Comments on the 2Q13 Financial Results

Banco de Chile

Good afternoon. It's a pleasure for me to share with you our comments on Banco de Chile's second 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.** During this call we will discuss the 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 an overview of the recent developments in the macroeconomic environment. After three years of strong growth of around 6% per year, the Chilean economy has showed signs of a deceleration in activity during the first semester of this year, posting a GDP growth of about 4.0% YoY. This downward trend has been widely expected by the market due to a slowdown that has been seen in emerging economies, a weak recovery in developed nations and a local aggregate demand that has leveled off to a more sustainable long-term rate.

This decrease in economic activity has been mainly due to a contraction in investment, boosted among other factors by a drop in corporate confidence due to lower commodities prices, higher operational costs and a more cautious outlook regarding the social and political scenario. Private consumption has also decelerated, but more gradually, in line with the persistent positive fundamentals for Chilean households.

As a result, the outlook for GDP growth for 2013 decreased, from 5.0% in March, to 4.4% according to latest estimates. Despite the reduction, this figure implies an improvement in GDP during the coming quarters. The more optimistic view for the rest of the year is based on a persistent low unemployment rate which maintains a positive consumer confidence, relatively flexible conditions in the banking system and the positive effect from a more optimistic outlook in developed economies.

Regarding inflation, at the end of the second quarter, CPI began an upward trend posting a 12-month increase of 1.9% in June 2013 approaching the Central Bank target range and more in line with historical rates. In fact, the most recent forecast suggests CPI variation may total 2.4% at the end of the year, according to the last expectation survey of the Central Bank.

As for monetary policy, the Central Bank has kept the policy rate at 5.0% since January 2012 due to a solid performance in the economy and anchored inflation expectations. However, it's worth mentioning that the current deceleration in the activity has increased the probability for a downward adjustment in the policy rate in the coming months, an option that was confirmed by the Central Bank during its last monetary policy meeting, where they pointed out that a further deterioration in GDP growth would require a more expansionary monetary policy.

Please turn to slide number four to review the Chilean banking industry's main figures. In terms of total loans, volatility continued. After a moderate increase of 1.5% in 1Q13, total loans grew 3.2% during the 2Q despite a less dynamic scenario. However, on a yearly basis, total loans continued to slow down from previous quarters but still with double digit growth rates in all major product lines, reflecting the resilience of credit demand of corporations and individuals.

In terms of results, net income during the second quarter recorded an increase of 6% compared to the same quarter last year, mainly due to an increase in operational income that more than offset the lower inflation figures, higher loan loss provisions, operational expenses and the rise in the corporate tax rate.

Consequently, the Chilean banking industry posted a ROAE of 13.9% in 2Q13, which translates into 121 basis point reduction compared with 2Q12 figures, due mainly to a stronger capital base. It's also worth mentioning that we are expecting an upward trend in inflation for the remainder of the year and consequently an improvement in net income for the industry.

On the next slide**, number five,** is a snapshot of Banco de Chile's main Income Statement figures. As can be seen, operating revenues increased 8% over the same period last year and 2% over the prior quarter.

On the following slide, **number six,** is a breakdown of Operating Revenues. Customer revenues, which comprise of interest income from loans, deposits and net fee income, grew 9% over the same period last year and 3% over the first quarter. This trend continues to be driven by a proactive management of lending spreads, growth in loans… especially retail loans…, growth in non-interest bearing deposits and, to a lesser extent, higher fee based income. All these factors have been obtained through a sound commercial strategy that has focused efforts in strengthening areas which are more profitable while maintaining an adequate risk-return relationship in our loan book.

On the other hand, **non-customer revenues**, which are mainly composed of income from the contribution we generate by managing the Bank's term and currency mismatches on our balance sheet as well as trading activities, remained relatively flat over the same period last year and the prior quarter. This result occurred despite the lower contribution from our net asset position indexed to the UF, as this currency recorded a variation of -0.07% as compared to the positive variations recorded in the other periods. Additionally, during the quarter we recorded an initial charge of Ch$8 billion related to the adoption of counterparty value adjustment for our position in derivatives. On the contrary, this charge was more than offset by the positive effect on the hedge we manage in US$ dollar indexed loan loss provisions amounting to roughly Ch$5 billion, the positive one time effect of the sale of Master Card shares for Ch$4.8 billion and other trading gains of about Ch$5 billion.

