

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

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

Please turn to slide number two. Similar to other calls, we will start with a discussion on the macro environment in Chile followed by a review of the results of the banking industry and end with an analysis of Banco de Chile's strategy and 1Q15 results.

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

After a disappointing 1.9% GDP growth rate in 2014, there is a wide consensus that the Chilean economic activity will show a modest rebound in 2015. Current figures exhibit mixed trends: on one hand the labor market remains solid, exports thrive and both fiscal and monetary policies are expansionary. On the other hand, however, private investment is still struggling, consumer confidence has not recovered and inflation remains high.

In effect, the monthly indicator of economic activity (IMACEC) on the top left shows an upward sloping trend that began during the last quarter of 2014. The sectorial breakdown of this indicator, nonetheless, reveals mixed results. The soundness of the labor market—where the unemployment rate stays at 6.1% and nominal wages grow above 7% in annual terms—has shored up retail sales that currently grow around 3% on a yearly basis. This soundness, however, does not translate into durable consumption: car sales, for instance, are shrinking at annual rates of roughly 30%.

This outlook confirms the scenario revealed by the last release of national accounts data corresponding to 4Q14, where investment continued to drag down domestic demand and the currency depreciation helped boost exports, as you can see in the lower left chart.

Please continue to slide number four.

As you can see on the upper left hand chart, both headline and core measures of annual inflation have remained above the Central Bank's target ceiling of 4% for roughly a year now. The narrow slackness of the labor market and the sizeable currency depreciation have increased the CPI and the core measures noticeably. Even though international energy prices have fallen in recent months, and therefore headline inflation has decreased marginally, core measures are still high. In particular, the price index of non-tradable goods grew above 5% on a yearly basis, which implies that regardless of the currency depreciation, output and labor market gaps are lower than anticipated, a fact that has recently been acknowledged by the president of the Central Bank.

Even though inflation expectations on a two-year horizon are well anchored at the policy target of 3%, the Central Bank signaled a possible monetary policy rate hike towards the end of 2015 during the release of the last monetary policy report at the end of March. This is partly explained by the persistent current inflation, but such an announcement also paves the way to avoid further currency depreciations once the Fed starts normalizing its monetary policy.

The graph on the bottom left shows how the exchange rate weakened for the most part of 2014 and beginning of 2015. This can be attributed to several factors such as the stronger multilateral dollar, the path of domestic monetary policy shown on the top right, and lower copper prices. The Chilean peso has depreciated 17% since the end of 2013 and 1.5% since the end of 2014 to April 20th of this year.

Public finances remain strong. According to official figures, in 2014 there was a fiscal deficit equivalent to 1.6% of GDP, slightly below the official estimate released in October 2014. The breakdown shows that this decrease was due to the weak 1.5% increase in fiscal revenues, led in turn by the 8.2% real annual contraction in copper revenues.

On the other hand, fiscal spending rose 6.5% as a consequence of the 7.4% increase in its capital component. The structural balance of the central government, however, was only -0.5% of GDP and total fiscal savings represented 12.9% of GDP, suggesting that Chile still has enough room to implement countercyclical policies.

Regarding overall prospects for 2015, there is a broad consensus that economic growth will improve this year. Private forecasters gathered by Consensus Forecast point toward a 2.9% GDP expansion and the survey conducted by the Central Bank indicates a 2.8% growth. This is consistent with the Central Bank forecast, which shows that GDP would expand between 2.5% and 3.5% in 2015. These estimates suggest that Chile will grow below its potential, even though we are starting to see a discussion regarding the exact magnitude of the local GDP growth potential, where the official figure is 4.3% annually.

As a wrap up for this section, let us mention the main factors underlying the economic recovery and the risks faced by the Chilean economy. The key factors include the lagged effect from interest rate cuts that are still in historically low levels, the positive contribution of net exports due to the weaker currency, the expansionary fiscal policy, and the robustness of the labor market. Regarding downside risks, either an additional slowdown from China, or a faster-than-anticipated monetary policy tightening in the US will certainly induce an ensuing adjustment in the outlook we have presented.

