Comments on the 3Q13 Financial Results

Banco de Chile

Good afternoon. It's a pleasure for me to share with you our comments on Banco de Chile's third 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.

To begin, please turn to **slide number two.** To begin, we will discuss the current economic environment, the results of the banking industry, Banco de Chile's results during the quarter and we will end the call with a peer comparison.

Please turn to slide number three which contains the recent developments in the macroeconomic environment. During 3Q13, GDP grew similar to the average of the past two quarters, expanding 4.4%, mainly boosted by a positive quarter for mining production and a solid trend in retail sales. On an annual basis, GDP accumulates an expansion of 4.4%, the lowest figure within the last three years. Accordingly, and given a less positive scenario for emerging markets, expectations for 2014 GDP growth have been repeatedly revised downwards to 4.4% as of October.

In terms of internal demand, private consumption continues to grow strongly in line with a surprisingly low unemployment rate and a positive, but downwards, evolution in real wages. However, for the comings quarters, we expect a slowdown in private consumption due to a decrease in consumer confidence and lower job creation. On the other hand, investment has shown a sharper deceleration due to a drop in business confidence and to postponed mining and energy projects.

In response to the downturn in economic activity and its possible effect on inflation expectations, the Central Bank recently reduced the Monetary Policy Rate by 25 basis points to 4.75% after 20 months without changes. The decision surprised analysts and the market, who were expecting cuts in December or even 1Q14. For the coming quarters, we expect at least one more reduction in the policy rate, without ruling out a broader adjustment if the economic environment requires it.

Finally, as for inflation, CPI has continued to grow modestly, evolving below its historical patterns and with some volatility, posting a variation of 1.9% as of September and 2.0% yoy, adding an additional support to the monetary policy rate cut. Recently, lower prices of oil have constrained internal inflation despite the rise in food and service prices. By the end of the year, we expect inflation to be slightly above 2.0%.

Please turn to slide number four for a review on the main figures for the Chilean banking system. Total loans for the industry grew 2.1% qoq, maintaining the average pace observed in the previous quarters in line with a stable credit demand from companies and individuals. On a yearly basis, total loans rose 11% yoy, aligned with the slight slowdown of the economic activity and their historical elasticity of two times the GDP growth. By product, commercial and consumer loans have gradually slowed growth to grow at low double digit rates while mortgage loan growth has remained stable.

We expect the banking industry's total loans to continue reducing its expansion in line with a less positive economic environment, growing around 9% and 7% in real terms at by the end of 2013 and 2014, respectively.

As for results, the banking system's net income totaled Ch$487 billion during 3Q13, an expansion of 16% qoq. The improvement in net income was largely explained by a solid performance in operating revenues associated with a larger benefits from the system's UF position, as a consequence of the higher inflation recorded during the quarter and a solid trend in loan and deposit volumes.YTD, net income rose 13%, entirely caused by higher operating income, that more than offset larger operating expenses, provisions for loan losses and income taxes.

On the next slide**, number five,** is a snapshot of Banco de Chile's main Income Statement figures. To begin, operating revenues increased significantly by 10% quarter-on-quarter and 26% year-on-year, posting an attractive result of $380 billion pesos.

On the following slide, **number six,** is a breakdown of Operating Revenues. As you can see on the chart, part of this strong year-on-year growth of 26% was achieved by a sustainable and consistent positive trend in customer revenues due to proactive management of lending spreads, focused growth in loans and higher non-interest bearing liabilities, with average balances expanding 8.4% and 11.8%, respectively.

Nevertheless, non-customer income contributed to the increase in operating revenues. In fact, an important part of the quarter's increase in operating revenues was associated with higher inflation that resulted in greater revenues from our UF net asset position due to a 1% rise in inflation during the quarter as compared to a deflation of 0.2% in the 3Q12. To a lesser extent, our operating revenues also benefited from a positive exchange rate effect on both derivative positions that hedge our exposure to allowances for loan losses denominated in US$ and expenses related to our customer loyalty programs provided through credit cards. This positive impact in operating revenues has a similar negative impact in fees and loan loss provisions. For the fourth quarter, we expect inflation, measured as the variation in UF, will be in a range close to 0.7%, which is consistent with the central bank's 12 month target of 3%.

