Banco de Chile: Comments on the Second Quarter 2014 Financial Results

Good morning. It's a pleasure for me to share with you our comments on Banco de Chile's second quarter 2014 financial results.

Please turn to slide number two. To begin, we will discuss the developments in the Economic Environment, the results of the banking industry followed by a review of Banco de Chile's results.

Please turn to slide number three which contains the economic highlights.
Looking back at the first quarter, Chile posted a weak 2.6% annual GDP expansion after recording a 2.7% growth in the previous quarter. As a result, the activity has grown at a slower pace since the 4Q13. Following the trend seen in previous quarters, the slowdown was led mainly by the 5% annual contraction in Gross Fixed Investment which followed the 12.3% contraction in the previous quarter. This is a consequence of the very weak growth in Machinery and Equipment investment. On the other hand, private consumption posted a healthy 3.7% growth, due partly to tight labor conditions given that the unemployment rate was 6.4% in the moving quarter ending in May. The good news, however, is the reduction in the current account deficit, as a consequence of both lower investment and import growth. Particularly, the deficit decreased to 1.2% of GDP in 1Q14, reducing the 12 month rolling deficit to 3.1%from 3.4% in 2013.

Several recent figures suggest that this below trend growth will remain until the 3Q14, as some leading indicators -such as consumer and business confidence- have continued to be subdued. However, we expect the recent weakness in the exchange rate and delayed effects of the expansionary monetary policy to lead a recovery as of the 4Q14. In this context, we expect economic growth to increase from 2.6% this year to a range between 3.5% and 4.0% in 2015.

It is also worth mentioning that the GDP breakdown is changing. Particularly, the recovery of key tradable sectors -such as mining and manufacturing- suggest that the local economic growth is being led by the improvement in net exports, partially offsetting the slowdown in sectors closely related to private demand, such as construction. Private investment remains weak although the recovery in the margin of capital goods imports suggest that gross investment won´t be falling further. On the other hand, lower real wage bill growth and the slowdown in waged employment indicate that a moderate deceleration in private consumption is likely, **as demonstrated on the following slide, number 4.**

In terms of inflation, there was a sharp increase in the annual rate, from 3.0% in January to 4.3% in June. This is highly attributable to the sharp depreciation of the Chilean peso observed exchange rate, which has decreased7.2% this year and 11.8% since October of last year. However, we expect inflation to converge to the 3.0% target in the first half of 2015, as several core inflation measures and expectations have remained passive and the economy has grown below its long term expected growth.

In this context, the Central Bank resumed the easing cycle in July, by reducing the interest rate 25 basis points to 3.75%, after consecutive cuts that totaled 100 basis points between October and March. This can be seen in the upper left graph. We believe that further rate cuts are likely since the central bank maintained the easing bias in the press release which was published after the meeting.

Regarding fiscal policy, the National Budget Office updated its macroeconomic scenario for this year. In particular, it is important to mention that the government reduced the GDP growth estimate for this year to 3.2%, which is substantially below the 4.9% expansion considered in the original budget, resulting in an upward revision of the expected fiscal deficit for this year to 2.0% of GDP from the previous 1.3% estimate.

On the political front, there have been important steps taken in the tax reform discussion. Representatives from both the government coalition and opposition signed a preliminary agreement with several modifications to the original proposal. Today, the proposal has two alternative systems for companies to choose from: The first is the original proposal, which considers an increase of the corporate tax to 25% and preserves the accrual system, whereas the second mechanism removes the accrual basis but considers a higher corporate tax hike to 27%. It is important to highlight that in both cases the government removed the 10% additional withholding tax. Further details will be discussed in the senate which will probably be focused on measures oriented to mitigate negative impacts over small and medium companies. Additionally, the official deadline for the bills approval in congress is before the end of September, which is when the fiscal budget has to be submitted. It is worth remembering that the tax reform aims to increase fiscal revenues by 3.0% of GDP in the long term, in order to finance the educational reform and other social plans. Other potential measures to be discussed in the short term include the changes to the consumer protection agency, new liquidity regulations for banks, changes to the constitution and educational reform, among others.

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

In line with the recent economic figures, the Chilean banking system in terms of loan growth has begun to show signs of deceleration due to more moderate demand coupled with stricter acceptance criteria from banks. During the 12 month period ending May 31, 2014, total loans grew 5.2% in real terms and when compared to the prior quarter, loans grew less that 1%. This is mainly due to weaker growth in commercial and consumer loans. Mortgage loans, however, remained strong, increasing over 9% year-on-year.

