Banco de Chile 3Q21 Financial Results

Conference Call

Operator

Good afternoon everyone, and welcome to Banco de Chile's third 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 joining this conference call today.

We are proud to present the performance of Banco de Chile during the third quarter. Once again, our bank was able to post outstanding results, leading the industry in terms of profitability and capitalization, and comprehensive income, which is also an important measure to analyze the overall performance of a bank, given its direct impact on the shareholder's equity value. This approach is more important than ever, given the increased levels of uncertainty and volatility we are facing.

In order to cover these aspects, we have divided this presentation into three main sections. First, an analysis of the macro and financial conditions; second, a review of the main advances and achievements in our key strategic pillars; and finally, a review of the breakdown of financial earnings.

Let me start with the discussion of the macro and financial environment. Please go to slide number 3.

Chile has been posting a faster than expected economic growth. Generally, this has been driven by the joint contribution of several factors, including strong fiscal and monetary policies, the temporary impact from several pension funds withdrawals, and the significant improvement in sanitary conditions that have allowed greater mobility in the country.

The chart on the upper left shows the speed of recovery in Chile. The GDP went up by 17.6% year on year during the third quarter, after expanding 18.1% in the previous quarter. The breakdown shows that the activity has been led by the material improvement in commerce and services.

Although the pick-up in annual figures was influenced by the weak comparison base, as the country was under a national lockdown one year ago, the economy has been growing on a sequential basis. As you can see in the chart on the upper right, the activity is 6% higher than the pre-pandemic level. In fact, the GDP achieved its pre-pandemic level in February, becoming one of the few emerging countries that achieved a complete recovery earlier this year. Nevertheless, it is essential to be aware of the unbalanced recovery, as some sectors, like retail, have grown significantly faster than the rest of the economy. These sectorial differences are unsustainable; therefore, a future slowdown is highly likely.

The higher dynamism has been reflected in the labor market. As can be observed in the chart in the bottom left, the unemployment rate has gradually been improving, reaching a figure of only

8.4% in September, well below the 13% seen one year ago. This has been supported by a recovery in total employment, which went up by 13.3% YoY, although it remains below its pre-covid level. The labor force has experienced a similar trend.

In line with this recovery, private expectations have also improved during the last months. This can be seen in the chart in the bottom right, which displays the upward trend in both consumer and business confidence, the latter reaching levels even better than those observed before the social crisis of 2019. All in all, the combination between stronger growth, lower unemployment, and better confidence, coupled with the successful vaccination process, anticipate a good level of growth in the short term. However, inflationary pressures have increased, as we have seen especially during the last months. Given the material change of inflation and interest rates, I'll now refer to these aspects. **I'd like to ask you to move to the next slide, number 4.**

We have seen a gradual shift in policy targets in Chile. While most of the measures taken last year focused on promoting economic growth, the rapid increase in inflation has raised several challenges. Even though higher inflation is consistent with better growth, the magnitude of the actual CPI trend is surprising and concerning.

The chart on the upper left shows that today, all the inflationary measures are above the policy range set by the Central Bank. Specifically, the headline CPI rose by 5.3% in September, reaching the highest figure since 2014; while the core CPI, which excludes food and energy prices, rose by 4.4% in September, the highest in more than 5 years. These trends have been accompanied by increasing signs of an economy that is overheating and a continuous weakening in the Chilean peso, as you can see in the chart on the upper right. These factors are increasing even more, the upward risks on overall inflation towards the future.

In this environment, there have been sharp adjustments in local interest rates. On the monetary policy side, the Central Bank began a tightening cycle in September, when the board decided to lift the overnight rate from 0.5% to 1.5%, a decision that was followed by an additional tightening of 125 bps, to 2.75% in October, as the chart on the bottom left shows. According to the press release that accompanied the decision, further interest rates hikes will come in the near future.