It is important to note that our mid-term strategic plan has allowed us to consolidate our business model, based on a deepened segmentation, enhanced value offerings and improved service quality in all of the targeted segments. This has resulted in a superior capacity to generate customer income, representing more than 80% of total operating revenues and undoubtedly contributing to preserve our leading position in this matter.

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

During the quarter, our loan book grew 11% year-on-year and 5% quarter-on-quarter. Our growth, over the past 12 months, has been led by retail banking, which is consistent with our focus on increasing the penetration in this segment through tailor-made business solutions. As a result, our retail book expanded 12% year-on-year, with commercial loans to SMEs posting an increase of 14.4% year-on-year, followed by mortgage and traditional consumer loans growing 13.5% and 11.1% year-on-year, respectively. Lagging behind were consumer loans to lower income individuals, rising only 3% during the same period. The lower growth in this segment has been mainly due to a more prudent risk approach that we have adopted since 2012. This is in line with the less dynamic local economy and recently adopted regulations, all of which has reduced the attractiveness of the risk return relationship for some segments of this market.

This strategy has resulted in a gradual change in the mix of our loan portfolio, where today we are much more focused on the retail segment than five years ago. The keys for reaching this goal have been related to expanding our customer base selectively, taking measures in order to increase loyalty amongst our customers and improving value offerings to maintain a sustained upward trend in capturing new customers. This together with the development of new service standards and long term commercial relationships have allowed us to reduce attrition and post a 5% year –on-year increase in our customer base.

In terms of our wholesale segment, loans picked up this quarter, growing 10% year-on-year and 7% quarter on quarter. This sharp quarter on quarter increase is largely explained by the acquisition of roughly Ch$430 billion in healthy corporate commercial loans from a local financial institution. Excluding this purchase, loans granted by our wholesale banking segment would have grown by 5% year-on-year and 2% quarter on quarter. This moderate organic increase in commercial loans is the result of our effort to focus on more profitable customers, which provide higher margins and cross-selling opportunities. As such, loans to Large Companies with sales between US$3 million and US$140 million expanded by 14% year-on-year, while our Corporate Banking book, which services customers with sales above US$140 million, has increased by 3% year-on-year. Nevertheless, we have increased our operating margin in the Corporate book by almost 20 basis points when comparing the 2013 YTD to the same period last year, in line with our aim of growing profitably rather than gaining market share at any cost.

All in all, our strong growth during the quarter managed to place us first in terms of total loans in the Chilean financial industry with a market share of 19.3% excluding foreign subsidiaries. As you can infer, the most important gains in market share came from commercial loans, which posted an increase of almost 80 basis points quarter-on-quarter, followed by mortgage loans with an increase of 4 basis points within the same period. This rise was partially offset by a slight drop in consumer loans market share of 17 basis points quarter-on-quarter mainly due to our more stringent acceptance criteria for the retail segment, particularly in the lower middle income segment.

On slide **number eight**, we show a breakdown of our balance sheet structure.

As most of the listeners to this call know, the main assets on Chilean banks balance sheets are loans. For Banco de Chile, loans represent 84% of assets while investments only represent 9% of assets, as you can see on the chart on the left. This is very important because we are a bank that is focused on traditional banking and not trading.

In terms of liabilities, non-interest bearing deposits continue to be a strategic priority for us. We ended this quarter with an exceptionally strong increase of 19% year-on-year, representing 23% of our total liabilities and equity. If we break this figure down between individuals and companies, current account balances for individuals increased 22% year-on-year reaching a market share of 32.5% while companies have increased their balances by 17% year-on-year, attaining a participation of 21.3%. Accordingly, our leadership in DDAs, together with our excellent credit rating gives us a competitive edge against our competitors in terms of funding. As you can see on the bottom left chart, we posted an average cost of funds of 3.3% as of September 2013, substantially below our peers.

