

## **Banco de Chile: Comments on the Second Quarter 2015 Financial Results**

Good afternoon, it is a pleasure for me to share with you our comments on Banco de Chile's second quarter 2015 financial results.

**Please turn to slide number two.** We will briefly discuss the macro environment and the banking industry's results for this quarter. This will be followed by an analysis of Banco de Chile's strategy and 2Q15 results.

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**Please turn to slide number 3, which contains the economic highlights.**

After a slow 1.9% growth rate in 2014, the Chilean economy showed promising signs of modest recovery during the first quarter of this year but soon began to falter. The seasonally-adjusted monthly index of economic activity or IMACEC, has been flat for the last two months. As you can see in the top-left chart, the YoY 3-month average growth shows a downhill path after favorable records over last December to January. According to the economic expectations survey conducted by the Central Bank, analysts now expect GDP to post a 2.3% expansion in 2015 and 3% in 2016.

The main drivers of this moderate growth include a mix of international and domestic factors. First, a lesser growth of trading partners and ensuing lower commodity prices are hurting investment in the domestic mining sector, which accounts for roughly 35% of total investment. On the other hand—as the top-right chart shows—domestic consumer and business confidence are weak and therefore are delaying the recovery in domestic demand.

As the bottom-right chart shows, in line with the developments in international commodity markets and the strong pace of the dollar, local currency has depreciated strongly, at about 7% since last December, which has consequently improved trade by increasing the contribution from the net exports to economic growth.

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**Please continue to slide number 4.**

Despite the cool-down of local activity, labor hadn't shown signs of deterioration until recent months. As the top-left chart shows, since the end of 2014 nominal wages have been growing at roughly 7% YoY and unemployment rate has remained at levels of around 6%. However, the latest figures show the effect of slower activity on labor market data, presenting an unemployment rate of 6.6% and nominal wages marked a remarkable drop.

One of the most noticeable aspects of the Chilean economy since mid-2014 has been the increase in inflation. As the top-right chart shows, until May of this year both headline and core measures seemed to decrease, but recent data recorded an additional take off from the inflation target ceiling of 4%. Indeed, headline inflation grew 4.4% YoY and core inflation showed a 4.7% increase. Both the depreciation of the local currency and particular food and energy items are the main driving forces behind these last figures.

Even though current inflation is above the policy ceiling, Chile's Central bank reinforced its neutral bias in the last monetary policy meeting, in a context where most of the economists in the market expect the central bank to maintain the monetary policy rate at least to the end of this year. This scenario is sustained by well-anchored inflation expectations over a two-year horizon at the 3% target, in addition to the slow growth observed and projected for this year. As the bottom-left chart shows, both nominal and real long rates have shown slight increases in line with the developments of international financial markets.

Although public finances remain strong, the finance ministry adjusted its fiscal deficit estimate to 3% of GDP for this year –from 1.9% of GDP in the original budget-, due to both higher than expected expenditures and lower growth of revenues, as a consequence of domestic slowdown. Net debt of the central government remains at a

negative 0.4%, which suggests that Chile still has room to perform countercyclical policies, even though it has fallen from the 19.9% recorded in 2008.

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**Please turn to slide number 6 for a review of the main figures for the Chilean banking system.**

First, as seen on the chart on the left, loan growth for the industry posted an increase of 5.6% YoY in real terms. Mortgage loans were the main driving force behind this figure with a YoY increase of 11%. The behaviour of mortgage loan growth has surprised us given the current the economic cycle. The general view is that individuals are anticipating home purchases due to changes introduced by the tax reform approved in 2014, which includes the implementation of VAT on property transactions and may increase prices in 2016. On the other hand, consumer and commercial loans show a dynamism that is more in line with the weaker economy, low confidence levels and rising unemployment rate, and are growing between 3% and 4% real YoY, respectively.

In terms of results, the banking industry posted a strong bottom line of \$665 billion. This is a 43% increase over the prior quarter, in line with higher inflation that reached almost 1.5% this quarter versus 0% last quarter. Additionally, results were accompanied by good asset quality indicators, with a LLP ratio of only 1.10% compared to 1.13% in 1Q15.

