Banco de Chile 2Q21 Financial Results

Conference Call

Operator

Good afternoon everyone, and welcome to Banco de Chile's second quarter 2021 results conference call. If you need a copy of the press release issued yesterday, it is available on the company's website.

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

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 afternoon everyone. Thanks for attending this conference call today, where we will discuss the financial earnings posted by Banco de Chile during the second quarter. As we have made in previous calls, we will share a presentation divided into three parts: first, an analysis of the economic and financial environment, followed by a review of the main advances in our key strategic initiatives, and finally a review of our outstanding results achieved during this period.

I will start with the macro discussion, and then Pablo Mejia, our Head of Investor Relations, will continue with an analysis of the Bank. Please move to the slide number 3.

Generally, the Chilean economy has had a positive trend, outperforming the expectations held at the beginning of this year. All the charts presented in this slide show the significant improvement observed in the activity and, to a lesser extent, in the labor market.

Specifically, as you can see in the figure on the upper left, growth has posted an impressive pick up during this year. In the second quarter, the monthly GDP expanded by 17.4% YoY, after increasing by 0.3% YoY in the previous period. On a broad sense, this positive trend can be attributable to the joint contribution of three main factors: First, very strong economic policies adopted since the beginning of the pandemic, which has positioned Chile as one of the most active countries not only in the region but also in the world. Second, a temporary impact from the three partial withdrawals from pension funds, which have increased private consumption. Third, the improvement in external factors, such as higher copper prices and the acceleration in key trade partners. I'll refer to these factors later in this presentation.

Additionally, it is relevant to be aware that the annual growth rate increased even more due to the weak comparison base from one year ago when the activity plummeted more than 40% on a sequential basis. This means that the two digits growth rate will not last for a long period of time.

As a consequence of the faster growth, activity has reached its pre pandemic level. Several figures suggest that GDP has been led by the surge in consumption (retail sales and durable goods rose by 61% and 126% respectively in June), allowing the commerce sector to be 26% above the pre-pandemic level. On the other hand, services remain subdued since they haven't recovered their pre-covid levels. Overall, it is worth mentioning that Chile was the first Latin American country to recover all the production lost during the pandemic.

In line with the robust growth, the CPI has shown a steady rise, a trend that is reflected in the upper right chart. In June, the headline inflation rose to 3.8% YoY. All the different core measures have followed a similar trajectory: the core CPI, which is the index that excludes energy and food prices, rose 3.1% YoY, achieving the highest rate since 2016. As a result of these trends, the Central Bank began a tightening cycle in the Monetary Policy meeting held in July, when it increased the interest rate by 25 bps, to 0.75%. According to the press release of the meeting, further adjustments in the near future are likely. Prices continued increasing in July, since the annual inflation rate rose to 4.5%, while the core CPI increased to 3.6%, the highest figure since mid-2016. These figures, that were released this morning, confirm the material increase in inflationary pressures in the Chilean economy.

In this environment, long term interest rates have been increasing, as the chart in the bottom left clearly shows. This trend can be explained by several cyclical factors, including the upward trend in global rates, expectations for higher monetary policy rates and inflationary pressures. This is also explained by some structural changes in the Chilean economy, such as the increasing supply of bonds (due the higher fiscal deficit) coupled with the decreasing demand for bonds due to the pension funds withdrawals. The new structure of interest rates in Chile also have several impacts for available for sale financial instruments that affect comprehensive income for banks. Since we have been aware about inflationary risks and their potential impacts on interest rates, we have avoided taking risk in our financial portfolio, especially in available for sale instruments, given its negative impact in the economic value of shareholders equity. We will go over these aspects in more detail later in this presentation.

The labor market has also posted a positive trend, although at a slower pace. In June, the unemployment rate fell to 9.5%, following the downward trend that began last year, as the chart in the bottom right shows. The lower unemployment level is explained by the partial recovery in total payrolls, even though it remains below the pre-pandemic number, a similar trend can be seen in the labor force.