With inflation and interest rate surpassing any expectation held at the beginning of this year, this unexpected situation, in conjunction with the impact of three pension funds withdrawals, has led to an unprecedented rise in long-term interest rates, which have increased nearly 400 bps on average during this year. The chart in the bottom right shows that Chilean long-term rates have been increasing much faster than the U.S. rates, confirming the weight of local factors in this trend.

Having said that, I'd like now to share our baseline macro scenario for this and the next year. Please go to slide number 5.

The table summarizes our forecasts. We expect the GDP to grow by 11% this year, led by private consumption. However, we foresee a slowdown in 2022 due to the contractionary monetary policy and the end of several temporary fiscal measures. We expect that, in relative terms, total consumption continues offsetting the weak investment growth.

Despite this slowdown, we see an inflation rate above the policy target of 3% for at least until 2023. We expect an inflation rate of almost 6% and 4% this and the next year, as a result of lagged effects of the weaker currency, higher inflation expectations, and the inertia arising from UF-linked prices. Due to this, we expect the Central Bank to continue increasing the interest rate to 3.75% this year and 5.5% in 2022. Since there is an upward bias in CPI, we acknowledge the possibility of higher interest rates in the future. Despite the slowdown, Chile will continue posting the strongest growth in LATAM as you can see on the chart on this slide.

Also, I'd like to mention some risks, which are more relevant than ever. Some factors to pay special attention to include: first, the evolution of the global economy. Second, the pandemic, as the implementation of further restrictions could negatively impact the economy. The last but not the least important factor is the evolution of the political scenario in Chile. Specifically, it is important to analyze the results of key events such as the presidential and congressional elections and the outcome from the ongoing constitutional process.

Before moving to the bank, I'd like to describe some recent trends observed in the banking industry, please move to slide 6.

The last 18 months have been extremely unusual, mainly due to the existence of some decoupled trends between the banking industry and the economy. Despite the damage caused by the pandemic, especially on employment and GDP, the banking industry profitability has improved, in part due to the exceptional payment behavior from customers, which has been supported by the huge amount of liquidity. High levels of inflation, as mentioned earlier, have also benefited the UF net asset structural position of the banking system, offsetting the impact from reduced consumer loan growth demand.

As a consequence of these factors, total net income reached $845 billion pesos in the third quarter, substantially higher than the same period last year. Consequently, return on average equity reached 15%. This was due to inflation, better fee revenues and low cost of risk of only 1.1%, well below historical levels. The end of excess of liquidity should contribute to normalize these risk ratios in the near future.

With regards to loan growth, we have begun to see some improvements across the board. As the left chart shows, total loans during the quarter grew by 3.6%, driven by strong commercial loans and, to a lesser extent, by consumer lending. The mortgage portfolio showed the same dynamism of the last quarters, but it is expected to slowdown in the coming quarters a result of the sharp increase observed in long-term interest rates.

After analyzing these trends, 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

Thanks Rodrigo. Please go to slide 8, to discuss our main advances in strategic projects.

Banco de Chile has demonstrated time and again that our consistent and long-term strategy generates superior and more consistent earnings and value creation than our peers. In the next slides, we will go over our advances in our key strategic areas, which are, Digital Transformation, Efficiency, and ESG.

Please turn to slide 9, to go over our advances in Digital Banking.

Throughout the years, we have work steadily to create a digital driven organization. This year we have deployed many advances in both the back and the front office. In this sense, we are improving our customer experience by expanding digital channels, adding new products and functionalities. We are also increasing sales through these points of contact; working with advanced analytics; cross-selling our new FAN account holders with insurance, investment and other products; transforming operational processes and IT architecture; and, we are working in our talent and digital culture development.

Regarding the advances in our digital onboarding Cuenta FAN account, we have seen an impressive evolution of new customers reaching 630 thousand since its launch just one year ago. This quarter we released a new customer service channel with a chatbot called FANi that answers frequently asked questions and we are proud to mention that based on usage rates, more than half of FAN clients use this as a primary account. In the future, this customer base will be an important driver for our revenue growth.

