

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

Good afternoon. It's a pleasure for me to share with you our comments on Banco de Chile's first quarter 2014 financial results.

Please turn to slide number two. To begin, we will discuss the developments in the Economic Environment, the results of the banking industry followed by a review of Banco de Chile's excellent results and lastly, Pedro Samhan, the CFO of Banco de Chile, will end the call with some closing remarks.

Please turn to slide number three which contains the economic 1Q14 highlights.

As you know, in 4Q13 GDP posted deceleration which implied the activity averaged a 4.1% year-on-year expansion, after three periods growing at a pace of around 6%. The latest activity figures confirm that this less positive scenario continued during 1Q14, where we estimate a GDP expansion of 2.4% YoY.

In effect, the slowdown continues to be largely explained by a deceleration in investment, mainly associated with postponed mining projects, a less dynamic construction sector, a drop in machinery and equipment imports, some uncertainty associated with the proposal of a tax reform and future energy challenges.

In terms of private consumption, which represents over 60% of GDP, has continued to be the main driver of the economy, but growing at a slower pace, due to a weaker labour market and the depreciation in the exchange rate which has raised the price of durable goods. In fact, unemployment reached 6.5% as of March, a higher level when compared with prior quarter and the 6.2% figure posted in the 1Q13. This, together with a slower increase in real wages, will affect the purchasing power of households, reducing the performance of private consumption in the coming quarters.

In this scenario, and in spite of lower aggregate demand pressures, inflation rallied during last six months reaching a 3.5% YoY variation as of March 2014, approaching the upper limit of the Central Bank's target range. The rapid acceleration in inflation has been explained by higher prices in gasoline, utilities and food. In addition, the recent depreciation of the Chilean Peso has reinforced those effects in tradable goods. For year end, the range of expectations is wide, but has shown an upward trend, moving to an inflation figure of around 3.5% for the year. In terms of monetary policy, the Central Bank has reduced the referential rate by 100 basis points to 4% within the last seven months. Despite that, during April the Monetary Authority decided to take a pause, we expect that more cuts on the rate will be made in the coming months to reach a value of at least 3.5% as of December 2014.

For next quarters we expect a gradual improvement in activity as the strong contraction in investment eases, especially because Chilean companies remain in good shape and financial conditions remain accessible to medium and large companies. In addition, we also expect a gradual positive effect in aggregate demand in line with the establishment of a more expansionary monetary policy.

Before moving on to a discussion on the banking system, I would like to briefly mention the main proposals of the recently announced tax reform.

The main changes that this bill establishes are (i) the corporate tax increase from 20% to 25% in the next 4 years, (ii) the decrease in the maximum rate in personal income tax to 35%, from 40%, (iii) the end of the tax deferment on retained earnings fund (FUT), moving from a system based on taxation of cash distribution of earnings to one based on accrual basis and (iv), higher attributions to the Chilean Tax Bureau to reduce tax avoidance and evasion. Its worth mentioning that the main purpose of the reform is to carryout important changes in our educational system, so as to improve quality and to gradually shift towards a free universal education system. This reform seeks to collect approximately US\$8 bn. or 3% of GDP.

We expect that there will be the political willingness to deeply analyze the tax proposals in order to modify and introduce all the necessary changes so as to avoid undesired effects in investments. However, its too early to make an accurate estimate about the implications, but we do know that the Chilean economy is strong enough to implement these measures gradually, and to face any possible adverse effects that could emerge, maintaining our well known economic stability.

As for Banco de Chile, initially we can mention two possible effects. First, we expect a positive one-time effect from the gain of our net deferred taxes assets, which will be repriced on a higher tax rate, and secondly, a gradual increase in our net income effective tax rate.

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

For a better understanding of the banking system's performance, we isolated in this analysis the volumes from subsidiaries abroad and the non-recurrent consolidation of a consumer loan portfolio carried out by a Chilean bank related with a retail company, which added approximately \$430 bn. on the industry's balance sheets in December 2013. Also, variations for loan volumes of the Banking Industry are presented in real terms.

Thus, total loans grew 7.1% YoY as of March 2014, compared to the 7.6% expansion in December 2013 and 9.6% in March 2013. The current deceleration in loan volumes has been gradual and slower due to the economic cycle; hence we expect it should continue as such in the short-term as the economy loses momentum. Also, in the short term, banking activity should reflect stricter credit conditions because of the prudent risk approach that defines the Chilean banking industry.

A breakdown by product shows that commercial loans grew 6.1% YoY as of March 2014 versus 6.8% as of December 2013 following a similar downward trend like investment. This behaviour was amplified in March 2014, when commercial loans experienced an m/m decline resulting in an annualized quarterly growth of only 3.4% during 1Q14.