Undoubtedly, the strong capacity of recovery shown by the Chilean economy has been a differentiating factor. That's why I'd like to analyze the key drivers that have made possible such speed of growth. Please move to the slide number 4 to discuss them.

Beyond the positive figures that I described in the previous slide, it is essential to identify and understand the critical factors behind this improvement. Generally, we can highlight the following two:

First is the improvement in sanitary conditions. As the chart in the upper left shows, there has been a successful vaccination process as more than 70% of the total population, has been immunized, exceeding any country in Latin America and becoming a reference globally. Thanks to these advances and the restrictions implemented earlier this year, we have seen a substantial drop in active cases of infections, as you can see in the chart on the upper right. In fact, the positivity rate has also fallen to less than 2%, posting the lowest level since the beginning of the pandemic. Undoubtedly, this improvement is a key piece that allows normalization of mobility and activities in the country.

A second element has been the unprecedented fiscal stimulus. According to official estimates, the government has implemented 9% of the GDP in direct transfers and other 9 points in indirect measures, such as capitalizations of Fogape and the unemployment fund. The magnitude of the fiscal stimulus can be seen in the bottom left chart, which shows the strong pick up of the fiscal spending during this year. In fact, the total expenditure of the government will probably increase to around 30% in 2021, after growing by 17% in 2020. Given the size of the fiscal stimulus, it is worth mentioning that Chile had a gross debt of 33% of the GDP last year, well below the average global debt, as seen in the chart on the bottom right. It confirms that Chile could implement such a fiscal response without compromising fiscal sustainability, a situation that has been possible in only a few countries in the world.

Now, I'd like to share with you our baseline scenario for this and the next year. Please go to the next slide, number 5.

Probably, 2021 will be marked by the strong recovery of Chile. We expect the economy to grow by 8.4%, after falling by 5.8% in the last year. Due to this, Chile would be the country with the highest average growth rate between 2020 and 2021, a comparison that the chart of this slide clearly shows. Additionally, as can be seen in the table, GDP growth this year will be driven by a substantial increase in private consumption, followed by a cyclical recovery of investment. For 2022, we foresee slower growth due to the expected normalization of the expansionary policies that were implemented during the pandemic.

We expect an inflation of 4.4% at the end of this year, due to the stronger domestic demand. For next year, however, we forecast an inflation rate of 3.0% with an upward bias. In this environment, we predict that the Central Bank will continue raising the interest rate to 1.5% and 2.75% by the end of this and the following year.

I want to finalize this section by mentioning a couple of risks, which today are more important than ever. One of them is the evolution of the pandemic, especially in terms of the potential impact of new variants.

On the local side, the main risk is the evolution of the political scenario. This year there will be important events, including the presidential and congressional elections in November, the runoff of the presidential race in December, and the exit referendum scheduled for mid-year of 2022, where people will decide to approve or reject the proposal of the new constitution. We acknowledge that unexpected developments in this area could have an important impact in economic perspectives for Chile.

Before moving to the Bank, I'd like to review the main trends in the banking sector. Please move to the slide number 6.

The evolution of the banking industry is a good reflection of the overall economy. In line with the greater dynamism, we have seen a recovery in profitability, although loan growth remains subdued.

Total net income reached $854 billion pesos in the second quarter, 4% below the previous quarter and substantially higher than the same quarter last year. Consequently, profitability reached almost 16%. This positive result was a consequence of the following factors:

First, asset quality remains low. Particularly, the cost of risk posted a ratio of only 0.8%, well below historical levels. NPLs also remained very low at 1.5%, similar to prior quarters. Despite the positive evolution of the economy, we are aware of some temporary factors affecting these measures, such as the higher disposable income, transfers made by the government, and excess liquidity. Hence, the normalization of these ratios in the future is highly likely once financial aids from the government expire.

On the other hand, we continue seeing mixed loan growth trends. As shown on the chart to the left, total loans during the quarter grew by 1.4%, driven by strong mortgage loans growth and partially offset by the contraction in consumer lending. The commercial portfolio activity is consistent with the lagged investment and the higher uncertainty of the economy, while consumer loans were affected by the temporary disposable income and the partial withdrawals from pension funds.