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

On this slide we can see loan growth by product for the industry and also accumulated net income to March since 2012.

The weaker dynamism in real loan growth in 2014 has continued this quarter, with total loans growing only 4% YoY. Mortgage loans are the exception, growing at a solid

10% real YoY. Growth in consumer and, particularly, commercial loans has been decreasing steadily, in line with the weaker economy that has seen a strong drop in both investment and consumption levels reflecting the current negative business and consumer confidence.

In line with this economic context and lower inflation, net income as of March reached \$466 billion pesos, compared to the \$595 billion to the same date last year. The 22% decrease is mainly associated with the strong drop in inflation, which went from 1.3% to 0% variation in UF to March of each year. This variation affected operating income negatively and the high accumulated inflation during the last year affected expenses, since most of these are indexed to inflation.

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

In order to concentrate our efforts and accomplish our medium and long-term goals we have defined strategic objectives, which are listed here. These are used as guidelines for our business strategy and, consequently, for the initiatives we undertake to create significant economic value for all of our stakeholders.

This first quarter we continue to make progress in each one of these objectives, particularly in leading the retail and wholesale business through a focused commercial strategy and also by diversifying our funding structure. We have also made important developments in service quality and in building social reputation.

Over the next few slides, we will share with you our progress in the three strategic pillars listed on the left, beginning with our growth in the retail and wholesale business.

Please turn to slide number 9.

Our commercial policies, which combine our business goals with a suitable risk-return relationship, are targeted towards the most attractive markets and segments. This approach has enabled us to outperform the industry and key competitors in profitability ratios, amongst other indicators. Our achievements can also be attributed to the importance we place on commercial initiatives in the retail segment. Our objective is to grow by continuously developing and improving a global offering of products and services that provide considerable added value to the final customer.

As shown on the left, overall loan growth was 4.4% YoY. Despite this low figure, it's important to point out that this growth was driven by our effective business strategies to continue deepening our penetration in attractive areas of the retail segment. As such, the retail segment grew almost 10% YoY with important increases in key products. In turn, mortgage loans grew 12% YoY, followed by consumer middle and upper income individuals which grew 10% YoY and SMEs, which increased 7% YoY.

These rates have been achieved by understanding our clients specific needs at each stage of their lives and also by our continuous efforts to implement new and better initiatives that are based on providing the best possible service. At the forefront of this strategy are the new developments in business intelligence tools, which allow us to get to know our customers on a more personal level. This permits us 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 by more than 200% over the past two years. Along with this initiative, almost 70% of all preapproved consumer loans are sold online, which has doubled when compared to the pre implementation of this sales strategy. This effort in providing a better experience for customers has also been reflected in various innovations during 2014, for both Banco de Chile and CrediChile remote banking platforms. As a result, Banco de Chile was recognized as "Best Place to Innovate".

Regarding our CrediChile consumer loans, these expanded a modest 1.2%, which is in line with the information presented by the Central Bank survey on loans concerning the lower demand seen on behalf of households for these loans. This, together with the fact that most banks including Banco de Chile, have begun reducing their risk appetite for this segment due to the weak economic environment and stricter regulations that have recently been implemented and affect the fundamentals of this business unit.

The wholesale segment, on the other hand, decreased 1% YoY, due partly to a high comparison base related to short term loans which we granted at the end of 2013 and also to the economic reasons mentioned previously, which have had an important impact on investment and consumption during 2014. This has led to a weak demand from customers and high competition to capture these loans by banks. As such, we have taken an approach of maintaining an adequate risk return relationship, allowing unprofitable deals to pass when they fail to meet this criteria.

A recovery in the economy will allow these numbers to grow as uncertainty lessens and confidence rises. Nevertheless, it's important to mention that we continue to and have historically led the wholesale business, evidenced not only by our market share in commercial loan products but also the quality of our customers and services.

Please turn to slide number 10.

As we have mentioned in previous calls, our funding strategy is based on improving our liability structure by moving towards more diversified financing sources, such as retail deposits and bonds.