However, year to date net income as of June 2015 has decreased by 9% mainly due to the effects of high inflation presented last year.

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**Please turn to slide number 8, where we present our strategic pillars**

Banco de Chile has five main strategic objectives, which define our medium and long term goals. Each of these pillars serves as a guideline for new projects and initiatives in all areas of our bank, in order to continue creating value for all of our stakeholders.

The following slides show advances made in order to meet some of these objectives.

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**Please turn to slide number 9.**

Loan growth picked up momentum this period, growing 8.3% year on year and 3.5% over the previous quarter.

The main factor that improved loan growth this quarter was a pickup in the wholesale segment, which grew 5.2% YoY versus what we presented last quarter, when volumes shrank on a year on year and quarter on quarter basis. The increase was primarily a result of commercial decisions implemented to grow selectively in trade finance and short-term working capital loans with very low risk and high cross sell customers, thus reinforcing our business relationships.

On the retail side, growth remained strong, increasing 11.0% YoY and 3.5% QoQ. Mortgage loans continued to drive growth with a 13.4% increase YoY and 5.1% QoQ due to new tax regulations that are incentivising customers to anticipate home purchases in order to avoid paying value added tax. Consumer loans in upper income individuals also carry on showing good growth of 10.9% YoY and 1.9% QoQ as opposed to the decreases that occurred in the lower income consumer loan portfolio, in line with our risk approach to this segment. Finally, SME loans have picked up this quarter, posting a rise of 9.7% YoY, up from the rate posted last quarter. This growth is in line with our strategy to continue penetrating this segment together with several innovative initiatives to improve loyalty amongst these customers.

Through technological improvements, we have been able to create new virtual channels for our customers to get to know and use our products and services. The progress that has been made on all online platforms undoubtedly allows us to continue strengthening our relationships with customers and providing them with better service.

Thanks to these online and technological initiatives, Banco de Chile was awarded the *Best Digital Bank Award* for 2015 by Global Finance Magazine. This prestigious magazine recognized Banco de Chile for its digital strategy, emphasizing especially on the set of mobile apps that was introduced last year.

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**Please turn to slide number 10.**

As we announced earlier this month, we have entered into an agreement to acquire a loan portfolio from a local bank for approximately \$590 billion, which represents just below 3% of loans outstanding. Due to our size, we were capable obtaining funding for the operation without problems, closing the deal in record time. This portfolio will be gradually recognized in the banks books between July and September.

Some key facts of this transaction include:

- 1) Over 90% of the total loans are with customers that already have relationships with the bank
- 2) Over 80% of this portfolio is wholesale and is concentrated in the middle market segment
- 3) The residual average term of the loans outstanding is about 3 years and a duration of approximately 1.7 years

The benefits of this transaction are even more enhanced due to the important synergies created from the scale of our operations. First, since most of the customers are already Banco de Chile clients, the additional operational costs implied by incorporating the portfolio are minimal. Finally, this transaction entails an important

increase in loans and market share, as you can see on the chart on the right, increasing our market share today by approximately 40 bps.

As we find ourselves in a weak economic context with lower loan growth, acquiring this loan portfolio was very attractive given its profitability. Historically, we have privileged organic growth over inorganic growth, and even though this continues to be a solid belief, we know that this particular opportunity undoubtedly creates great value for our shareholders.

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**Please turn to slide number 11.**

In terms of funding, we continue to diversify our liability structure while also improving the stability of our liabilities in terms of liquidity. Core deposits continue to play a key role in our funding structure, representing 26% of our funding on average. Demand deposits and debt issued, in particular, have increased significantly YoY and have decreased their participation from institutional customers, privileging more stable sources of funds.

On the left, you can see that current account deposits have increased 18% YoY, 49% of which are retail deposits. The remaining demand deposits are split in wholesale and institutional representing 43% and 8%, respectively. The strong growth in these deposits is due mainly to an important increase in retail funding as a result of our strong customer relationship strategy, which is far more stable than institutional funding. This has been achieved through diverse mechanisms including improved online services and important developments in client satisfaction.