Consumer loans also lost dynamism over the last quarters, aligned with a gradual temperance in private consumption. Thus, on a yearly basis, this product grew by 7.4% as of March, after a peak of 8.7% as of December 2013.

On the other hand, mortgage loans continued to display stable annual growth rates by recording a 9.3% YoY growth in the 1Q14.

Finally in terms of loan volumes we believe that total loans should grow by 7.0% real YoY in 2014, as a result of an improvement in the macroeconomic scenario boosted by a decrease in levels of uncertainty and the effect of the more expansive monetary policy established by the Central Bank.

As for results, industry's net income totalled Ch\$595 Bn. in 1Q14, a 57% rise over 1Q13. This notable variation was principally explained by larger operating revenues, which more than offset higher provisions and operating expenses. As a result, banking system profitability climbed to 18.2% ROAE in 1Q14 vis-a-vis 13.2% in 1Q13 and 16.0% for the whole year 2013.

The annual gain of Ch\$215 Bn. in the bottom line was driven by higher operating revenues for an amount of Ch\$452 Bn., in line with a profitable expansion on loan volumes, and the comparative higher expansion in the UF during the quarter, posting higher benefits from the structural UF net asset position maintained by the industry.

The positive evolution in operating income was partially offset due to larger loan loss provisions by Ch\$64 Bn., caused by the deterioration in the payment behavior of

individuals and companies, and a rise in operating expenses of Ch\$133 Bn., due to higher personnel and administrative costs.

For 2Q14 we also expect positive results in the banking industry aligned with important effects from inflation, which should offset the deceleration in loans and the riskier economic environment.

On the next slide, **number five**, is a snapshot of Banco de Chile's main income statement figures. To begin, operating income increased in the first quarter of 2014 by an impressive 20.4% when compared to the same period last year. This strong increase was due to a variety of factors as explained on the following slide.

Please turn to slide, **number six**.

On this slide, we present a breakdown of operating income by interest income from loans and deposits, fees and treasury income which is mainly related to income from activities such as gapping, trading and the management of our capital and reserves.

As you can see, part of the increase in the first quarter of 2014 was attributable to the management of our UF GAP structural position and treasury related activities. In the first quarter of 2013, inflation only reached 0.13% while in the first quarter of 2014, inflation rose to 1.28%. Additionally, our treasury area took advantage of the reduction of long-term interest rates which increase the value of our securities portfolio, generating revenues of roughly Ch\$7 billion in the AFS securities and Ch\$3 billion from our trading portfolio. Also, we benefited by a moderate steepening in the yield curve structure, and a positive exchange rate effect on our net asset position in US\$ that hedge allowances denominated in that currency. On the other hand, net interest income from loans rose 7% year-on-year, which was

slightly lower than the 9% increase recorded in loan balances during the same period, principally due to the reduction of the interest rate cap. Additionally, we were able to maintain the contribution coming from DDAs by successfully growing average volumes in the double digit range which completely offset the effect of the reduction in the overnight rate.

Lastly, due to a variety of reasons, fees have been under pressure during the last few quarters. The main elements that explain this year-on-year decrease are:

- First, the impact of regulations which limit flexibility in pricing of banking products and services we offer,
- Second, the recent regulation that obligates to refund insurance premiums in the case of early termination of insurance policies which took place in December 2013, and
- Third, the negative effect of the depreciation of the Chilean peso on cobranding expenses being offset in fx revenues by hedging this position.

Moving on, **slide number 7** is a review of our loan portfolio by segment.

Loans continued to grow strongly, up 9% nominal year-on-year, however when compared to the 4Q13, growth dropped to 0.5%. The slower quarterly growth is consistent with the less dynamic Chilean economy . This has led to decreases in demand from both individuals and companies combined with stricter credit acceptance criteria. In addition, during the quarter there were a few short-term wholesale loans which came due for about \$260 billion pesos and which were originated in the 4Q13.

Nevertheless, thanks to our focused retail strategy that has been concentrated on improving customer business intelligence and productivity, we were able to grow our retail book at a pace of 11% year-on-year and 3% quarter-on-quarter, which more than offset the lower growth experienced in wholesale banking which grew 7% year-on-year and decreased 2% quarter-on-quarter. These excellent results in our retail book have been achieved through the implementation of comprehensive business intelligence models which include improvements in pricing strategies by sales channels, new propensity models, and optimizing our incentive models for account officers. Thanks to these enhancements, we were able to increase sales, improve spreads in consumer loan campaigns and for the first time ever, internet sales became the main sales channel for installment consumer loans in March, a fantastic achievement.

