Banco de Chile: Comments on the Third Quarter 2014 Financial Results

Good morning, it is a pleasure for me to share with you our comments on Banco de Chile's third quarter 2014 financial results.

Please turn to slide number two. To begin, we will discuss the developments in the Economic Environment and the results of the banking industry, followed by a review of Banco de Chile's results.

Please turn to slide number three, which contains the economic highlights.

Several recent indicators have shown that domestic activity grew weakly during the last quarter. Specifically, IMACEC, which is the monthly proxy of GDP, posted a weak 0.9% and 0.3% annual expansion in July and August respectively, suggesting that the economic growth achieved its lowest level in the third quarter, nearly 1.2%. Although the breakdown of national accounts will be available on November 18th, recent information suggests that private investment continues to be the main factor behind the slowdown. Private consumption, however, is also weakening as a consequence of the higher inflation rate and the slowdown in waged employment. As a result, retail sales decreased by 0.9% year over year in September after recording a weak 1.8% growth in August, whereas supermarket sales fell by 1.9% in the last month.

Please turn to slide number four.

In spite of the weak figures we´ve just mentioned, we believe that there is a high probability that economic growth will increase within the next few quarters, due to three main reasons:

- First, the Central Bank resumed its easing cycle in the third quarter by reducing the interest rate to 3.0% this month. This brings us to a total reduction of 200 bps since October of last year. Consequently, the interest rate is in expansionary territory, nearly 0% in real terms, while the long term interest rate has reached the lowest levels. In this context, the Central Bank indicated a neutral bias in the press release of the last monetary policy meeting, suggesting that the interest rate will remain at the current level for a long time.
- Second, the government announced an expansionary fiscal policy for the next year. According to the budget submitted to Congress, which must be discussed and approved before the end of November, the fiscal spending will grow by 9.8% in real terms due to the 27.5% annual increase in civil works. This is the highest rate since 2009. In this context, both increases in the size of the civil works, which is intensive in labor, and in the structural deficit to 1.1% of GDP, are a signal towards a more expansionary fiscal policy during the next year. We believe that it is also worth mentioning that the fiscal position in Chile remains robust, as net debt remains negative at -5.8% in 2Q14.
- The third element is the positive impact from the weaker Chilean peso, which has depreciated by 14% in nominal terms over the last 12 months. This should contribute to a recovery in the tradable sector, partially offsetting the slowdown in domestic demand.

On inflation, the annual rate has increased to 4.9%, above the upper bound of the central bank range which is between 2.0% and 4.0%, influenced by the weaker exchange rate. However, we think this higher inflation rate is temporary, as we expect the looser output gap to lead disinflationary pressures from the demand side. In all, we expect the inflation to converge to the 3.0% target within the next few quarters.

Regarding the external accounts, both the weaker exchange rate and the weak domestic demand have led to an improvement in the trade balance. Specifically, the rolling 12 months surplus increased to US$7.2 Bn in 3Q14, from US$5.4 Bn in the previous quarter, as a consequence of the 0.6% annual expansion in exports and the 9.3% annual decline in imports.

Please turn to slide number five for a review of the main figures for the Chilean banking system.

As you can see on the chart on the left, there has been a downward credit growth trend in real terms, dropping from 8.4% in the 3Q13 to an estimated 4.2% in the 3Q14. This is completely in line with the decelerating economy, which has reduced demand and increased strict credit conditions set by banks. Nevertheless, based on estimated information, 3Q14 figures seem to have decoupled and show a slight recovery when compared to the 2Q14.

With regards to net income for the first eight months of 2014, the industry recorded an increase of almost 40% year-on-year. This strong rise was mainly due to higher operating income from the extraordinary levels of inflation, which boosted net interest income as well as a more favourable funding and term gapping given lower short-term interest rates and a steeper yield curve.

As a result, the industry posted a very attractive ROAE of 18.0% as of Aug 14, which was well above the 14.9% posted last year.

And now I will pass the call on to Pablo, who will speak to you about this quarter's results.

On slide **number six,** you can see a snapshot of Banco de Chile's main income statement figures. To begin, 3Q14 net income increased almost 16% year-on-year. This strong rise was due mainly to three factors.

1. First, a non-cash accounting benefit of Ch$18 billion net related to deferred tax assets,
2. Second, a strong 12% decrease in provision expenses, and
3. Third, an increase of 2% in operating revenues

We will discuss all of these of factors on the following slides.

Please turn to slide **number seven.**

Here we present a breakdown of operating revenues, which is composed of interest income from loans and deposits, fees and non-customer income which is mainly related to income from activities such as funding and gapping, trading and available for sale securities.

Operating income in the third quarter rose 2%. This increase was primarily due to our growth in net interest income from loans, which increased by 10% year-on-year thanks to three factors:

1. First, a 7% increase in average loan volumes,
2. Second, stable overall lending spreads, and
3. Third, an extraordinary gain of $9 billon from a commercial loan that was prepaid during this quarter.