Looking forward, risks will be an important factor to pay attention to, mainly those related to the evolution of the economy and changes in the business environment. Nevertheless, it is worth mentioning the resilience that this industry has shown through the cycles.

After analyzing this improved scenario, I'd like to note that Banco de Chile has continuously improved its competitive position in the country. During the rest of the presentation, Pablo

Mejia, our Head of Investor Relations, will share the main achievements and results posted by our Bank during the quarter.

PABLO MEJIA

Thank you Rodrigo. Please move to slide number 8, to begin our discussion on our main advances in strategic projects.

Over the years, Banco de Chile's proven consistent and long-term strategy has allowed us to post superior profitability for our shareholders. To continue doing so, we continually reinforce three key areas in our strategy which are Digital Transformation, Efficiency and Productivity, and Sustainability. Over the next few slides, we will take a look at the advances we have made during this quarter with regards to these areas.

Please go to slide number 9, where we will highlight some of our initiatives and advances in Digital Banking.

The pandemic has been an important driver for us and the economy as a whole to increase the use of technology in order to reduce the strain that the crisis has had on us as individuals and to our businesses. We have advanced steadily during the pandemic, launching new products that our customers value. In our corporate segment, we recently launched a new app for businesses that has been installed on over 44 thousand smart phones since February 2021.

We are also proud that we are leading the industry in reactivating the economy through the government SME loan guarantee program, Fogape Reactiva, with over 20 thousand loans provided and over half of these loans have been originated 100% online. We also implemented a new feature in our personal banking webpage that allows customers to transfer internationally in different currencies.

In addition, we successfully implemented new innovations to our payment platforms where we have seen hundreds of thousands of transactions of our customers using their smartphones or smart watches to make purchases at businesses. We also reinforced this project by entering into an agreement with Transbank, the main acquiring business in Chile, to accept payments using our Mi Pago mobile app on their POS platforms. We are sure that these projects make a real difference for our customers and strengthen our relationship.

In terms of our advances in our digital account, Cuenta Fan, we continue to see strong growth. We are delighted to share with you that we have more than 500 thousand new customers and that we have seen that our Cuenta Fan customers are actively using our account, not just opening it because it’s free, as we have seen that it has occurred with other competitors. Based on internal studies, our accounts have substantially higher balances than our peers and greater usage levels.

Please turn to slide 10

A key part of our success has been our customer-centric strategy. We continuously strive to improve our operations and we always keep customer experience in mind when developing new products and services. The results of these ambitions are absolutely reflected in many different customer preference indicators, as shown on this slide. We continue to lead the industry in net promoter score, top of mind, and bank preference. We also out ranked all of our peers in other indicators such as the ones shown on the bottom where customers chose us as the bank with the best security and solvency as well as selecting Banco de Chile as the most transparent and reliable. I'd like to highlight that all these measures were released by Adimark and Procalidad, which are leading surveying companies in Chile and that consider representative data of customers from all banks in Chile, reducing potential bias that would appear if we only pooled our customers. By doing so, we can reaffirm that Banco de Chile definitively has the best customer service and net recommendation in the Chilean banking industry.

By focusing on providing customers first class experience, we can gain more loyal customers and higher cross-sell ratios. This is especially relevant in the upper income segment, where we lead the industry. These customers demand more but they also provide higher profitability with very low risk. It's also important to mention that through digital evolution, it's easier for customers to switch banks and it will be even easier in the future as new advancements develop. For this reason, we must be aware of changes and provide continuously improvements to give the highest level of customer experience that our clients require.

Please turn to slide 11

Optimizing and improving our operations is even more relevant today, where the banking industry faces a challenging environment with rising competitive pressures that can have an impact on profitability. In view of this, we have been persistent in our advancements in optimizing our resources, automating processes by leveraging technologies and simplifying procedures. As you can see on the charts on the top, we have seen continuous advances in total expenses to asset, loans to employees and loans per branches.

