Banco de Chile 2Q17
Financial Results Conference Call

Operator

Good morning everyone, and welcome to Banco de Chile's second Quarter 2017 results conference call. If you need a copy of the press release issued on Monday, it is available on the company's website.

Today with us we have Mr. Rodrigo Aravena, Chief Economist and Senior VP of Institutional Relations, Mr. Pablo Mejia, Head of Investor Relations and Daniel Galarce, Head of Financial Control.

Before we begin, I would like to remind you that this call is being recorded, and that information discussed today may include forward-looking statements regarding the company's financial and operating performance. All projections are subject to risks and uncertainties, and actual results may differ materially. Please refer to the detailed note in the Company's press release regarding forward-looking statements.

I will now turn the call over to Mr. Rodrigo Aravena. Please go ahead.

Rodrigo Aravena

Good morning everyone and thanks for joining us today on our conference call for the 2Q17 results. To begin I'll present some comments regarding the macro environment in Chile and the results of the banking industry. Pablo will review our second quarter results and our strategic progress.

Please turn to slide number 3.

In line with previous conference calls, the Chilean economy continues to face a negative economic cycle. GDP has persistently grown below Chile's potential long-term capacity. Specifically, in 1Q17 the economy rose a weak 0.1%, the lowest expansion since 2009. However, as we highlighted in the prior conference call, the key reason for this number was the strike in Escondida (the biggest copper mine in Chile), which was a temporary factor. On the other hand, several figures have been suggesting that the economy is slowly recovering. In particular, monthly GDP went up 0.1% and 1.3% in April and May, but its sequential monthly growth rose to 0.5% and 0.9% in the first two months of this quarter, after posting reductions in February and March.

It is important to mention that there are differences in the dynamism between different economic sectors. On the negative side, mining production fell by 6.1% and manufacturing production grew 0.9% in June. On the other hand, retail sales posted a strong 5.5% rise, while new car sales grew an impressive 16%. All in all, we think these figures confirm that private consumption continues to support GDP expansion.

In the labour market, the unemployment rate has continued to rise, as we mentioned in previous calls. In June, it went up to 7.0%, 20 bps higher when compared to the rate recorded one year ago. More importantly, the quality of jobs continues deteriorating, as self-employment was the main driver behind the increase in total employment. In fact, it grew 3.8%, while salaried employment rose only 1.2%. We have been observing this trend since early 2016.

Additionally, June surprised the market with an important reduction of 0.4% in monthly inflation, which led annual inflation rate to 1.7% (from 2.6% in May). CPI has remained under the Central Bank target (which is 3.0%) since October of last year and even Core CPI is below the lower bound of the Central Bank range, which is 2.0%. The main driver behind lower inflationary pressures has been the decline in tradable inflation (it posted 1.7% in

May), as the exchange rate has remained stable since the end of 2016. However, it is important to mention that lower inflation has led to an increase in the real wage bill, providing additional support to the private consumption growth.

Lower inflation has also contributed to the Central Bank to conduct a more expansionary monetary. This year, the Central Bank has cut the interest rate by 100 bps. The last reduction was in May, a decision that was accompanied with a neutral bias in the press release of the meeting. In the last monetary Policy Report released in June, the Central Bank expected the below trend growth to remain at least until 2018, while the interest rate would remain unchanged in the next quarters. Nevertheless, lower inflationary pressures together with weak activity, has increased the likelihood of new reductions in the overnight rate.

Now, I'd like to share with you our macroeconomic baseline scenario for 2017 and 2018. Please turn to slide number 4.

We expect the domestic economic growth to improve, led by positive global conditions, copper prices remaining at current levels, a weak currency and a gradual improvement in domestic confidence. In this context, we project the economy to grow around 1.4% this year, which assumes an expansion between 2% and 2.5% in the second half of the year (from 0.1% in the first quarter). For 2018, we are currently expecting a rate of nearly 2.7%.

On prices, we don't see material changes in the inflation rate. We are still expecting a CPI hovering around the current levels, as a consequence of the opposite forces between a below trend growth and a weak currency. We see a CPI inflation of around 2.3% and 2.8% by the end of 2017 and 2018, respectively.

Finally, we expect the Central Bank to reduce the interest rate by 25 bps during the coming months. Therefore, we estimate the overnight rate to be at 2.25% at the end of this year.

Please turn to slide 6.

The banking industry posted once again strong results for the quarter, 7.5% above the figures reported during the same period last year. Thanks to this, return on average equity increased by 23 basis points, from 13.6% to 13.9%.

