Banco de Chile: Comments on the Third Quarter 2015 Financial Results

Good afternoon, it is a pleasure for me to share with you our comments on Banco de Chile’s third 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 3Q15 results.

Please turn to slide number 3 for the economic highlights.
After a disappointing 1.9% growth in 2014, the Chilean economy continues to show weak performance according to latest data releases. As top-left chart indicates, the Central Bank foresees a 2015 GDP growth between 2 and 2.5%, but the September drop in economic activity, -1% MoM seasonally-adjusted, suggests that even the 2% threshold will be more challenging to reach. Official estimates for 2016, according to market consensus point towards a GDP growth of around 2.5%.

The sluggish GDP growth seen since 2014 has been explained by an important drop in investment, which, in turn, has been driven by domestic and international factors. As the top-right chart shows, the global slowdown mainly induced by China has been affecting all commodity exporters. In Chile, particularly, lower copper prices—which account for nearly half of Chile’s exports—have dragged investment down in mining-related sectors, decreased government revenues, and depreciated in an important manner the local currency against the dollar as the bottom-left panel shows.

Slower growth from trade partners explain only part of the below trend growth of the Chilean economy. Several domestic factors such as subdued consumer and business confidence and the recent slowdown in real wage bill have also contributed to the weak performance in domestic demand.

Please turn to slide number 4.

Since a large portion of goods that are included in the CPI basket are imported, inflation has remained above the Central Bank's 4% tolerance ceiling as a result of the peso slump. This inflationary scenario, as the top-left chart shows, is expected to slowly disappear towards the end of 2016 as oil prices remain low and the local labor market starts to deteriorate.

Even though the economy is growing slowly, both the persistent records of high inflation and a slight increase of two-year-ahead inflation expectations led the Central Bank to increase its monetary policy rate in 25 basis points during its last meeting as shown on the top-right chart. Such a move was expected by the majority of analysts, as the Chilean Central Bank signaled its intention of beginning the tightening cycle before the end of this year. The press release that accompanied the decision suggested that the future path of the monetary policy rate will depend on the evolution of the macro scenario. According to the Central Bank's expectation survey, market analysts expect further rate hikes in the next quarters, reaching around 3.75% in 2016.

As it is the case of monetary policy, fiscal policy will also be tighter in 2016. The Finance Ministry announced a 4.4% annual real increase in the fiscal spending in 2016, falling from an expected 8.8% rise this year. This decision followed a reduction in Chile's long run potential GDP- which went from 4.3% last year to 3.6%- and the intention of reducing the structural balance. However, the deficit is still expected to be roughly 3% of GDP in such year, as a consequence of lower copper prices.

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

Loan growth for the industry was 6% real YoY in the 3Q15, still low for past figures but the highest we´ve seen since 2Q14. The main reason for this slow growth continues to be the weak economic activity, low levels of confidence and high uncertainty in line with the quarterly survey on bank credit conducted by the Central Bank. In the survey, on average, banks reported becoming stricter in terms of their credit risk acceptance criteria in all segments and customers show weaker demand on most product families with the exception of mortgage loans and commercial loans for SMEs.

In line with this demand and despite stricter acceptance criteria, mortgage loans continue to be the main driver for growth, increasing 10.5% YoY, based on high demand from expectations regarding the effect of the tax reform on property prices and the low rate scenario.

Secondly, commercial loans have recorded a 4.8% YoY expansion, which is due in part to the effect of the weaker peso exchange rate on dollar denominated loans and good growth from SME customers.

Finally, consumer loans grew 2.9% real YoY, a slight decrease from the 3.6% YoY growth presented last quarter and the same period last year, in line with the credit survey.

In terms of results, the banking industry posted a net income of $546 billion pesos, about 20% below 3Q14 results. This decrease is mainly explained by an important increase in provision for loan losses, and a lesser extent, to an increase in operating expenses due to the effect of past inflation on salaries and the impact of the depreciating peso on administrative expenses.

Finally, in terms of ROAE the industry reached a figure of 15%, versus 20% posted the same period last year and 18% recorded during the prior quarter, reflecting the lower dynamism in the economy.

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

Our six main strategic objectives define our medium and long term goals and serve as guidelines for new projects and initiatives across our entire organization.

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

Please turn to slide number 9, where we discuss our advances for first and second strategic objectives.

As you can see, we have picked up considerable loan growth this quarter thanks to our effective commercial strategy, which targets the most attractive markets and segments while maintaining a good risk/return relationship.

As detailed on the table on the left, overall loan growth was 12.3% YoY and 6% QoQ. We achieved this thanks to strong growth in the retail and wholesale products, which was further enhanced by the acquisition of a loan portfolio from a local bank for approximately $564 billion, which represents just below 3% of loans outstanding. Due to our scale we were able to close the deal in record time. Also as mentioned in the last call:

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

Additionally, since most of these debtors are our customers, the additional operational costs of incorporating the portfolio were minimal.