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 we continued to expand our retail book in line with our long-term business strategy, which focuses on profitable growth. In turn, our total loan book expanded 6% year-on-year, while our retail book, where we have focused our efforts to grow, expanded 12% during the same period with a focus in SMEs, mortgage and middle income consumer loans.

This focus has resulted in a gradual change in mix of our loan portfolio, as our total loans granted to SMEs grew well above the average of the total loan book by recording an annual expansion of 14%, reflecting the Bank's consistent focus on this segment. This strong growth has been achieved through our solid commercial platform consisting of around 150 nationwide branches with specialized SME account managers, improved loyalty programs and enhancements in the incentive structures in order to better align branch managers' targets with the corporations strategy. Also, we have been very proactive in taking advantage of government-backed guarantees for SMEs which are lower risk and represent an important portion of the flow of new loans into the bank as well as the volume we manage.

In terms of consumer loans to individuals, these represent roughly 15% of our total loan portfolio and have grown at a pace of 10% year-on-year reaching a market share of 21.7%.

If we break this figure down further, one can see that Credichile, which is our area for loans to lower income individuals, has grown at a slower pace of 3% year-over-year. The lower growth in this product is mainly due to our more prudent risk measurers, which are in line with the less dynamic economic environment and due to the wave of regulations which were passed during the last couple of years and a few are still being discussed.

As for our traditional banking area, this area grew 12% over last year, with a focus in gaining customers in the middle income segment. One of our strategies has been to get customers to use our products more frequently through improved services and benefits on cards. The effect of this is that customers begin to use us as their primary bank. This in turn moves us into a more strategic position to target higher quality and less risky customers through pre-approved loans which is an important percentage of loan growth in this segment. . In terms of product mix, we have significantly increased credit card loans by 17% year-over-year and to a lesser degree installment consumer loans by 12% year-over-year.

In terms of mortgage loans, we continue to show attractive growth rates of 13% year-on-year reaching a market share of 17.4%. In recent months, this product continues to grow strongly but at a slower pace principally because we are reaching a level that is more in line with our overall market share. In addition, we have also adjusted pricing in order to reflect new market realities and have increased customer requirements in terms of loan to value. Nevertheless, we plan to continue growing mortgage loans as it is a great product in retaining customers and provide opportunities for cross-selling.

Overall, during the last 12 months we have increased the retail segment mix from 48% to 51% of our total loan portfolio and we will continue growing in the future given the positive outlook in consumption fundamentals and private and public policies oriented to strengthen entrepreneurship through the creation of new SMEs.

In terms of our wholesale segment, loans have grown only 1% year-on-year. This lower pace in growth is the result of our strategy to focus our efforts on more profitable customers which provide higher operating margins and higher cross-sell opportunities in our wholesale segment. As such, loans to Large Companies with sales between US$3 million and US$140 million have grown 13% year-on-year, while our Corporate Banking book which services customers with sales above US$140 million has decreased by 10% year-on-year. Nevertheless, we have increased our operating margin in the Corporate book by almost 10 basis points when comparing the first semester of 2013 with the same period last year, clearly demonstrating our strategy to improve profitability and avoid growing for the sake of market share gains.

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

Similar to previous quarters, we have continued to increase non-interest bearing deposits in the bank from both individuals and companies. Individuals' current account balances have increased by 9% year-on-year while companies have increased 4% year-on-year. These increases has been the driving force that has permitted us to improve our funding from non-interest bearing deposits, representing 24.2% of total funding at the end of the quarter, 22 basis points higher than the same period last year.

It's also worth mentioning that we have continued our strategy of diversifying our funding base this quarter by issuing US$635 million in bonds in the Swiss market at historically low spreads for a non-government foreign corporation. Additionally, this focus has allowed us to increase the proportion of funding from bonds by 230 bp over the last year, representing today 15.9% of total funding.

As you can see on the bottom right, we continue to lead the industry with the lowest cost of funding of only 2.9% due to our strong reputation, first-rate credit rating and leading market position in current account deposits where our total market share is 24% and more importantly above 30% in individuals.