We are also finishing the implementation of the new service model that includes merging the consumer finance network into Banco de Chile offices, implementing new self-service terminals and adjusting responsibilities of our staff to improve customer experience. This quarter we reduced the size of our network by 35 branches or almost 20% year-on-year. In the last 18 months we have optimized the branch network by 90 branches, reducing the total number of branched to 277, which is lower than our main competitor.

Another relevant change that has accelerated the optimizing of our costs is the creation of the productivity and efficiency division in 2020 that has focused on implementing a cross-enterprise cost management strategy. This area is implementing best market practices throughout the bank to seek incremental savings gains throughout all the procurement value chain.

These initiatives are bearing fruit and we expect that these enhancements on how we run our business should lead to efficiency ratio gains in the medium term, to around 42%.

Please move to slide 12.

Our commitment to sustainability is a relevant part of our strategy. On account of our responsibility to our stakeholders, we are reinforcing our efforts to take our bank to another level of sustainability and in turn increase our long-term value. In this context, during 2021, we developed several initiatives in order to strengthen our relationship with our stakeholders.

One of the hardest hit sectors during this pandemic has been small and medium sized businesses. We are proud that our permanent commitment to entrepreneurship has allowed us to lead and assist many customers to set the stage for a new cycle of growth, granting more than US$1.5 billion in Fogape Reactiva loans since February. Along these lines, in alliance with Digital Country Foundation (Fundación País digital), we presented a technology adoption conference for SMEs to support the digitalization of their businesses. We also implemented free Financial Education courses; donated computers to improve connectivity for hundreds of students; and we launched the “inspiring women” recognition that rewarded women that manage projects with positive impacts for the community. Within the actions related to the environment, we launched a sustainable banking kit for new clients that include biodegradable bags and recycled plastic cards as well as green leasing products that provides special conditions for financing solar projects and electric cars.

In addition, in order to provide our stakeholders with relevant sustainability information, we adopted for the first time the SASB disclosure framework and it is available for your review on our website within the sustainability section. This is another step taken in order to improve, even more, the levels of transparency and quality of information available to the market.

Finally, as a result of our commitment to sustainability that has built a solid corporate reputation, we received recognitions from local and international institutions including The European that recently considered us as the best bank of the year, the most innovative digital bank and the best bank for financial inclusion.

Please turn to slide 14 to begin our discussion on our financial results.

Once again, we have posted strong figures this quarter in terms of loan growth and net income, despite the challenging environment that the pandemic has produced. We are pleased that our customer-centric strategy along with a prudent approach to risk and cost discipline has produced this excellent bottom line of $162 billion pesos, which includes additional provisions by $50 billion in the quarter. This translates into a strong return on average equity of 17%, especially when we consider our solid Tier 1 capital ratio as shown on the chart to the right. Our capital strength undoubtedly allows us to be the bank in the best position to address the Basel III schedule of higher capital requirements.

Please turn to slide 15.

Operating revenues continued showing a recovery, driven by customer income. This confirms that our revenues are generated from more stable sources of lending and fee-based products, which is the core business of a commercial bank. Along these lines, our financial risk and revenues have remained more stable, as our goal is to avoid an excess of volatility in our bottom line and to reduce the risk in the economic value of our capital base, which is relevant since rates are increasing.

Specifically, as can be seen in the chart on the left, operating revenues posted a sequential growth rate of 3.4% over the 1Q21. This was driven by a 3% rise in customer income generated from fees and as well as interest revenues, as broken down on the chart on the top right. Fee income rose thanks to the better economic activity and an economy that has evolved and successfully adapted to the new normal. Despite that we had new lockdowns in 2Q21, we saw strong income generation from transactional products, stock brokerage, mutual funds and wholesale fees. It’s especially relevant to highlight that we have witnessed consistent improvements in fee income generation since the 4Q20, as shown on the chart on the bottom right, posting a 15% increase over the same period last year when we exclude revenues generated from the upfront fee from a joint venture with an international insurance company. Net interest income also rose this quarter versus 1Q21, primarily due to the expansion of both the loan portfolio and non-interest bearing deposits, the latter rising 11% on a sequential basis.

