negative effect on Brazilian banks' profitability in 2020, as it weakens asset quality in 2021. However, we expect banks pre-provision earning generation to improve as business volumes benefit from a continued recovery in economic activity. Improving profit will support capital in the coming quarters. Brazil's operating environment also takes into consideration challenges related to low government effectiveness and political developments, which could still hurt the sweeping structural reform agenda. Our Macro Profile also reflects Brazil's favorable credit conditions that will benefit from a low interest rate environment supporting credit demand, borrowers' repayment capacity and private consumption.

## ESG considerations

Banese’s exposure to environmental risks is low, consistent with our general assessment for the global banking sector. See our environmental risk heat map for further information.

Overall, banks face moderate social risks. The most relevant social risks for banks arise from the way they interact with their customers. Social risks are particularly high in the area of data security and customer privacy, which are mitigated by sizable technology investments and banks’ long record of handling sensitive client data. Fines and reputational damage because of product mis-selling or other types of misconduct are further social risks. 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 demand for financial services or socially driven policy agendas that may translate into regulation that affects banks’ revenue base. See our social risk heat map for further information.

Governance is highly relevant for Banese, as it is to all participants in the banking industry. Corporate governance weaknesses can lead to a deterioration in a bank’s credit quality, while governance strengths can benefit a bank’s credit profile. We do not apply any Corporate Behavior adjustment to Banese, as concerns about risk management and corporate governance are included in the financial scores. Corporate governance, however, remains a key credit consideration at Banese and requires ongoing monitoring.

## Support and structural considerations

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

### Government support

There is a limited likelihood that Banese will receive support from the federal government for its rated wholesale deposits and senior unsecured debt, given the nonmaterial share of deposits in Brazil. However, because of the importance of Banese to the state of Sergipe, the bank's high integration with public policies and its significant deposit market share in the region, the bank would be supported by its shareholder, the Government of Sergipe, if necessary. However, the state of Sergipe is not rated and, thus, the deposit rating assigned to Banese incorporates no uplift from regional support.

### 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; 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.

**Banese's CR Assessment is positioned at Ba1(cr)/Not Prime(cr)**

The CR Assessment of Ba1(cr) is one notch above the Adjusted BCA of ba2, based on our view that senior obligations represented by the CR Assessment will be more likely preserved than senior unsecured debt to minimize losses, avoid disruption of critical functions and limit contagion. This CR Assessment reflects an issuer's probability of defaulting on certain operating liabilities and other contractual commitments that are less likely to be subject to the application of a resolution tool to ensure the continuity of operations.

## Methodology and scorecard

### About Moody's Bank Scorecard

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

## Rating methodology and scorecard factors

Exhibit 3

**Banco do Estado de Sergipe S.A.**

| **Macro Factors** | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Weighted Macro Profile** | **Moderate -** | **100%** | | | | | |
| | | | | | | | |
| **Factor** | **Historic Ratio** | **Initial Score** | **Expected Trend** | **Assigned Score** | **Key driver #1** | **Key driver #2** | |
| Solvency | | | | | | | |
| Asset Risk | | | | | | | |
| Problem Loans / Gross Loans | 3.3% | ba1 | ↔ | b1 | | | |
| Capital | | | | | | | |
| Tangible Common Equity / Risk Weighted Assets (Basel III - transitional phase-in) | 9.8% | b1 | ↔ | b1 | | | |
| Profitability | | | | | | | |
| Net Income / Tangible Assets | 0.8% | ba2 | ↔ | ba3 | | | |
| Combined Solvency Score | | ba2 | | b1 | | | |
| Liquidity | | | | | | | |
| Funding Structure | | | | | | | |
| Market Funds / Tangible Banking Assets | 4.7% | baa1 | ↔ | ba1 | | | |
| Liquid Resources | | | | | | | |
| Liquid Banking Assets / Tangible Banking Assets | 43.2% | baa2 | ↔ | baa2 | | | |
| Combined Liquidity Score | | baa1 | | baa3 | | | |
| Financial Profile | | | | ba3 | | | |
| Qualitative Adjustments | | | | Adjustment | | | |
| Business Diversification | | | | 0 | | | |
| Opacity and Complexity | | | | 0 | | | |
| Corporate Behavior | | | | 0 | | | |
| Total Qualitative Adjustments | | | | 0 | | | |
| Sovereign or Affiliate constraint | | | | Ba2 | | | |
| BCA Scorecard-indicated Outcome - Range | | | | ba2 - b1 | | | |
| Assigned BCA | | | | 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** |
|---|---|---|---|---|---|---|
| Counterparty Risk Rating | 1 | 0 | ba1 | 0 | Ba1 | Ba1 |
| Counterparty Risk Assessment | 1 | 0 | ba1 (cr) | 0 | Ba1(cr) | |
| Deposits | 0 | 0 | ba2 | 0 | Ba2 | Ba2 |

[1] Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.

*Source: Moody's Investors Service*

## Ratings

Exhibit 4

| Category | Moody's Rating |
|---|---|
| **BANCO DO ESTADO DE SERGIPE S.A.** | |
| Outlook | Negative |
| Counterparty Risk Rating | Ba1/NP |
| Bank Deposits | Ba2/NP |
| NSR Bank Deposits | Aa3.br/BR-1 |
| Baseline Credit Assessment | ba2 |
| Adjusted Baseline Credit Assessment | ba2 |
| Counterparty Risk Assessment | Ba1(cr)/NP(cr) |

*Source: Moody's Investors Service*

## Endnotes

1 The bank ratings shown in this report are the bank's deposit rating, and Baseline Credit Assessment.

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CLIENT SERVICES

| | |
|---|---|
| Americas | 1-212-553-1653 |
| Asia Pacific | 852-3551-3077 |
| Japan | 81-3-5408-4100 |
| EMEA | 44-20-7772-5454 |

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