Since 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.

In terms of the retail segment, mortgage, commercial loans for SMEs, and consumer loans for middle and upper income individuals had great dynamism during the quarter, growing YoY 17%, 14% and 12%, respectively. These rates have been achieved by better understanding our customer's specific needs at each stage of their life cycle and providing the best possible service. At the forefront of this strategy are new developments in business intelligence tools, which allow us to get to know our customers on a more personal level and to select the best channel to offer our products and services, at the right price and time.

Additionally, we have put greater emphasis on digital channels that have allowed us to drive online sales up to record levels. In line with this initiative, an important part of all preapproved consumer loans are sold online, which have increased 30% when compared last year. This effort in providing a better experience for customers has also been reflected in launching various innovations during prior quarters, for both Banco de Chile and CrediChile remote banking platforms such as new mobile apps. This growth in the upper income and SME segments not only allows us to grow interest income but also help drive non-interest income revenues from fee based products, as you will see later in the presentation.

Regarding our CrediChile consumer loans, these have decreased 1.3%, in line with our lower risk appetite for this segment due to the weak economic environment and stricter regulations that have been implemented and affect the fundamentals of this business unit.

The wholesale segment, on the other hand, increased 12% YoY and 6% QoQ, due in part by the loan portfolio we purchased amounting to approximately $564 billion pesos and also to good loan growth in other commercial loans, which is a result of business decisions implemented to grow selectively in trade finance and other wholesale loans with low risk and high cross sell potential, thus reinforcing our business relationships and fee income.

Looking forward, we believe that strong competition from banks, continued weak economic figures and growing uncertainty in emerging markets limits possibilities of strong demand, which is the main reason that our loan growth should slow down in the coming quarters to levels more in line with the industry average.

Please turn to slide number 10.

On the left, you can see that our net promoter score that measures customer recommendation has continued its positive trend, reaching 71.4% this quarter. This is a clear reflection of the results of customer satisfaction initiatives that we have introduced, such as our customer experience project, workshops in specific branches throughout the country and defining and following up quality measures.

In order to achieve our organizational objectives, we believe that we must have a clear integration of our goals with those of our employees. In line with this, we seek to enhance the skills of our employees, hence enabling them to deliver the best service and, consequently, complement their careers. So, we are pleased to share with you the results of our most recent climate survey, achieving 87% for total workplace satisfaction, which took into consideration climate, commitment, culture and overall satisfaction. These scores have been achieved through diverse programs and benefits that we have provided in order to offer a great work environment and the opportunity to grow within the company, as you can see on the slide. Through these workshops and training courses we have been able to improve employee satisfaction and offer better service quality, while giving individuals new skills to become more self-reliant and productive.

These results challenge us to keep working hard to continue improving these levels and further provide our workforce with the tools they need to achieve our corporate goals.

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

On slide number 12 we present the quarterly results for Banco de Chile.

Banco de Chile presented a bottom line of $134 billion pesos. This figure is lower than the prior quarter mainly because additional provisions of $31 billion pesos were established in September, which we will discuss in more detail further on in the presentation. Excluding additional provisions, Net Income would have reached a level around $158 billion, implying an ROAE for the quarter of 24%, and in line with the prior quarter.

Please turn to slide number 13 on Operating Income.

Operating income for the 3Q15 was $432 billion pesos, thanks to good growth figures accompanied by higher than normal inflation. As you can see on the left, despite a weaker economy, core revenues from customers show a stable YoY and QoQ growth. Specifically, we posted $305 billion of customer income during the third quarter of 2015, which is 3% above the same period last year and 2% above the prior quarter. These figures are primarily a result of good loan growth and a pick-up in fee income.

If we look at the red line on spreads on the chart to the right, net interest income from customers has decreased from 4.4% in the 3Q14 to 3.9% this quarter. First, it is important to mention that last year we recognized a higher margin of approximately 20 bps due to a large one-time loan prepayment from a corporate customer. This variation is also due to a change in mix, since we have been growing fundamentally in mortgage loans, consumer loans to upper income individuals and commercial loans. This change in mix is further intensified by the large commercial loan portfolio purchased in the 3Q, which had attractive spreads for the wholesale segment but are lower than the average spread of the overall loan book. Finally, other factors that have had an impact on profitability include higher competition in a market with low growth. Nevertheless, it's important to point out the excellent evolution of our fee income, which has remained stable as a percentage of average loans at 1.3%, as you can see represented by the green line, despite the very strong growth experienced this quarter in loans.