Also, we have been able to maintain the contribution from DDAs almost flat despite the strong decrease in the overnight rate by growing average volumes by 13% year-on-year as customers prefer to maintain more liquidity in their accounts in a context of low short term interest rates.

Additionally, income was further increased by effective treasury activities, which offset lower inflation revenues almost completely. Specifically, we generated higher revenues from improved funding as a result of repricing short-term liabilities, benefitted from term gapping, and also realized important gains from the sale of Available For Sale securities as a result of an important decrease in long term interest rates.

Lastly, these results were further enhanced by the positive effect of depreciation of the Chilean peso against the US dollar assets positions that hedge our allowances for loans denominated in this currency, generating approximately $9 billion in higher operating income.

On the other hand, these results, due to our UF structural GAP, we recognized less non-customer income than prior quarters since inflation only grew 0.6% this quarter versus 1.0% recorded during the last four quarters. It’s important to note that there is a lag in the UF versus the Consumer Price Index, which means that the strong CPI of 0.8% in September affects the UF of October and November.

In addition to inflation, fees continue to be under pressure which is principally due to a reduction in fees from our stock and insurance brokerage subsidiaries which was partially offset by attractive results in our mutual fund business thanks to a 30% increase in AUM over the same quarter last year.

Moving on, slide number eight is a review of our loan portfolio by segment.

During the quarter, loans have grown 5% over the past 12 months and 2% quarter-on-quarter. When compared to the same period in 2013, we can see a downward growth trend, even if we exclude a loan portfolio purchase from a local bank in 3Q13 for $430 billion. This less dynamic activity is in line with the quarterly survey that was published by the Chilean Central Bank, which reported that Banks have become more restrictive in overall credit conditions, especially in construction companies and SMEs, and also revealed that there continues to be weaker demand from customers.

If we break this down by segment, our wholesale divisions presented a slight decrease of 1.5% year on year, which is due to the high comparison base from the purchase of the previously mentioned commercial loan portfolio in 2013. If we exclude this, our growth in wholesale would have been 2.8% year-on-year, which is still a modest figure and reflects, on one hand, the weak demand from companies and on the other hand, our decision to maintain an adequate relationship between risk and return in the context of the current economic environment and high competition. As a result of the weak demand for loans from larger companies, we grew 2.4% when compared to the 2Q14. Going forward, we will continue to focus on growing selectively with high quality corporate customers.

Meanwhile, the retail segment has continued to show dynamism with an increase of 11% year-on-year. This growth was primarily from mortgage loans and consumer loans in the middle and upper segments which continued their strong growth trend, posting an increase of 14% and 10%, respectively. It's also important to note that this growth in mortgage loans has been accompanied by an improved risk-return relationship by focusing on the higher income segments, strengthening the effectiveness of our sales channels and implementing important business intelligence tools to achieve market share gains. These measures, among other initiatives, have also shown positive results in consumer loans.

With regards to SMEs, we have seen a slowdown in commercial loans, growing 7% versus 9% in the 2Q14. This slower loan growth in SME lending is due to the current economic cycle, which naturally affects this segment more than others since they are financially more vulnerable in the context of a slowing economy. Therefore, we have prudently tightened our credit acceptance criteria, in line with our risk management requirements.

In terms of the lower income segment, growth remained flat year-on-year, in line with the strategy put in place in prior quarters as a result of the diverse regulatory changes which have affected this segment for example the interest rate cap and regulations regarding insurance.

Before moving on, I think it is important to take note that despite the current environment, we have continued to increase our customer base. On average, we have grown our customers by 4.2% year-on-year. This is very important because it allows us to diversify our customer base permitting us to grow in demand deposits and loans, while also providing opportunities to generate new sources of fee income, which is particularly important due to the various regulations that have been implemented over the recent years.

Please turn to slide number nine. Here we show a breakdown of our liability structure. As you can see, the most important sources of funding are savings accounts and time deposits, demand deposits and debt issued. Over the past 12 months, these sources of funds have changed the most. The reason for these changes are:

- First, we have continued to improve our DDAs, growing end of quarter balances 7% year-on-year and average balances 13% year on year thanks to customer confidence in the Bank solvency and a greater liquidity preference from customers, particularly companies. ,
- Second, the important decrease in Time Deposits, which fell 8% year on year, as a result of a decrease in short term interest rates that have reduced the attractiveness of this product versus other products such as mutual funds and current account deposits, and
- Third, the strong increase in bond issuances, which grew 26% year-on-year.

A few benefits of these changes are:

- The increase in the duration of our liabilities,
- The diversification of our funding base by issuing bonds in other markets such as Japan and Switzerland, among others.
- Improves our cost of funds as the relationship between non-interest bearing liabilities to total liabilities has increased.