In terms of earnings, the banking industry posted excellent results thanks to the high inflation experienced during the first five months of the year, benefits from funding repricing and term gapping and loan growth expansion. As a result, net income grew 61% over last year and return-on-average equity reached 19.3%.

And now I will pass the call on to Pablo, who will speak to you about this quarter's results.

On the next slide**, number six,** is a snapshot of Banco de Chile's main income statement figures. To begin, operating income increased in the second quarter of 2014 by 20% when compared to the same period last year. This strong year-on-year increase was due to a variety of factors which will be explained on the following slides.

Please turn to slide, **number seven.**

On this slide, we present a breakdown of operating revenues which is composed of interest income from loans and deposits, fees and non-customer income which is mainly related to income from activities such as funding and gapping, trading and available for sale securities.

Similar to what occurred in the first quarter of 2014, part of the increase in operating income in the second quarter of 2014 was attributable to non-customer income, particularly to the management of our UF structural GAP, as inflation was up 1.8% this quarter versus deflation of 0.1% recorded a year earlier. Also, but to a lesser degree, the increase in net interest income was due to the average volume growth of our loan portfolio which grew 8% year-on-year with stable lending spreads and our ability to maintain the contribution coming from DDAs almost flat despite the strong decrease in the overnight rate by successfully growing average volumes of DDAs by 14% year on year.

Additionally, income was further enhanced by effective treasury activities which improved funding as a result of repricing of short-term liabilities in line with the decrease in the overnight rate and a more steeply sloped yield curve which allowed us to benefit from term gapping.

These positive effects allowed us to deal with negative exchange rate effect on operating revenues of roughly $5 billion, given by a high basis for comparison in the 2Q13.

In addition to this, fees continue to be under pressure this quarter. The main elements that explain this year-on-year decrease are:

- First, the recent regulation that obligates the refund of insurance premiums in the case of early termination of insurance policies which began in December 2013, and
- Second, lower business activity that translates into lower credit card and stock brokerage fees

Net/Net, this has resulted in an improved operating margin this quarter reaching 7.0%, or 76 basis points above the same period last year.

Moving on, **slide number eight** is a review of our loan portfolio by segment.

Even though loans have shown a 7% growth over the past 12 months, they have begun to show clear signs of deceleration. When we compare the second quarter to the first quarter of 2014, loan volumes have remained relatively flat during the first half of 2014, consistent with the less dynamic Chilean economy as illustrated by the recent results of the Monthly Business Confidence Indicator, IMCE, which as of June reached levels that placed overall business expectations at pessimistic levels. This negative outlook has led to decreases in demand from both individuals and companies, and has taken us to implement stricter credit acceptance criteria.

In terms of year-on-year figures, the retail segment continues to drive loan growth with an increase of 12%, substantially above the 3% rise in the wholesale portfolio. This growth was primarily from mortgage loans and consumer loans in the middle and upper segments which continued their strong growth trend, posting an increase of 15% and 12%, respectively. SME commercial loans have also contributed to growth, posting an attractive year-on-year increase of 9%. We are achieving these figures, especially in consumer loans, by better using business intelligence tools and improving effectiveness of all sales channels, in particular online, along with other initiatives. On the other hand, the lower income segment remained flat year-on-year and the growth in our wholesale portfolio continued weak, growing only 2.4% year-on-year, in line with the sharp contraction of investment economic figures.

On slide **number nine**, we show a breakdown of our funding structure. First, thanks to the important effort realized in increasing and diversifying our funding base, we were recognized in May by MTN-I, a database platform that is recognised by market leaders as the most relevant source of new issue information and longer term trend analysis of the MTN market. This magazine distinguished Banco de Chile as the "2013 Rising Star", based on our successful cross-regional funding diversification. This was a result of the relevant rise in international debt placements over the past couple of years which continued in the second quarter of 2014, placing bonds in Japan and in Hong Kong for over US$120 million dollars with terms of 8 years and 6 years, respectively. As you can see on the left chart, debt issued has increased by 363 bp year-on-year, representing 19% of total liabilities as of June 2014.

It's worth mentioning that these bond issuances contribute to increasing the duration of our liabilities and have allowed us to replace less stable time deposit funding from institutional customers, thus improving our liquidity.

