Banco de Chile: Comments on the Full Year and Fourth Quarter 2013 Financial Results

Good afternoon. It's a pleasure for me to share with you our comments on Banco de Chile's year-end and fourth quarter 2013 financial results.

As a reminder, a link to the slide presentation is available on our webpage, www.bancochile.com, within the investor relations site.

Please turn to **slide number two.** To begin, we will discuss the developments in the Chilean Economy, the results of the banking industry, Banco de Chile's results and comparative performance and we will end the call with a discussion on the Bank's effects of the recent secondary offering of our shares by our controlling shareholder, LQIF.

Please turn to slide number three which contains the recent developments of the macroeconomic environment. In 2013, GDP grew in accordance to consensus, expanding 4.0% year-on-year. Despite that GDP is below the average of previous years, it still remains above the region and the world. During the year, the slowdown was largely explained by a deceleration in investment, mainly associated with postponed mining projects and their negatives effects on other sectors linked to this industry. In contrast, private consumption, which represents over 60% of GDP, has continued to be the main driver of the economy, thanks to strong employment levels which were concentrated in high quality jobs together with real wage increases and stable credit conditions in the financial market. However, the latest retail sales data points to a gradual slowdown in the coming quarters.

In terms of investment, despite the deceleration which took place in 2013, we expect to end the year with a figure around 27% of the GDP. We believe that this level of investment will continue in the future, especially because Chile needs to develop new energy projects to sustain the country's growth.

Finally, in terms of inflation, we ended the year with a figure of 3%, very much in line with the Chilean Central Bank target range. Nevertheless, inflation, measured as the UF, expanded 2.1% during 2013, a lower figure compared with the 2.5% reached in 2012. For 2014, market expectations continue forecasting inflation at 3% as of December. This perception could change in the future depending on the effects in the recent depreciation of the CLP against the Dollar and the current deceleration in the economy.

Please turn to slide number four. Before moving on to a discussion on the banking system, I would like to point out some of Chile's competitive advantages which are important in the current less favourable environment for emerging economies. Chile is a low risk country, rated AA- by S&P, with very low levels of public debt and a sustainable current account deficit. Also, the country has international reserves of over 20% of GDP, pension fund assets of 60% of GDP and a potential growth of 5%, based on both the highest GDP per capita in Latin America that supports domestic demand,growth and by being one of the most open economies in the world. Thus, we firmly believe that our country will successfully face this less dynamic cycle for the developing world and will return to potential growth figures gradually.

Please turn to slide number five. The previously mentioned advantages support our attractive financial system, which is characterized by its soundness and growth potential.

As you can see, loans represent 82% of GDP and a large portion of this penetration is focused on commercial loans which are mainly associated with large companies. A clear difference with our neighbours is that residential mortgage loans represent 20% of GDP in Chile. This is a result of long-term funding that is available from Chilean pension funds and other institutional investors. Also, as you can see on the chart on the right, we believe that our GDP per capita of US$16 thousand should continue growing, which should translate into a higher loan penetration, particularly in the retail segment. Going forward, we estimate that total real loan growth for the industry should be about two times GDP in real terms. This translates to a figure of about 11% nominal growth for 2014.

Please turn to slide number six for a review on the main figures for the Chilean banking system. Total loans for the banking continued decelerating during 4Q13 reaching an annual nominal expansion of 10.3% as of December, in line with the historical relationship of two times GDP growth in real terms. Among products, the evolution was led by consumer loans with an expansion of 14% YoY followed by mortgage and commercial loans posting annual expansions of 11% and 9% respectively.

It is important to mention that loans, with the exception of residential mortgages and isolating the positive non recurrent effect in consumer loans occurred in December from the incorporation of a retailer's credit card business into their banking business, showed a slowdown on a yearly basis, due to a weaker domestic demand, narrower credit conditions in the lower income individual segments and to the significant number of bonds placements by local companies in foreign markets that served as alternative sources of funding.

In terms of results, the banking system's net income increased by 18% yoy, supported by a strong performance in operating revenues, which increased 13% in annual terms. This was mainly explained by profitable business growth which compensated the adverse effects of lower inflation, as measured by the UF, and a low net fee income.

As for credit risk, loan loss provisions recorded an increase of 12% during the year, in line with loan growth of 10% and a slight deterioration in credit quality as a result of a slower economy.

In terms of operating expenses, the industry recorded an increase of 10% during the period. This is explained by higher salaries and administration expenses.

In addition, the banking industry also registered higher non-recurring income from investments in other companies as a result of a sale of a banking subsidiary for 78bn pesos.

Net/net, the return on average equity of the industry averaged 15.2% in 2013, slightly above the figure achieved in the previous year.

On the next slide**, number seven,** is a snapshot of Banco de Chile's main income statement figures. To begin, operating income increased in the fourth quarter by 7% when compared to the same period last year and in terms of the full-year, we grew this figure by 10%.

On the following slide, **number eight,** is a breakdown of Operating Income.