In terms of the balance sheet, we continued to see weakness in loan growth principally driven by lower demand in the wholesale segment. Commercial loans only grew 2.1% year-on-year in line with Central Bank survey, which reported in the second quarter weaker demand from both large companies and SMEs. Consumer loans also showed less dynamism growing 8%, meanwhile Mortgage loans posted a timid acceleration to 10% yoy during the quarter. This was also in line with the Central Bank survey that reported weaker demand from individuals for these products, along with stricter credit requirements from banks.

In terms of risk, NPLs for consumer loans increased 13 basis points year-on-year, in line with the weaker economic scenario of lower growth and higher unemployment levels. We expect a slight recovery in 2018 when the economy is estimated to improve.

Finally, it is important to mention that the Government announced several changes to the General Banking Law. As expected, proposals were focused on three main aspects: 1.- Higher capital requirements, which aim to converge to Basel III; 2.- The creation of a Financial Market Commission, which is a board composed of 5 members. The Financial Market Commission will include and replace the current role of both superintendencies, this is, Securities and Insurance as well as the banks. 3.- The third area was oriented towards updating requirements of banking resolution.

Once the new General Banking Act is passed by the congress and enacted by the government, there will be some critical aspects to be jointly defined by the financial maket commission and the Chilean Central Bank, such as the risk-weighted factors for assets, methodologies to determine buffers for systemically important banks and countercyclical buffers, among others. So far, however, there is not enough information to provide more precise estimates for new capital ratios and thresholds that will apply to Banco de Chile. In any case, it is worth mentioning that the government's proposal considers a phase-in period for capital adequacy has to be achieved by 2024.

Now I would like to pass the call to Pablo, who will go over the results of Banco de Chile.

Thanks Rodrigo, our results for the 2Q17 have been outstanding. In the next slides we will go over these results and the progress that has been made toward achieving our strategic objectives. Please turn to slide number 8.

Despite the persistent weak economic environment, we ended the quarter with a strong bottom line of $160 billion pesos, equal to an ROE of 22%, up 6% from the same period last year and 14% from the prior quarter. I think it's also important to note the consistency of our profitability over the quarters that has ranged within our guidance and that this quarter in particular is one of the best in terms of net income in our history, ranking us first amongst our peers in terms of net income and ROE. I would also like to highlight that these figures have been recorded in a scenario of lower inflation, demonstrating our ability to cope with a less favourable environment and maintain a solid top line based on strong customer income and cost control initiatives that are paying off.

Please turn to the next slide, number 9.

This successful track record has been a result of our customer centric strategy that focuses on delivering sustainable and profitable growth by promoting greater penetration in the retail segment, strengthening customer experience, improving digital contact channels and making greater use of business intelligence tools. This is being done with continual improvements in productivity while taking appropriate levels of risk for the returns that we aspire.

Please turn to the next slide, number 10.

Increasing share of wallet in the retail segment has been our focus in recent years and it continues to be one of our main strategic goals. We have consistently reached attractive growth rates in this segment in both loans and deposits balances, as well as current account holders. Along these lines, we are steadily increasing our customer base, as you can see on the chart on the left, by 6.4% year-on-year, outperforming by a large margin all of our peers, and providing the foundation for our future growth by means of increasing cross-sales and up-sales. Additionally, we have been able to gain deep customer insight, which has permitted us to grow steadily with no significant changes in asset quality.

In this manner, loan growth was led by the retail segment, increasing by 9% year-on-year, as described on the chart on the right. Within retail, SME commercial loans were the fastest growing product while loans to individuals grew almost 8% year-on-year thanks to continued positive growth levels in the mortgage loan book. Regarding SMEs, we keep on promoting long-term relationships by accompanying customers along their life cycle. Accordingly, we expect to continue taking advantage of the dynamism of this segment while maintaining a favourable risk return equation. In addition, we expect that the dynamism of mortgage loans should continue decreasing marginally and stabilize around 5% in real terms for us and the industry by the end of the year. On the other hand, consumer loans have grown 2.7% year-on-year due to weaker demand fostered by the economic deceleration and our aim to maintain good asset quality indicators. As such, our expansion has been centered in middle and upper income segments, which has grown slightly above 4% year-on-year. Despite the riskier environment, we were able to achieve these growth levels through our solid business initiatives, for example our loyalty programs, new personalized pricing model, preapproved customer database that promotes higher productivity from our account managers, among others. In terms of wholesale loans, this segment continued showing weakness, decreasing 2.5% year-on-year due to the sluggish investment that has reduced demand for loans from larger companies.