In terms of non-customer income, we recorded $127 billion pesos this quarter, more than a 40% increase over last year and a 7% increase over the prior quarter, which is also shown in the purple line on the chart on the right. As a reminder, non-customer income includes proceeds from the contribution of the UF GAP position and other treasury activities. The strong YoY increase reflects mainly the important benefit we receive from our structural GAP in UF, the positive FX effect from US dollars that hedge allowances denominated in this currency due to the strong depreciation of the Chilean peso this quarter, lower charges related to CVA for derivatives due to lower risk premiums and a sale of a loan portfolio this quarter.

Please turn to slide number 14, on Fees.

As mentioned in the previous slide, fee income has been growing in line with loan growth. Fees grew 17% when compared to the same period last year and 5% when compared to the prior quarter. Despite the fact that this quarter had a couple of one-timers that drove fee income to be higher than normal, I would like to concentrate on the quality of our fee income generating capacity.

Thanks to our leading position in customers in the upper income segment and our ability to be the primary bank account for most of our retail and wholesale customers, we have developed an outstanding capacity to generate consistent and stable net fee income. As you can see on the chart on the right, net fees are mainly generated from our retail division and subsidiaries, which are mostly retail related. These two segments represent 84% of our total fee income while the remaining 16% is generated from our corporate wholesale customers.

This mix provides us with a superior position versus our peers in this source of revenue. If we breakdown fee income from subsidiaries, the main business segments that generate fees are our mutual fund business where we are leaders in Chile with a market share of over 20% in AUM, and our insurance brokerage unit. As a result, this provides us with more stable and recurrent fee income.

Please turn to slide number 15, on Loan Loss Provisions.

A strong, deeply-rooted risk culture is a core aspect of our risk management approach at Banco de Chile. In view of this, we maintain a solid track record of managing risk achieved by strict and prudent risk policies and meticulously monitoring risk factors that can impair our loan portfolio. These firm policies ensure that our credit exposures are adequately provisioned and well collateralized. Additionally, we have a very rigorous and effective collection process.

This quarter, loan loss provisions increased almost 70% over the same quarter last year. However, it's very important to understand that the greater part of this increase was not due to deterioration but to other factors, including:

- First, as shown on the chart on the left, we recorded additional provisions amounting to about $31 billion pesos during the quarter. These provisions were made in view of the slowdown in the local economy and expectations over the next quarters. It is important to note that these allowances do not relate to any specific customer or industry sector, but instead to an overall outlook on the evolution of the economy.

- Second, in line with our business strategy, loans have been growing 12% year-on-year. As a result, the effect of greater loan volumes in LLP was equivalent to Ch$7.0 billion when compared to the same period in 2014.

- Third, a net effect of Ch$2 billion due to exchange rate shifts affecting our US$-denominated allowances for loan losses.

- Lastly, a net deterioration of Ch$3 billion mainly due to two specific customers in our wholesale book, which is partially offset by the good payment behavior of our retail banking customers.

The effectiveness of our credit risk management is clearly demonstrated in our LLP and coverage ratios. Taking these factors into account, we posted LLP ratio this quarter of 1.78%. However, if this figure is adjusted for additional provisions, we would have presented a figure of around 1.25%, which would be even further reduced if we exclude the other effects previously mentioned.

In terms of our coverage ratio, we maintain the highest ratio amongst our closest competitors with a multiple of 1.8 times. This ratio is further increased when we take into consideration additional provisions. Our excellent figures have been achieved through our credit risk management philosophy. These beliefs drive us to have a constant and deep presence throughout the entire credit cycle including approval, granting, monitoring and collections, in order to consistently reduce risk and improve the return to our shareholders.

Please turn to slide number 16 on Operating Expenses.

As you can see on the chart on the left, operating expenses have increased 11% YoY. This is mainly due to:

1. The effect of high inflation on salaries, as they are adjusted twice a year for inflation, and administrative expenses as these are also indexed to inflation. This explains nearly half of the increase while the rest is explained by real wage growth, based on merit, together with benefits associated to the last bargaining process and a slight rise in head count.
2. Higher country risk provisions which are expected to decrease as certain cross-border loans expire during the year.
3. And higher advertising expenses in light of recent campaigns we have carried out as a result of the new Delta Airlines strategic alliance and to reinforce our brand name.

In summary, it´s important to highlight that our cost base has increased because of specific issues, including inflation and country risk expenses. Excluding these factors, expenses on a recurring basis have only grown 1-2% real annually, which is below our loan growth.

In terms of efficiency, our ratio remained flat as compared to last year at 43% and compares favorably to our main peers at 45.2%. Year to date we continue to show positive levels with 43.7%.

Please turn to slide number 17.

The results achieved this year have shown Banco de Chile´s great capacity to adapt to the weaker economic scenario by using competitive advantages and specific skills to maintain a leading position and high ROEs. Thanks to our prudent risk management, consistent strategy and strong customer base, we have been able to preserve a stable risk-return relationship, identify important business opportunities, make important progress in digital innovation, and continue deepening the relationship with our customers.

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.