As you can see on the charts, we have divided operating income into two groups. The first, customer income, is what we consider to be our core business, while the rest, non-customer income is mainly related to revenues from activities such as gapping and trading. As you can clearly see, we have been consistently increasing customer income each quarter and on a yearly basis, we have grown by 9% or $94 billion pesos over 2012. This growth has been due to our proactive management of lending spreads, focused growth in loans and higher non-interest bearing liabilities, while fee income has remained unchanged.

On the other hand, non-customer income during the second semester of 2013 and the full year grew due to our effective management of our structural UF gap position, together with the benefit received from the devaluation of the Chilean / US$ exchange rate. The latter applies on derivative positions that hedge both, our exposure to allowances for loan losses denominated in US$ and expenses related to loyalty programs provided through credit cards.

On the following slide, **number nine,** is a review of our fee based business.

As you can see on the chart on the left, our market share in net fees was 22.2% as of December, substantially above all of our competition. This strong competitive advantage has been accomplished by effectively cross-selling our entire customer base to fee based products.

On the chart on the right is a breakdown of our fees by business segment. As you can see, our retail segment represents 50% of net fees while our subsidiaries which include our mutual fund, financial advisory, insurance and stock brokerage businesses as well as other smaller business units, represent 36% of total fees. On the other hand, our wholesale division also contributes an important portion of these fees thanks to our high cross sell ratio with corporate customers.

In the same way that we have been able to offset the negative impacts of regulations already put in place, we expect to compensate the adverse effect of the new regulation for early termination of insurance policies, which began in December 2013, through the expansion of our customer base as well as an increase in cross-sell.

Moving on to **slide number 10**, is a review of our loan portfolio by segment and the evolution of our market share.

We grew total loans by 11% year-on-year and 2% quarter-on-quarter, ending with a market share of 19.1%. This annual growth has been balanced between retail and wholesale loans. However, on a quarterly basis, we grew our retail book by 3% versus our wholesale book which only grew at 1.3%. Moreover, in terms on average balances, retail grew YoY by 12.2% versus wholesale which grew on average 5.5% YoY.

The stronger average growth recorded in the retail segment is due to our focus on increasing our profitability and the penetration in this segment through tailor-made business solutions. Accordingly, during the 4Q13 consumer loans to middle and upper income individuals grew 5%, residential mortgage loans increased 3% and commercial loans to SMEs grew about 2%. In contrast, consumer loans to lower income individuals continued to lag behind the rest of the book, growing only 0.3% during the quarter. The lower growth in this segment continues to be due to our more prudent risk approach that we have adopted since 2012, which is in line with the less dynamic local economy and recently adopted regulations.

Our strategy in this area is to increase gradually our competitive position in retail which is the most profitable and dynamic segment. We firmly believe that there are many opportunities to improve our position by concentrating our efforts on increasing the use of transactional services, business intelligence tools and improving the productivity of our different contact channels. Also, thanks to our consistent strategy that has focused on providing great customer service, we have achieved what we believe is the lowest attrition rate in the local industry. This is an incredible competitive advantage.

Regarding the wholesale segment, we believe that there’s still room to continue increasing the profitability by taking further advantage of our connectivity agreement with Citi, effectively cross-selling these customers to fee based services and by using our leadership position in this segment to generate business for the retail segment by providing customers with products and services such as payroll loans and bank accounts.

On slide **number 11**, we show a breakdown of our funding structure.

In terms of liabilities, we continue to have the best funding structure in Chile. Demand deposits which are non-interest bearing, represent almost 23% of our total sources of funds with an overall market share of 22% and more importantly, retail customers represent 46% of this source of funds. This is another significant competitive advantage that no bank in Chile has and is something that we have held historically, providing us with one of lowest cost of funds in the industry.

It's also important to note that time deposits are a large source of funding; financing 40% of total assets and 38% of these deposits come from the retail segment, giving more stability than institutional investors provide.

In addition, we have recently carried out several bond issuances in international markets in order to further diversify our liabilities and improve liquidity, including Hong Kong, Japan and Switzerland. As a matter of fact, bonds represent almost 17% of total funding versus 10% three years ago.

As you can see on the chart on the bottom right, all of these factors have translated into an average annual cost of funds for Banco de Chile of 3.4% as of December 2013, ranking us first among our local peers. Please also consider that the savings for every 10 basis points of cost of funds represents roughly US$ 45 million in net interest income.

To summarize these last three slides, our strong level of operating revenue is based on our focus on the retail business, our high cross-sell ratio and our lower cost of funds.