It's also worth mentioning, as detailed on the table on the right, that we have continued our strategy of diversifying our funding base and improving liquidity ratios by issuing US$754 million in bonds in foreign markets and almost US$1 billion locally, all at very attractive rates. In terms of our foreign bond issuances, these are generally placed in foreign currency and swapped back to UF under hedge accounting. This allows us to fund our local currency portfolio without taking on any currency or interest rate risk on our balance sheet.

Lastly, in terms of capital, we continue to have solid capital adequacy indicators by holding a total capital - to - risk weighted assets of 13.2% and a tier 1 capital over risk weighted assets of 9.9%. It's important to note that tier 1 in Chile is basically tangible equity, so we do not have any hybrid instruments in this figure.

Please turn to slide nine. On the next few slides, we will review Risk followed by a discussion on the evolution of operating expenses.

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

A strong, deeply-rooted risk culture is a core aspect of our efforts to manage risk at Banco de Chile. Accordingly, we maintain solid and prudent risk policies and continuously monitor the main risk factors that can impair our loan portfolio. These strict policies also ensure that our credit exposure are within levels consistent with prudent standards and internal limits.

In terms of our concentration levels, our loan portfolio, as you can see on the chart on the left, is quite diversified. Our most important sectors in the corporate book are commerce and financial services. Additionally, we also hold a low concentration in terms of customers, where the top 10 customer groups represent less than 12% of total loans and related party loans represent less than 2% of total loans.

Additionally, a basic principle of our credit risk management is our constant and deep presence throughout the entire credit cycle, including approval, granting, monitoring and collections. For example, since the first semester of 2012, we anticipated a higher risk from the expected slowdown of the economy and certain negative effects of the implementation of new regulations. Accordingly, we adjusted our acceptance criteria for the lower income segment and put into practice different initiatives intended to enhance the collection process. This strategy was successful in lessening the effects of a change in payment behavior from retail customers.

The effectiveness of this credit risk management is clearly demonstrated on our NPLs to Loans and Coverage ratios, as you can see on the charts on the right. At the end of the third quarter, non-performing loans as a percentage of loans remained at 1.1%, significantly below our peers and the banking system. Also, our coverage ratio, measured as allowances to total past due loans, remains healthy at 2 times, well above both our peers and the industry.

On the next slide, **number eleven.** As demonstrated on the chart on the left, loan loss provisions have increased from of $40 billion pesos in the third quarter of 2012 to $70 billion pesos in the third quarter of 2013. However, it is very important to note that more than 50% of this increase is attributable to factors other than loan deterioration. The chart on the right, shows the main effects of the increase between the third quarter of 2013 and 2012.

- First, in line with our business strategy, loan growth has been concentrated on retail loans, with balances growing 12% year-on-year versus wholesale loans expanding 10% within the same period. As a result, the effect of greater loan volumes in LLP was equivalent to Ch$6.0 billion when compared to the same period in 2012.

- Second, under our prudent criteria, we charged Ch$7 billion in countercyclical provisions, in view of the actual loan growth, the slowdown shown by the local economy and our expectations on higher volatility over the next years. It is important to note that this provision does not relate to any specific customer or industry sector, but instead to an overall outlook on the evolution of the economy.

- Third, a net effect of Ch$4 billion due to exchange rate shifts affecting our US$-denominated allowances for loan losses. This was the result of a 5.3% decrease in the Ch$/US$ rate in the 3Q12 in comparison with a 0.7% drop in the present quarter.