On slide **number 8**, we show a breakdown of our funding structure.

In terms of liabilities, as we commented in prior releases, we continue to have the best funding structure in Chile. Demand deposits which are non-interest bearing, represent 25% of assets with an overall market share of 22% and more importantly, retail customers represent over 40% of this source of funds. As you know, funding from retail customers is more valuable because of its stability as compared to wholesale deposits. This is also true in terms of our time deposits which have a high proportion of funding from retail customers.

During the quarter we have continued to carry out bond issuances in international markets in order to further diversify our liabilities and improve liquidity. In February, we issued US\$315 million in Switzerland, in March we placed US\$20 million in Japan and in April we issued US\$70 million in Hong Kong. As a result of this strategy, as of March 2014 debt issued represents just over 18% of total assets, 363 basis points above only one year ago, thus reducing our exposure in shorter term time deposits by 310 basis points.

All of these factors have translated into generating an excellent cost of funds ratio of only 3.7%, significantly below the average of the system of 4.2%. Also, on chart on the right, we compare the cost of funding in time deposits by currency, which is in our opinion a good indicator for comparison purposes, due to the fact that they are more similar in terms of duration than other liabilities. As you can clearly see, that we excel our main peers in funding in Pesos, UF and Foreign Currencies. Also it's important to mention that Banco de Chile has one of the lowest concentrations in funding from AFPs and Mutual funds, representing only 13% of this source of funds.

Please turn to the next slide, **number 9**.

As demonstrated on the chart, loan loss provisions have increased 53% from \$50 billion pesos in the 1Q13 to \$76 billion pesos in 1Q14. However, it's important to note that this increase is due to four factors:

- First, the strong loan growth experienced in our retail business which increases provision charges by Ch\$ 6 billion,
- Second, a release of provisions of approximately Ch\$9 billion related to a specific corporate customer loan in 1Q13 which reduces the comparison base. This was due to an upgrade in the risk classification of a wholesale customer that experienced financial difficulties back in 2012.
- Third, the effect of the depreciation of the Chilean peso on provisions for loans denominated in US dollars for Ch\$5 billion, and
- Finally, a credit deterioration, in line with the weaker economy which affected the wholesale and the SME segments for an aggregate amount of Ch\$ 7 billion.

In summary, loan loss provisions as a percentage of loans increased during the period to 1.45%. If we exclude the effect of the depreciation of the Chilean peso, this figure reaches 1.38%. This higher level of provisions is consistent with the less expansive economic cycle that has been reflected in less dynamic economic environment for companies and higher levels of delinquencies for individuals. The bank has been taking measures to mitigate these effects by restricting exposure in certain products and sectors of the economy, monitoring more closely the performance of companies and strengthening collection activities.

Please turn to slide **number 10** for an overview of our operating expenses.

This has once again been an extraordinary quarter in terms of efficiency. We reached an outstanding ratio of 39.2% in the period, significantly below our average levels in the past, thanks to our very strong operating revenues and our strict expense control.

As demonstrated on the chart on the right, our operating expenses have been very stable during the last 12 months, growing 7% year-on-year. The main drivers for this increase as compared to the same quarter last year is mainly due to:

- An increase in salaries which are indexed to inflation and adjusted every May and November and a slight increase in headcount to reinforce our business areas.
- Higher administrative expenses reflecting the increase in business activity in particular to expenses related to credit evaluation, IT rental and maintenance.

Before we move on, I want to reinforce that the excellent efficiency ratio posted this quarter has been achieved not only thanks to strong operating income but to also improved economies of scale and higher levels of productivity that have arisen from the growth in our retail business segment. This can be clearly seen if you look at the evolution of our costs to asset ratio, which have consistently improved, decreasing from 2.57% in the first quarter of 2013 to 2.27% in the first quarter of 2014.

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

Please turn to slide 11.

In summary, we had another great quarter. As you can see on the chart on the right, all the factors which Pablo mentioned in the presentation have permitted us to consistently grow our business. This quarter was not an exception, we reached a record quarter in terms of net income, operating income and efficiency with figures of over \$150 billion pesos in net income (24% above the same period last year), \$408 billion pesos in the second and lower than 40% in the latter.

However, the challenges of the future quarters cannot be ruled out, as we face regulatory changes combined with a slowing economy. Despite these factors, I truly believe that our ambition to make Banco de Chile the leading bank in every segment we serve is being accomplished in a sustainable and profitable manner, which should provide the foundation for Banco de Chile to outperform our competitors throughout the economic cycle.

Thank you. If there are any questions we would be happy to answer them.