We expect that as long as the economy improves, we should see a rebound in commercial loan growth from this segment, given a scenario of historically low interest rates and controlled inflation that should promote new projects.

In terms of funding, we continue to lead the industry with the lowest cost of funds in local currency, thanks to our solid deposit base, particularly in demand deposit accounts. Through excellent service quality, improved attrition levels and important increases in product usage rates, our customers prefer Banco de Chile to other banks when saving their funds. This has resulted in important increases in DDAs from individuals of 8.2% year-on-year and in turn, total Core Deposits grew by a similar level of 8.3% year-on-year.

Please turn to the next slide, number 11.

Operating income came in at $448 billion this quarter, down 6% year-on-year on an unadjusted basis. However, when adjusting for a one-time sale of AFS instruments which occurred during the 2Q16, recurrent operating income was up 8% from a year earlier, thanks to robust growth in customer income.

As you can see on the charts, we achieved a noteworthy year-on-year increase in Customer income from both the retail and the wholesale segments, which grew by 8.1% and 6.7%, respectively. These figures clearly demonstrate the results of our efforts in improving our spreads across all business segments, up 16 basis points year-on-year, which more than offset lower inflation income and supported net interest income growth of 6% on an annual basis, well above the level of loan growth reported for the period.

Fee income was also an important factor driving operating income growth. Fees were up 9.8% year-on-year, chiefly due to higher net revenues from transactional products because of greater cross-selling and a growing customer base due to effective commercial strategies that pursue to increase penetration of high income individuals. Also, fee income from credit cards has benefited from an improved loyalty program that has introduced new alliances that appeal to our customers. In addition, this quarter was particularly favourable for our subsidiaries, which reached an important increase in fees related to stock brokerage and mutual fund management. Our subsidiaries have been able to take advantage of the positive figures displayed by the local stock market this year, as well as a low interest rate scenario that leads investors to seek more attractive opportunities. To a lesser degree, our insurance brokerage subsidiary has also contributed to increase our fee income.

These positive effects were offset by lower non-customer income, which decreased almost 32% year-on-year, but as I mentioned earlier, this reduction is largely explained by an extraordinary recognition of revenues from the sale of AFS securities in the 2Q16 amounting to Ch$60.2 billion. This was partially compensated by higher revenues generated by a positive effect of CVA on derivative positions, more convenient funding due to a larger capital base and a positive impact of repricing generated by reductions in the overnight rate.

Before moving on to the next slide, I believe it’s important to mention that our long-term business strategy and the progress that we have made in our key strategic projects has permitted us to keep a sustainable and consistent growth level in customer revenues. While this progress has eased a bit due to the lower dynamism of the economy, which has reduce the growth from interest income and fees, particularly from our corporate clients, we have managed to support operating income by improving lending spreads.

Undoubtedly, the strong trend shown by our customer income has been the consequence of a strategy aimed at strengthening customer experience, improving digital contact channels and taking more advantage of business intelligence tools. Please turn to slide 13.

As mentioned, during the last two years we have entered into new alliances with different airlines such as British Airways, Delta, Iberia and Sky, which further expands the benefits we provide customers through our loyalty programs when they use our credit cards. In addition to generate further fee income by increasing usage rates, these improvements have enabled us to attract new customers, reduce attrition and boost revolving credit on our cards while strengthening relationships.

We are also convinced that the banking model is changing. Branches are being used less than before. This has driven us to streamline our branch network, optimize how we offer services, and invest in remote banking platforms. In this context, we have achieved significant progress over the years, launching world-class apps, a new online banking platform for individuals and we have been recognized for these achievements by prestigious publications and locally when banking customers are asked to rank their favourite mobile banking apps. We are also currently redesigning our company online banking platform, which we hope to launch by the end of this year and we are expanding the functionalities of our mobile apps. These and other technological initiatives are critical to keep our solid track record and success in the future.

Business intelligence is another very important tool that has improved several key commercial activities while keeping risk at market-leading levels. We have developed a personalized pricing platform in loan interest rates for retail customers, used public and internal information to make a large database of potential customers and uploaded this information to the cloud. This allows our account managers to gain remote access to this information from a smart phone, supporting sales activities. We have also implemented intelligent follow-up and monitoring practices to reduce attrition and increase share of wallet with customer.

We are also making progress in implementing our new CRM platform that is being built in-house, taking advantage of the knowhow and the deep customer knowledge we have gained over the past. The new platform will be used by all commercial segments, from Corporate to consumer banking, providing a complete on-line 360 degree view of our customers. This is our most important project in progress and we are confident that it will allow us to offer a better and faster service to our customers by delivering new functionalities, independence and business management tools for our front office over the next years.