On the other hand, time deposits seen on the right have increased 4% YoY, in line with expectations. Currently, 42% of these deposits are retail, 34% are institutional and 25% are wholesale. Total deposits from institutionals only represent around 20%, which is significantly lower than the industry, especially when compared to smaller banks that depend much more on this source of funding.

In terms of debt issued on the bottom left, this has increased 16% YoY, in line with our growth in mortgage loans. This is the result of initiatives seeking to open to new, international markets and decrease exposure to local institutionals. Today, debt issued represents 19% of total funding, which is a remarkable increase from the 10% it was in 2010.

As you can see on the chart on the bottom right, our strength in funding has translated into an average annual cost of funds for Banco de Chile of only 2.4% as of June 2015, ranking us first among our local peers. This is very impressive, especially when you consider that the savings for every 10 basis points of cost of funds represents roughly US\$ 35 million in net interest income.

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**On slide number 12, we present Service Quality.**

Our strong focus on this strategic pillar is one of the main reasons we have been able to achieve great accomplishments over the past years. Today, it is the core of our business strategy.

On the left you can see that our Net Promoter Score has had a positive trend since 2012, moving from 60% to 70% this quarter. This increase is partly due to important developments in our customer experience programs, which seek to give our customers the highest satisfaction when hiring and using our products or services. Another important factor is the array of online and mobile solutions that have been introduced to facilitate all bank operations for customers.

These initiatives have also continued to empower our brand, as you can see on the right. Our strong brand name has always been a competitive advantage, but today it's enhanced by an improving level of customer service which should facilitate growth in this competitive environment.

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**Please turn to slide 13.**

In terms of Operational Excellence, we have also made important progress in various projects this first half of 2015. Amongst these, three initiatives stand out that are focused on modernizing different bank services in order to make operations easier for our customers.

The first of these is a new online platform for retail customers, who will now be able to buy and sell currencies directly from their computers or mobile phones and allow them to collect the cash quickly at any branch. This service will be given to all individuals and SME clients who hold a current account with us.

The second project consists of a new service related to credit card sales, which will now be delivered and activated on the same day thanks to advanced technology that allows our sales force to collect the necessary documentation and receive approvals faster than the traditional process. This will greatly improve logistics in the delivery and activation of these products and should help increase sales.

Finally, we have come together with Servipag to enhance cash withdrawal availability in Chile. Servipag is a company that provides various transaction operations for individuals, such as bill payments and deposits. This service allows customers to make withdrawals and deposits at Servipag branches 7 days a week, thus boosting our 1,500 ATM network by 350 Servipag service points.

These are examples of the projects currently being developed to offer our customers fast and secure solutions to everyday needs, while also identifying operations and areas that need improving.

**Now I will pass the call over to Pablo Mejia to discuss Banco de Chile's first quarter results.**



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**On slide number 15 we present the quarterly results for Banco de Chile.**

This was a record quarter for us with a net income of \$168 billion, which represents an increase of 9% YoY and 44% QoQ. Thanks to this historically high result, we have almost completely closed the gap with 2014 accumulated earnings, which was extraordinarily high as a result of inflation. This was achieved by our effective and prudent risk management, which has permitted us to record lower provision expenses, together with the successful implementation and execution of our commercial strategy that consistently generates growth and stable core customer revenues.

In terms of profitability, we posted a 26% ROAE this quarter versus the 18% for the first quarter, which consequently results in a 22.3% ROAE for the first half of 2015.

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**Please turn to slide number 16.**

Operating income for this quarter was \$419 billion, a 10% increase QoQ and 1.6% when compared to the same quarter last year. The strong QoQ rise was mainly driven by non-customer income, which increased from \$84 billion in the first quarter to \$119 billion this quarter. This result was mainly due to our UF structural GAP, thanks to the UF variation that rose from 0% to 1.5%.