This growth in debt issued at first-rate spreads together with our leadership position in DDAs, which represent 24% of liabilities, have translated into generating a cost of funds ratio of only 4.0%, significantly below the average of the system which reached 4.4% as of May. Also, on the chart on the right, we compare the cost of funding in time deposits by currency, which we believe is a good indicator for comparison purposes, due to the fact that they are more similar in terms of duration than other liabilities. As you can clearly see, we continue to excel our main peers in funding in Pesos, UF and Foreign Currencies. Also it's important to mention that Banco de Chile has one of the lowest concentrations in funding from AFPs and Mutual funds, representing only around 13% of this source of funds.

Please turn to the next slide, **number ten.**

As shown on the chart on the left, loan loss provisions have grown 34% from $54 billion pesos in the 2Q13 to $72 billion pesos in 2Q14. However, it's important to note that part of this increase is due to factors which are not related to loan deterioration:

- First, under our prudent risk criteria, we established Ch$10 billion in countercyclical provisions, increasing our total balance to almost Ch$120 billion, or roughly 20% of last year's net income. It's also worth mentioning that these allowances don't relate to any specific customer or industry sector, but instead are intended to be used during negative economic cycles.

- Second, there was an increase in provisions for loan losses due to the expansion of our loan book that was mainly focused in retail loans, growing 12% on average over the same period last year versus our wholesale book that grew only 5% year-on-year in average balances. This expansion of our loan book explains approximately $6 billion pesos in higher loan loss provisions, and

- Finally, as explained earlier, the strong 8% depreciation of the Chilean peso relative to the US$ in 2Q13, increased our comparison base by Ch$5 billion because of certain loan loss allowances denominated in US$. Chilean peso depreciation was only 0.6% in the 2Q13.

In terms of credit deterioration, we recorded about Ch$7 billion in provisions for loan losses that was concentrated in wholesale banking. This was associated with one specific wholesale customer in the period. Unlike the previous quarter, loan loss provisions for retail banking remained stable -just under 2% as a percentage of total loans- thanks to measures we took in order to control our risk exposure in this segment.

Before moving on, I want to emphasize that we are confident in maintaining our good risk indicators thanks to the high involvement of the board of directors and upper management in the preservation of strong credit acceptance, collections, and monitoring practices at Banco de Chile, as well as the important human and financial resources allocated for this purpose. This has, on average over the last 10 years, allowed us to consistently post loan loss provision figures that are around 0.3% below the industry average, translating into a significant benefit for Banco de Chile.

Please turn to slide **number 11** for an overview of our operating expenses.

As you can see on the chart on the left, our operating expenses have grown 13% over the last 12 months. The main drivers for this increase are mainly due to:

- A 12% growth in personnel expenses, which is mainly explained by three factors:
    1. an adjustment in salaries which are linked to inflation,
    2. a slight increment in headcount, and
    3. higher expenses related to non-recurrent bonuses and variable compensation associated with commercial campaigns.

    It's important to mention that during this quarter, we successfully renegotiated a collective bargaining agreement with one of our unions, which represents approximately 7% of the total labor force. This implied a one-time expense equal to $4.2 billion for bonuses to these workers.

- Administrative and other expenses recorded a rise of 13% as compared to this same quarter last year, which is mainly due to a rise in expense provisions and to a lesser degree a 3% rise in IT and other general administrative expenses related to our branch network.

Overall, this has been a positive quarter in terms of efficiency, reaching a level of 41.3%, consistent with our past efficiency levels. This compares favorably to the 43.7% recorded a year earlier and the 43.7% posted by our peers in the first two months of the 2Q14. Although the improvement this quarter is chiefly explained by the excellent results in operating revenues, we believe that our strict cost control policies together with our productivity improvements should continue to provide us with first-rate efficiency levels that standout when compared to the banking industry as a whole.

Please turn to slide 12.

Looking back on the first half of this year, it is important to note that we have achieved excellent overall results despite the slowing economic cycle. For the second quarter in a row, we have surpassed the Ch$150 billion barrier in net income, a 26% increase when compared to the same period last year. I can also highlight that our ROAE is outstanding at 26% for this quarter and our efficiency continues to outperform our peers.

Additionally, selective loan growth and forward-looking decisions in asset and liabilities management boosted our operating revenues by 20% year on year, which was reinforced by a significant contribution of our UF net asset exposure and gains from funding and gapping. We have combined these achievements with improvements in business intelligence, operational risk management and efficiency. These elements should provide us with long-term competitive advantages that are particularly valuable for the challenging business environment ahead, especially for the coming quarters in which we will face an environment with lower inflation, partially affecting our results.

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.