Please turn to the next slide, **number 12.**

As demonstrated on the chart, loan loss provisions have increased 28% from $188 billion pesos in 2012 to $242 billion pesos in 2013. In terms of quarterly figures, loan loss provisions have increased 34% in the fourth quarter of 2013 versus the same period last year. It is very important to note that a large percentage of this increase is attributable to three factors:

- First, the unfavourable effect of the depreciation of the Chilean peso on provisions for loans denominated in US dollars for $13 billion,
- Second, an increase in loan loss provisions of $10 billion for a specific corporate client which has had financial difficulties during the year, and
- Finally, higher countercyclical provisions of $8 billion pesos recorded in 2013

I should also highlight that the overall annual increase in retail loan loss provisions of 11% relate primarily to loan expansion in this segment which grew at the same rate. Nevertheless, it is important to point out that within this segment we have recorded higher credit charges related to small and medium sized companies, which has been offset by lower provisions to individuals.

Please turn to slide **number 13.**

In line with our history, we have once again posted excellent asset quality ratios. As you can see on the chart, we ended December with a delinquency ratio of only 1.11% and a similar ratio for loan loss provisions to average loans of 1.23%. In addition, we lead the industry in terms of our coverage ratio, where we posted as of December a figure of 2x or 2.5x when we include counter cyclical provisions.

Finally, it's very important to mention our consistent and excellent asset quality has been possible thanks to both the high involvement of the board of directors and upper management as well as to the important human and financial resources allocated to develop strong credit acceptance, collections, and monitoring practices at Banco de Chile. As a result, Banco de Chile, on average over the last 10 years, has consistently posted loan loss provision figures that are around 0.3% below the industry average. In dollars, this translates into a significant benefit of approximately US$120 million per year for Banco de Chile.

Please turn to slide **number 14** for an overview of our operating expenses.

As demonstrated on the chart on the right, our operating expenses have been very much in control during the last 12 months, growing only 2% year-on-year. This has been accomplished by closely controlling our headcount, together with strict cost control policies, lower amount of IT projects put in place during this year, more moderate business growth as well as lower operational charge-offs.

Regarding quarterly figures, the higher expenses for the fourth quarter of 2013 versus prior periods is mainly due to three factors:

- First, a non-recurring bonuses paid to Banco de Chile employees to celebrate our 120 year anniversary,
- Second, the increase in the fourth quarter related to the periodic adjustment in wages due to inflation, and
- Finally, seasonal effects related to administrative and other expenses

Before we move on, I should mention that part of this improvement in efficiency has been due to the economies of scale and improved productivity that have arisen from the growth in our retail business segment. This has permitted us to become more productive by taking further advantage of available capacity in our branch network, back-office procedures, and sales productivity gains based on a consolidated CRM system. As a result of this, we have posted a strong efficiency ratio of 43% for both the quarter and the full year.

Please turn to slide 15.

In summary, we had another great year. As you can see on the chart on the left, we have increased our quarterly results substantially over last year and this has translated into a 10% increase in net income for the year, representing 27% of industry net income. This outstanding result is thanks to everything we have discussed but in particular to our strong increase in operating income together with great expense management.

Now to finish off, I would like to pass the call over to Pedro Samhan, Chief Financial Officer of Banco de Chile.

Thank you Pablo.

Please turn to slide 16.

First I would like to say that Banco de Chile is the leader in terms of return on average equity in the Chilean Banking system as well as among our peers in Latam reaching 21.3% in 2013. These figures have been achieved through solid fundamentals:

- First, we have achieved outstanding revenue generation based on a good mix of assets, high cross-sell, and an excellent funding structure
- Second, we have a prudent approach to risk management based on strict acceptance and admission criteria, strong monitoring practices and effective collection processes that secure low delinquent loans and loan loss provisions, and
- Finally, we have accomplished our goal of improving cost-to-income levels over time without sacrificing service quality.

Our ambition at Banco de Chile is to continue consolidating our leadership in every segment we serve and to continue building a bank based on a sustainable and profitable business model that creates value for our shareholders.

Please turn to slide 17.

Thanks to our strong competitive advantages and our consistent strategy, we have repeatedly posted attractive profitability during the last 4 years with the exception of 2009 when we still had higher expenses due to the merger with Citibank Chile and the negative effect of inflation for that year.

Moreover, despite two capital increases, the profitability gap that we have with our peers has widened during the last few years. Currently, our ROAE is 1.3x that of our peers and ROAA is 1.5x that of our peers.

It's also especially remarkable to note the stability of both indicators. This has been possible due to the quality of our earnings, supported by a focussed and consistent business strategy together with solid corporate governance practices.

Please move to slide **number 18.**

Before entering into the question and answer period, I would like to quickly discuss the public secondary equity offering by LQIF. In January, LQIF announced their intention of selling –through a public auction– a portion of their participation in Banco de Chile. In light of this news, our Board of Directors agreed to collaborate with LQIF to perform all the steps necessary to complete the transaction. The final offering, that was registered locally and overseas and was declared "successful" on January 28, 2014 by LQIF's board of directors and a total of 6.7 billion shares, equal to 7.2% of Banco de Chile, were auctioned at Ch$67 per share within the local market. Consequently this transaction has increased our free-float from 17.6% to 24.7% and LQIF has maintained their control of the bank by holding a stake –directly and indirectly– of 51.2%.

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