When we compare this quarter to the same quarter last year, the 1.6% growth was driven by customer income, despite the higher inflation posted last year during the same period. The main drivers behind the YoY customer income growth were:

- 1) First an 8% rise in fees mainly related to the good financial performance from our mutual fund business and debit and credit card administration, in line with customer growth and inflation.

- 2) Second, a 6.1% YoY expansion in average loans, which was partially compensated by both a mix effect -residential mortgage loans growing faster than consumer and commercial lending- and a slight drop in lending spreads of commercial loans.
- 3) Finally, a positive effect on our FX hedges which are mainly related to USD denominated allowances for loan losses, amounting to Ch\$2.6 Bn., due to the depreciation of the Chilean peso versus the US dollar.

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**Please turn to slide number 17.**

Loan loss provisions decreased 18% YoY, from \$72 billion to \$59 billion this quarter due to effective and prudent risk management, which has greatly improved provision levels in our wholesale and SME segments. This result is also a consequence of a higher comparison base, since we recorded non-recurring additional provisions in the 2Q14.

The variation on the chart on the right shows these main drivers. As you can see this decrease was concentrated in additional and commercial loan provisions, which decreased by \$19 billion. This was mainly due to the strong financial position of our larger customers and higher recoveries from government backed loans to SMEs. This was partially offset by the negative effect of about \$3 billion pesos due to the depreciation of the Chilean peso on dollar denominated allowances, hedged in operating income and provisions from consumer loans by \$7 billion, in line with the weaker economy and higher unemployment rate as well as growth.

Overall, the decrease in provisions together with a loan book expansion resulted in healthier risk indicators. As a result, our LLP ratio for this quarter is 1.1%, which is significantly lower than the 1.4% reached during the 2Q14. NPL's, on the other hand, presented a more moderate decrease from 1.31% in the 2Q14 to 1.29% in the 2Q15.

**Please turn to slide number 18 on Operating Expenses.**

As presented on the chart on the left, expenses QoQ decreased by almost 4%, due mainly to extraordinary factors. On a YoY basis, expenses increased marginally by only 1.6%. The main factors explaining this YoY increase are:

- 1) The direct impact of inflation on salaries, which grew 8% since these are adjusted by inflation twice a year. This increase is also due to benefits negotiated in the last collective bargaining process with unions
- 2) The effect of inflation and an increasing exchange rate on various administrative costs, including higher IT and communication expenses. These expenses grew 8% YoY.

These factors were partly offset by last year's extraordinary payment for our collective bargaining agreement with unions and also due to the establishment of non-credit related contingency provisions established in the 2Q14.

As shown on the blue line to the right, we presented an efficiency ratio this quarter of 41%. The green line presents an adjusted efficiency level of 44% under a normalized inflationary scenario of 3%. However, we believe that our strict cost control policies together with our productivity improvements should continue to provide us with first-rate efficiency levels that stand out when compared to the banking industry as a whole.

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**Please turn to slide number 19.**

As represented by the blue line, Banco de Chile continues to lead in profitability with a 26.2% ROAE compared to the 18.1% presented by the industry this second quarter.

On the bottom right you can see our Operating Margin, net of risk, where we maintain a significant gap with peers. This quarter we present a 6.5% Net Operating Margin versus the industry's 5.7%. On the left you can see that our performance compared to the industry in terms of efficiency has significantly improved over the past years,

moving from almost 49% in 2009 to 41.3% this quarter, whereas the industry has slowly been increasing their cost to income ratio in the same time period reaching above 45% this quarter.

The large gap in all of these indicators versus our peers has been made possible due to the quality of our earnings, which is supported by a focused and consistent business strategy together with solid corporate governance practices. This has led us to consistently take greater advantage of new opportunities and once again break records and post the highest net income figure in our history.

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For the second half of the year it is important to keep in mind that the economy continues to present weak indicators, which have gradually decreased growth expectations for 2015 and have kept confidence levels low. However, we are confident that these factors can be overcome if we continue to apply our consistent strategy and assertive risk management, in particular the capacity to identify business opportunities like our recent loan acquisition. These actions are proof of our unique skills and capacities, which allow us to look at the future with confidence, despite a weaker economic context.

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**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.**