I've only mentioned a few projects that we are developing that should help to reduce lead times, increase automation and maintain better relationships with customers that when combined should translate into important revenue growth. Nevertheless, some of these initiatives are already paying off as it can be seen in our high and leading net promoter score, which evaluates net recommendation from customers. In June we reached 73%, a level that gives us an ample gap with our competitors and helps us to also maintain our leading attrition indicators.

Additionally, we are convinced that we must continue optimizing and streamlining processes in order to improve productivity in both front office and back office activities. These initiatives have permitted us to show improvements in operating expenses, as described on the following slide, number 15.

Total operating expenses decreased 4% year-on-year, allowing us to reach an efficiency ratio of 44%, a very notable level. Specifically, personnel expenses grew only by 0.8%, due to higher salaries in line with inflation and greater severance indemnities. These were partially offset by lower headcount as well as lower bonuses related to do a non-recurrent charge of $2.7 billion in the 2Q16, as a result of a special bonus granted to the staff of one of our subsidiaries for the completion of the collective bargaining process. On the other hand, administration and other expenses decreased 8.7% YoY largely owed to the establishment of a non-credit related allowances posted in 2Q16.

Our commitment to operational excellence and productivity are completely in line with our customer experience goals. This means that the strategic projects we are undertaking to control costs better, improve contact channels and optimize our branch network are being implemented with the customer in mind in order to avoid affecting service quality standards. The first results of the actions that we took in order to improve efficiency can be seen in the reduction in head count and branches, as well as improvements in productivity figures. More importantly, these changes have been implemented without affecting our net promoter score, as I mentioned earlier in the presentation. Going forward, we are confident that our permanent focus on cost control and ongoing commercial and operational initiatives will continue boosting productivity and customer service, resulting in better efficiency and lower attrition levels.

Regarding cost control, we have also implemented diverse initiatives for specific line items such as travelling expenses, paperwork, office supplies and communications. In addition, we have begun an in-depth analysis to identify sources of cost saving that should not only translate into lower expenses in the short-term but also promote a corporate culture oriented to productivity and efficiency.

Along these lines, risk management has been one of the main pillars of our success. Thanks to this long-term sustainable risk management approach, we have consistently posted outstanding performance throughout the years and this period is no different, as described on slide 17.

In this persistent challenging environment, we recorded another quarter of low levels of loan loss provisions reaching only $62 billion and a LLP ratio of merely 0.98%, both figures well below those posted last year.

As you can see, loan loss provisions decreased sharply over the same period last year. This reduction was principally due to $52.1 billion of additional allowances booked in 2Q16, partially offset by an increase in provisions owed to slight deterioration, loan growth as well as mix effect. It's important to note that last year represents a low basis of comparison. Actually, in the 2Q16 we released allowances for commercial loans due chiefly to an upgrade of one corporate customer, while our risk expenses also benefited from regulatory changes related to a decrease in credit exposure factors for contingent loans.

It's always important to highlight that a key part of our proven capability of managing risk is the high involvement of the board and upper management in risk decisions. We have weekly risk committees with active involvement of directors. This permits our board to have greater information about the risks and challenges we are facing and allows us to make better decisions. Also, we invest substantial human and financial resources to develop strong credit acceptance, collections, and monitoring practices. This allows us to identify risks more easily before they surge and implement adjustments to minimize our exposures.

Please turn to the next slide, number 18.

Before we move on to questions, I would just like to go over a few key ideas that we mentioned in this call.

The results of the first semester were outstanding in all areas. Growth in customer revenue, lower costs and limited risk levels were critical to achieve our high net income figure and ROE of 21.7%, once again leading the industry in net income for the quarter and year-to-date. In our view, this achievement demonstrates that the alignment with a consistent strategy pays off in the long-term.

Our good levels of efficiency and controlled operating expenses reflect the efforts and emphasis that we have put forth on improving productivity across all areas of the bank. More importantly, this has been done in a manner that has not affect customer experience-as we continue to lead the industry in service quality.

Finally, the Chilean economy has presented some signs of improvement, suggesting the inflection point was the first quarter of this year. We firmly believe that the competitive advantages and robust long-term customer centric strategy of Banco de Chile will permit us to take greater advantage of this more positive cycle and support our market leading profitability level.

Thank you for listening and if you have any questions we would be happy to answer them.

Q&A Session

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