First, you can see that we have increased demand deposits by 7% YoY. This growth was driven by a strong increase of 15% YoY in retail deposits. This not only means that we have obtained more stable deposits but is also evidence that our customer relationship strategy has had a positive impact by becoming our clients primary bank.

Time deposits, on the other hand, have decreased 7% YoY, while debt issued has increased by 12% in the same time frame, which is also in line with our approach to increase the duration of our liabilities.

On the bottom, you can see how our deposits from retail and wholesale are significantly more important than institutional funding. Retail represents over 45% of total deposits, which includes both current account and time deposits, while Institutionals represents around 15% of total deposits. This is especially important when taking into consideration that in the medium term Chilean banks will have to comply with stricter liquidity requirements. Finally, it is important to point out that today we have a more diversified fixed income investor base, where 26% of our total bonds have been placed in foreign markets. This strategy has helped us to open new markets and reduce our exposure to local insitutionals.

On slide number 11, we present Service Quality.

Here we would like to show how Banco de Chile has increased both its Net Promoter Score, on the left, and Customer Satisfaction, on the right, over the past 3 years thanks to our customer centric business strategy and our consistent efforts in improving our service quality.

Recently, we have also initiated a customer experience project that concentrates on giving clients an improved experience when interacting with us through different contact channels and while using our products or services. We anticipate that by taking these additional steps to establish deeper emotional bonds with our customers, we can improve loyalty and retention as well as continue to increase various customer satisfaction indicators.

Today, as you can see, our net promoter score is over 69%, a considerable increase from the 60% presented in 2012. Customer satisfaction has also seen an important increase in the call center, account managers and mobile channels.

We believe that by having a commercial focus that puts our customers as first priority allows us to understand them better in order to give them the best and most personalized service possible. Accomplishing this, we gain more satisfied and loyal customers who will be more likely to take on additional products with the bank.

On slide number 12 we present our commitment towards a better and more developed Chile.

Banco de Chile has consistently shown a strong social commitment with Chile through initiatives focused on health, education and entrepreneurship, among others. Additionally, Banco de Chile has also collaborated with important organizations during natural disasters in order to help those most in need. For Chile, 2015 so far has had a few of these events, the most important being the floods in the North during March, which left many families in vulnerable conditions. Through the organization “Desafío Levantemos Chile”, we have been able to help and provide aid to those who are suffering the most in these areas.

In terms of international relationships and development, Banco de Chile is a sponsor for this year’s Universal Expo in Milan, an opportunity to share new technologies, innovations, art and architecture with other countries over a 6 month period. The theme for this expo is Food and Natural Resources, in order to work towards solving the worlds current food crisis and future supply of crops.

We choose to become a part of these projects, among many others, because of our great commitment to Chile and to its wellbeing. Both of these initiatives reflect the importance we give to social responsibility, which is one of our main pillars and principles mentioned earlier in the presentation.

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

On slide number 14 we present the quarterly results for Banco de Chile.

For the first quarter of this year, Banco de Chile presented a healthy bottom line of \$117 billion pesos. This figure is much lower than prior quarters, as we discussed in the previous call, but it's also very important to establish the current context since it was obtained in an environment of 0% inflation, which means a 1.3% reduction from the UF variation presented last year. Under normalized annual inflation of 3.0%, or 0.75% per quarter, this number would have reached an estimated \$144 billion, which is very much in line with our results in recent quarters.

Please turn to slide number 15, on Operating Income.

Operating income for the 1Q15 was \$381 billion pesos and has been separated into customer and non-customer income. This reveals that core revenues from customers have maintained solid despite the slowdown in the economy and changes in inflation since the first quarter of 2014, among other external factors.

In this first quarter, customer income represents \$297 billion and non-customer income accounts for the remaining \$84 billion, which includes income from the contribution of the UF GAP position and other treasury activities. As you can see in the chart, non-customer income has decreased 70% from the 1Q14 and 40% since last quarter, reflecting the important difference in inflation between these quarters.