Before moving to the next slide, I want to highlight that we are more optimistic as a result of the recent improvement in sanitary conditions. As the economy continues to open, this should be further reflected in fee income and begin to be reflected in the growth of our portfolio, especially consumer and commercial loans. On the following slides, we will discuss how our portfolio has changed during the quarter and go over the evolution of our asset quality.

Please turn to slide number 16.

Total loans reached $32 trillion pesos this quarter, increasing by 1.6% when compared to the prior quarter, equal to 6.4% on an annualized basis. Year-on-year, the portfolio has grown 5%. Nevertheless, we saw mixed growth trends this quarter.

As you can see on the chart on the right, we gained 85 basis points in market share over the last 12 months. We grew actively in commercial loans, although at a slightly lower velocity than the first quarter. Most of this growth was focused in the SME Segment, as you can see on the chart on the bottom, which grew by 3% in the quarter. This dynamism continued to be driven primarily by new government guarantee program that is directed to SMEs and middle market companies. Year to date, we have placed $1.5 billion dollars in loans and we have the highest market share of 24% in this program. These originations have also helped improve our loan spread for commercial loans and has permitted us to reduce our risk through the government guarantee.

As for personal banking loans, we saw an increase of 1.5% quarter on quarter. This was driven by mortgages that continued to grow strongly as opposed to consumer loans which decreased by 1.5% quarter-on-quarter, in line with the industry. We believe that the sluggish consumer figures is due to the still low consumer confidence as well as higher temporary liquidity. However, we think that as a consequence of recent results from the vaccination campaign we should begin to see a reversal of this trend and commence a period of gradual growth in consumer loans in the near future.

Please turn to slide 17.

We pride ourselves by providing our customers with the highest quality products and services in the industry. This determination has been key in providing us with a low-cost funding base and for driving demand deposit growth. Today DDA's represent 37% of assets, which is substantially higher than all of our peers. Thanks to our brand positioning and soundness, we have seen a strong increase in demand deposits during this crisis from our customers. This preference to choose our bank as our customers' preferred bank is reinforced in chart on the bottom left, where you can see the strong rise in average balances per account versus our peers

In terms of our funding and gapping strategy, we are proud that we are a prudent bank that does not take large risks to generate short-term gains. In line with this, we manage our term gapping appropriately, as depicted by the chart on the bottom right. As you can see, bonds fund 89% of our residential mortgage loans, similar to the industry average but quite different to other competitors. This is important especially in light of the upward trend expected for interest rates as we mentioned in the beginning of this presentation. We expect that the interest rates given the economic scenario for Chile continue to rise and this may have negative effect for some banks holding significant term spread mismatches or, in other words, those funding long–term exposures in the banking book with short-term liabilities, which reprice faster than assets.

In terms of capital, we have the strongest Tier 1 capital base of 12.5%, with a substantial difference to our peers, as shown on the on the top. This together with our excellent credit risk ratings, further assists us in to continuing to diversify our funding base through the placement of bonds and growth in DDAs

Our fully loaded Basel III ratio was 16.6% in June 2021, with room to improve if we implement internal models for credit risk weighted assets that are permitted by the regulation today under some considerations. It's important to note that some of the regulatory thresholds are not yet in effect but we are confident that our capital base and the optimization of our risk weighted assets should enable us to successfully overcome this new framework. Also, we are one of the six systemically important banks in Chile and in our opinion and based on the current methodology, we should be subject to a systemic risk buffer of around 1.3% beginning December 2021. In turn, we are pleased that our strong capital base allows us to be well prepared for the transition to Basel III with no special actions needed to comply with the new standard.

Another driver for our bottom line during this crisis has been achieved through the sound policies and prudent risk approach that focuses on growing responsibly and sustainably.
Please turn to slide 18.

As you can see on the chart on the left, loan loss provision remained low at $77 billion pesos this quarter, slightly above the level posted in the prior quarter. Nevertheless, provisions from risk models amounted to only $27 billion pesos and additional provisions represented $50 billion pesos during the quarter. This composition together with our very low NPL ratio, confirms the high quality of our loan book which resulted once again with a low LLP ratio of only 0.96% this quarter, well below the average running rate prior to the pandemic.