- Lastly, an important part of the change in LLP year-on-year is due to changes in credit risk classifications for specific wholesale customers in the 3Q12 and the 3Q13. On the one hand, an improved risk profile of a specific customer resulted in a release of about Ch$8 billion in provisions during the third quarter of 2012. On the other hand, in the third quarter of 2013, we incurred Ch$4 billion in provisions due to one corporate customer which we downgraded based on their financial conditions. Net / Net, changes in risk profile of two corporate customers explain Ch$12 billion out of the Ch$13 billion increase in LLP during the quarter, while the retail segment only represented only Ch$1 billion of this total impact

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

As demonstrated on the chart on the right, our operating expenses have trended flat over the last five quarters, incurring expenses between Ch$150 and Ch$160 billion per quarter. 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, as well as a more moderate business growth.

Once again I should mention that we are continuing to see the fruits of our investments in terms of economies of scale and scope that have arisen from our growth in the 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 the above, we have posted an outstanding efficiency ratio of only 40.6% during the quarter and 42.7% YTD. However, it's also important to note that the higher inflation recorded this quarter positively impacted operating income, contributing to a relevant improvement in the cost to income ratio this quarter.

Please turn to slide thirteen.

The result of our excellent commercial initiatives together with prudent risk policies and cost control have permitted us to post excellent figures during this quarter. We recorded a pre tax income of Ch$156 billion, up 11% quarter on quarter and 49% year-on-year.

In terms of our effective tax rate, it is important to note that in the third quarter 2012 we posted a lower effective income tax rate, due to non-recurrent tax benefits associated with the effect of a corporate tax rate increase on our deferred tax position. This resulted in an effective tax rate of approximately 5% in the third quarter of 2012.

As a result, of all these factors we recorded net income after taxes of Ch$137 billion during the quarter, 13% higher quarter-on-quarter and 38% greater than the same period last year.

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 move to slide **number fourteen.**

This has been a historical quarter for Banco de Chile, as we have consolidated our leadership position.

First of all, as shown by the chart on the upper left, our strong loan growth during the quarter has placed us first in terms of total loans with a market share of 19.3%.
This was based on an effective long-term business strategy, which focuses on profitable growth and compels us to conduct a selective commercial approach in order to ensure a balanced risk-return relationship in all of our lending activities.

In terms of our revenue generating capacity, we have also ranked first in net operating margin, measured as operating revenues, net of risk charges to average interest earning assets, reaching 5.3% at the end of the period, far above all of our main competition. Nonetheless, it is important to mention that our business strategy strives to continue positioning the bank as the leader in retail banking, hence we feel that there is still room to continue improving this figure.

In terms of cost-to income, we recorded an impressive year-to-date ratio of 42.7%, below all of our competition. This has been achieved through strict cost controls as well as through initiatives that aim to increase productivity, improve virtual customer service channels, and automate back office activities. However, as mentioned earlier, this figure has also been influenced by certain lower expenses related to IT projects which should be realized next year along with a possible slowdown in business activity.

Finally, we came in far ahead from our competition in terms of return on average equity with a strong double digit ratio of almost 22%, 4 percentage points above the next leading competitor.

These leading indicators have been achieved through solid fundamentals based on a strong customer base, prudent risk management and a consistent commercial strategy. Our goal 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 for our investors.

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

Closing Remarks

Before ending the call, I would like to close by saying that 2013 has been an extraordinary year for Banco de Chile. Looking forward, it is important to note that 2014 will be a challenging year for all banks in Chile. From a positive perspective, we expect that assets and liabilities will continue growing at attractive rates and that the higher inflation will also help to increase operational revenue generation for the industry. Nevertheless, issues such as the implementation of new regulations on insurance and the possible implementation of a bill which limits interest rates for loans less than 200UF will have an adverse impact on results. In the former, the effect will be temporary and chiefly influencing a change in the way fees are recorded from cash to accrual basis, unlike the latter, which will force banks to adapt their business models in order to properly absorb these changes. We are confident that institutions like ours have the skills, resources and scale required to address them properly, so as to continue creating value for our shareholders. Thank you and we look forward to sharing with you our year-end results.