On the right, the blue line representing the total operating income margin shows a decrease consistent with the lower non-customer income, which is denoted by the purple line. Otherwise, we can see that interest income from customers and fee income remain stable. A marginal improvement in spreads, favorable change in mix, and demand deposit volumes have compensated lower margins from these deposits and negative regulatory impacts.

The solid performance in customer revenues demonstrates the resilience of the business model of Banco de Chile, even in a weak economy and highly competitive environment.

Please turn to slide number 16 on Loan Loss Provisions.

Loan loss provisions have decreased 14% over the past year, thanks to our continued prudent risk policies, characterized by strict acceptance criteria, strong follow up protocols and effective collections processes.

As you can see on the chart on the right, commercial loan loss provisions decreased \$16 billion pesos thanks to the good behavior from our wholesale and SME customers. About Ch\$5 billion resulted from a certain substandard loan's payments, which released provision charges. The remaining portion is due stable and no deterioration in our customer risk profiles.

In relation to our personal banking products, consumer loan loss provisions increased Ch\$5 billion YoY. This increase involved mixed trends in personal banking. On the one hand, loan loss provisions in the higher and middle income segment increased due to both loan book expansion of 9.8% YoY and a tempered deterioration in asset quality, which is reflected by higher delinquency rates in our consumer loans. On the other hand, risk expenses related to our consumer finance division —targeting the lower income segment— decreased over the same period, reflecting the positive effects of our strategy of contained growth on asset quality. Lastly, loans loss provisions associated with mortgage loans grew modestly Ch\$600 million during the same period in spite of the 12.1% YoY increase in volume.

We believe that the weaker economy is driving this modest increase in retail loan loss provisions but this has not yet been reflected in the labor market, since we continue to see good levels of employment as mentioned earlier in the presentation.

Please turn to slide number 17 on Operating Expenses.

As you can see on the graph on the left, operating expenses have increased 12% YoY mainly due to:

1. The full effect of the 2014 inflation, which reached 5.6% variation of the UF. This has a direct impact since salaries are adjusted twice a year for inflation and administrative expenses as these are also indexed to inflation.
2. Additionally, this quarter we introduced changes in the structure of our branch network, in order to improve various aspects regarding new challenges facing the banking business. This resulted in higher severance payments of \$3.2 billion pesos.
3. An increase of 3.3% in administrative expenses, attributable to higher IT expenses related to internal developments aimed at enhancing IT platforms and also higher expenses associated with our branch network, including rentals and maintenance.
4. Similar to inflation, the large increase in the exchange rate also had an effect on some of our expenses denominated in dollars, which includes principally IT related items.
5. And finally, to a lesser extent, increases in real wages and benefits as a result of the Collective Bargaining Agreements, which took place with our unions in 2014.

In terms of efficiency, we reached a level of 47% versus 39% reported the same period last year. This large difference is due to the high inflation we experienced last year, which affected our top line positively during that quarter, and also the nil inflation for this quarter. Under a normalized annual inflation rate of 3%, efficiency during the 1Q15 would have been 44%, which is completely in line with our expectations.

Please turn to slide number 18, which shows our ROAE compared to peers.

Banco de Chile continues to lead in profitability when compared to our main competitors, using figures reported by SBIF. This 1Q15 presented a ROAE of 18.4%, well above the 13.2% presented by the industry.

On the bottom right we show our performance compared to main peers in terms of Net Operating Margin, where we have maintained a steady leadership position. On the left, you can see our that our efficiency ratio has improved over time and has maintained lower levels than our competitors since 2012.

These results reflect the competitive advantages we have highlighted throughout the presentation, including a solid, consistent strategy, complemented by a proven ability to execute and adapt to the continuous changes in the business environment.

Before taking questions I would like to close by highlighting that this quarter has been excellent for us considering the environment of diverse negative external factors, including a 0% inflation rate, weaker economy, and slower demand on behalf of companies, SMEs and households for loans. We have been able to partially offset these factors with our effective retail focused strategy, prudent risk management, and the capacity to adapt to new and challenging environments.

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.