In terms of cost of funding, we continue to maintain a leadership position in DDA´s and in bond issues at very low spreads. Also, thanks to our solid business model and excellent credit rating, we are ranked amongst the safest banks in the world and the strongest private bank in Latam. Our Cost of Funding for the first 9 months of 2014 is 3.6%, significantly below the system average of 4.0%.

With regards to our Capital Adequacy ratios, we ended the period with a Tier I Ratio of 10.3% and a Total Capital Ratio of 13.2%., above de regulatory limits of 10% set by the regulator.

Please turn to the next slide, number ten.

As shown on the chart on the left, loan loss provisions have dropped 12% from last year. The reasons for this decline is mainly related to better overall credit risk behavior and to additional allowances set in the third quarter of 2013, as you can see on the chart on the right.

These positive factors were partially offset by a negative FX effect of about $9 Bn on US dollar denominated loan loss provisions. This was a product of a 8% depreciation and 0.7% appreciation of the peso against the dollar in the third quarter of 2014 and 2013, respectively. All of these effects consequently improved our LLP ratio to 1.2% this quarter compared to 1.4% in the third quarter of 2013.

Nonetheless, these better credit risk results should not be taken out of context since we continue to see mixed trends in economic activity. While we expect the economy to begin showing signs of gradual recovery in the coming quarters, we can't rule out the possibility that risk indicators could be affected as a result of the timing of when the recovery of the economy will begin or the velocity of which it will recover could take longer than expected.

Please turn to slide number eleven for an overview of our operating expenses.

As you can see on the chart on the left, operating expenses have grown 9% over the same period last year and have remained relatively stable when compared to the previous quarter. The main drivers for this increase are mainly due to:

- An 8% growth in personnel expenses, which is principally explained by three factors:
    1. An adjustment in salaries, which are linked to inflation. Accumulated inflation during the last 12 months reached 4.6%,
    2. A slight increase in the number of employees, and
    3. Higher expenses related to non-recurrent bonuses, specifically Ch$1.2 billion associated to the completion of a bargaining process in one of our subsidiaries this quarter and variable compensation associated with commercial campaigns
- Administrative and other expenses recorded a rise of 10% as compared to this same quarter last year, which is mainly due to inflation since some services are quoted in UF, a rise in IT and other general administrative expenses and impairments related to our branch and ATM network.

Even though inflation dropped on an annualized basis below the 3% this quarter, affecting negatively our operating income, we still managed to post a very positive efficiency ratio of 43.4% for the quarter and for year to date we achieved an efficiency ratio of 41.3%, comparing closely with the leader in the industry which posted 40.4% for the first eight months of this year and large positive gap with the rest of our peers.

Our expectations for the long term is to maintain a sustainable level of efficiency in a range of 42% to 44% through strict cost control policies, productivity improvements, and stable operating income growth.

Please turn to slide number twelve.

At the end of September, the government finally approved the tax reform. As you can see on the chart at the top of the slide, corporate tax over a five year period will gradually increase from 20% to 27% under the semi-integrated system and will go to 25% if a company adopts the integrated system. It's also important to take into consideration that the tax system must be approved in a shareholders meeting and requires presence of at least two thirds of votes. In accordance to this regulation, public companies must adopt by defect the semi-integrated system.

As a result of the increase in the corporate tax rate, we recognized a one-time positive effect one P&L of approximately Ch$21 billion due to deferred tax assets, which was partially offset by the 1% tax increase applicable to 2014 taxable earnings amounting to Ch$3.4 billion.

As a result, the Bank reported an effective tax rate of only 7.4% for the nine month period of 2014 versus 13% recorded a year earlier.

Please turn to slide number thirteen.

The first nine months of 2014 have been exceptional for Banco de Chile. We have consistently posted strong results despite the slowing economic cycle and we continue to lead the industry in terms of net income and profitability without steering away from our prudent risk policies that characterize us.

It´s important to highlight that 2014 results have been extraordinary for Banco de Chile and also for the banking industry, thanks to the high level of inflation and, in a lesser degree, to the one-time tax benefit from net asset deferred taxes.

These transitory factors, like the mixed economic trends mentioned earlier, should be taken into consideration when forecasting the performance of the Chilean banking industry for the following quarters.

Finally, it's important to note that we continue to develop improvements in business intelligence, product innovation, risk management, operational processes and technological infrastructure. These elements should provide us with long-term competitive advantages that are particularly valuable for the challenging business environment ahead, especially for the coming quarters in which we will face more competition from peers, lower inflation and lower interest rates.

Saying that, we are confident that we have the necessary abilities and tools to continue presenting better results than our competitors in this more scenario.

Now, if you have any questions we would be happy to answer them.

Closing Sentence

Thank you for listening and participating in our call; we look forward to sharing our next quarter's results with you.