Please turn to slide nine. As you can see provision expenses have grown 8% quarter-on-quarter and 7% year-on-year. On the other hand, operating expenses have grown more moderately, posting an increase of less than 1% when compared to both periods.

On the next slide, **number ten**, is a breakdown of loan loss provisions by segment. As can be observed on the chart on the left, Retail LLPs have remained relatively stable decreasing by $4 billion quarter-on-quarter and increasing $3 billion year-on-year. The year-on-year growth in retail provisions is simply due to our double digit growth rates in these loans. It's also important to mention that this modest increase is the result of solid risk management practices, together with prudent acceptance criteria which has permitted us to grow at these levels while maintaining stable credit risk figures.

On the other hand, Wholesale LLPs reached $6 billion this quarter which demonstrates our excellent asset quality in this portfolio. Moreover, the charge in provisions is mostly due to the effect of the depreciation of the Chilean peso on our provisions denominated in US$ which are related to our foreign currency loans. As a result, we recorded a charge of $5 billion pesos due to this effect, and as mentioned earlier, the results associated with that hedge are reflected by an equal offsetting amount in operating income.

As for our overall credit risk indicators, as shown on the table on the right, we have continued to record strong asset quality during this quarter. Actually, our ratio of loan loss provisions to average loans remained flat year-on-year despite the effect of exchange rates on provisions. This stable behaviour was also seen on our past-due loans ratio, allowance for loan losses and our coverage ratio.

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

As demonstrated by the chart on the right, our operating expenses have trended flat over the last five quarters, incurring expenses of about Ch$150 billion per quarter. This was accomplished by controlling personnel expenses closely together with strict policies as well as moderate growth in business activity which have maintained administrative expense growth low.

I should also mention that we are also seeing the fruits of our investments in terms of economies of scale 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, our cost control strategy and economies of scale have permitted us to post the best efficiency ratio among our peers during the quarter of only 43.7%, substantially below 2012 figures.

Please turn to slide twelve.

The result of our excellent commercial initiatives together with prudent risk policies and cost control have permitted us to post very positive figures during this quarter despite the negative inflation which impacted figures for all banks in Chile. The latter is especially noteworthy when we take into consideration that the second quarter of 2013 was almost 50 basis points lower in inflation and even with that, we posted net income before tax that was 18% higher than last year.

It's important to note that our effective tax rate was also higher this quarter when compared to last year due to the change in the corporate tax rate that went from 18.5% to 20% and due to lower inflation in the quarter which affects taxable net income.

Despite these factors, we still had an excellent quarter in terms of net income after taxes which reached $122 billion during the quarter, slightly higher quarter-on-quarter and 14% higher than the same period last year.

Saying that, I'll pass the call over to Pedro Samhan who will go over the next slide, **number thirteen**.

Thank you Pablo.

The following charts summarize our successful financial performance and benchmark the Bank to our peers.

First of all, as shown by the chart on the upper left, our net operating margin, measured as operating income, net of credit charges, over average interest earning assets, reached 5.3% at the end of the quarter, far above all of our competition. This figure is even more impressive if we consider that we are a bank that still has room to continue growing in the retail segment which is significantly more profitable than the wholesale segment.

In terms of Operating Expenses, we became for the first time in our history the bank with the best cost-to-income ratio among our peers, posting a figure of 43.9% for the first semester of 2013. As mentioned by Pablo earlier in the presentation, this ratio has been achieved through the gradual introduction of a cost control culture that aligns incentives with corporate goals as well as diverse projects and initiatives that aim to improve productivity in our commercial and back office areas. We are very proud that we have been able to post these figures and we are confident that in the mid-term we can continue to improve.

As a result of our excellent operating margin, net of risk, and our cost to income ratio, we have posted a very large gap in our favour, as compared to our competitors in both return on average equity and return on average assets as you can see on both of the charts at the bottom of this slide.

Taken together, these indicators clearly demonstrate our capacity to effectively implement our business strategy by growing our retail portfolio, increasing profitability of our wholesale segment, controlling operating expenses effectively and maintaining a prudent risk approach.

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