It is important to note that the $50 billion pesos of additional provisions that we established this quarter allows us to mitigate the transitory positive effect of the better behavior of overdue loans on provisioning models when taking into account some uncertainties for the long-term. The second quarter was highly uncertain for Chile with the rise of Covid cases and mobility restrictions. Nevertheless, the successful vaccination process deployed by the government has reduced cases and we are confident that we may finally see improved conditions in the following months. If this scenario is maintained, we can't rule out that we may release additional allowances in the future quarters if the positive evolution of the economy is confirmed and there is a reduction of uncertainties.

Finally, please take a look at the charts to the right. I think it is important to highlight that our sound risk policies have permitted us to continue showing attractive results combined with the best risk position in Chile. During our history, we have been the most profitable bank especially when adjusted by capital and we have managed to accumulate $410 billion in additional provisions with a coverage ratio of over 3 times. We are by far the leader in asset quality. We are confident that when the growth recovers, this solid position should enable us to take the most advantage of that cycle.

Please turn to slide 19

Total expenses this quarter dropped by 2% year-on-year and 3.2% quarter on quarter as shown on the chart on the top left. The main drivers for the sequential reduction in personnel expenses are related to lower variable compensation and administrative expenses due to a reduction in maintenance, subcontracted services and other general expenses.

Through our strict cost management, our efficiency ratio reached 43.6%, well below the level posted last quarter and the level recorded by the industry. To the right of this slide, you can see that in total expenses we substantially outperform our main competition and that we continue to beat our peers in improvements in productivity, as shown on the chart on the bottom right.

Please turn to slide 20

It is relevant to understand how our industry operates and generates value for shareholders, which is not only in the form of net income but also in comprehensive income. It’s essential to review how different market factors and funding strategies affect diverse lines of our balance sheets and for this reason we think it’s necessary to take a more complete view of the performance of financial institutions and supplement the traditional analysis of net income with the results recorded in comprehensive income, which includes unrealized gains and losses from the fair value of the available for sale portfolio and derivatives for cash flow accounting hedges, that are accounted directly against equity. In other words, only part of a bank’s treasury strategy is immediately recorded in net income.

As you can see, we once again outperformed all of our peers, with a year-to-date comprehensive income figure of $350 billion pesos, equal to a return on average equity ratio of 18%. This is significantly higher than all of our peers as you can see on the chart on the left and the table at the bottom of this slide. It's also important to highlight that losses in OCI increase ROE by reducing shareholders equity. We believe that it is important to take this approach into consideration when analyzing total profitability for shareholders, particularly in more volatile periods that can increase the risk appetite and impact adversely shareholders' equity.

A key difference of our business strategy with our main peer is our focus on commercial banking services that deliver solid customer income rather than treasury revenues, which usually involves higher risk. This can be seen in the chart on the right, which clearly shows the important difference in terms of the stock of AFS instruments that despite the potential short-term revenues, can add more volatility to both bottom line and economic value for shareholders.

Please turn to slide 21

Before moving on to questions, I want to highlight a few key ideas.

First, we are convinced that the successful vaccination program and government initiatives are bearing fruits, which should translate into better figures of activity, employment and loan volumes. We expect that this scenario will generate GDP growth for 2021 of about 8.4% with a level of inflation of 4%.

The better economy activity should permit us to continue posting attractive results with adequate levels of risks. Nevertheless, we think that a more reasonable long-term level of NPLs to loans should be closer to 1.1% or 1.2%, when the fiscal support programs come to an end. We expect in terms of cost of risk to settle at around 1.1% for us in the medium term with a more normalized economic scenario. Due to these relief programs, we expect that loans will grow around 7% this year for the industry but we are confident that we should pick up market in our base case scenario. Finally, in terms of profitability, we are optimistic that our strong competitive advantages should continue to position us as best long-term investment for our shareholders with return on average equity reaching similar levels prior to the pandemic, obviously depending on the permanent impacts of the crisis on the economy.

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