We are also continually integrating new digital solutions such as our new self-service modules at branches that include several functionalities that save time of our customers and we launched a new payment service so clients can use their smartphone or smartwatch to pay without their cards, among other initiatives.

Thanks to all these efforts to provide the best digital experience, we have seen a continuous improvement in our online channel usage rates as you can see on the bottom of the slide. Monetary transactions using our mobile app has grown over 40% year-on-year, surpassing by far the growth seen on our website that reached just under 10% growth. The adoption of digital channels for everyday banking needs has resulted in that 89% of all monetary transactions are now being done online. This is a huge success for us and will allow us to continue improving our productivity. Finally, all these efforts have permitted us to be recognized as the most Innovative Digital Bank in Chile by the European, a prestigious international publication.

Please turn to slide 10

Our focus to provide the best customer experience has continued to improve as we have rolled out new digital solutions. This customer-centric strategy is always present when we develop new products and services and the results are reflected in many indicators, such as the ones shown on this slide. First, we continued leading the industry in net promoter score, a recommendation indicator. We also out ranked significantly all of our peers in other areas as shown on the chart on the right, where customers consider that we have the most competent account managers in the industry and the chart on the bottom left that ranks our bank number one in terms of having the highest transparency. These indicators, along with many others, reinforce the conviction that customers prefer Banco de Chile, as you can see on the chart on the bottom right.

By focusing on providing customers with first class experience, we have gained more loyal customers that have higher cross-sell ratios than our competition. This is especially relevant in the upper income segment and large corporates and multinationals companies, where we are leaders. As the industry continues to evolve, we strive to maintain and improve our relationships with customers because we truly believe that this is the best way to differentiate ourselves from the competition.

Please move to slide 11

We've continued to diligently optimize and improve how we manage our business in order to use our resources better. As mentioned, we continue automating processes by implementing new tools to make operational processes more efficient. As a consequence of the new service model that began its implementation a few years ago, this has permitted us to reduce branches from a level over 400 to 272 across Chile. This service model, together with many other initiatives; has not only improved our ongoing expense base, as you will see later on in the presentation, but has also been achieved with enhanced customer satisfaction levels.

In addition, we are accelerating these changes through a specialized area that is implementing a cross-enterprise cost management program that seeks incremental savings gains. The results of these initiatives have been positive, as you can see on the charts to the right, where we have had continuous advances in total loans to employees increasing by 32%, loans per branches by 70% and total expenses to assets improved 57 basis points to only 1.8%, the lowest level recorded in the last decade.

Please move to slide 12

Another key pillar of our strategy is sustainability. This quarter we have continued to advance in various fronts. In order to do that, we have diverse social and environmental projects that we developed to generate long-term value for our organization and stakeholders. Some of the initiatives that were taken during the third quarter are shown on this slide.

In order to promote entrepreneurship and support SMEs, we have granted US$1.8 billion in Fogape Reactiva loans and we launched the Sixth National Entrepreneur Challenge, which attracted thousands of micro, small and medium businesses across Chile.

In terms of community relations, we held the Financial Education Program "Count on Banco de Chile" that benefited approximately 5 thousand people including micro-entrepreneurs and students from all over the country. In addition, we created a policy to further advance our diversity and inclusiveness across our organization.

On another front, we understand that to be sustainable over time, banks need to incorporate non-financial risks in its lending practices. For this reason, we have trained our risk specialists on international standards for best addressing and identifying social and environmental risks. These efforts will enable us to accompany our customers on the transition to a sustainable future, while minimizing risks. Additionally, we issued a Social Bond to finance female entrepreneurs.

Finally, before moving to the next slide, we recently received an unprecedented three notch upgrade on our MSCI ESG Ratings, moving from a B to an A rating, ranking us as the most sustainable bank in Chile. These results, among other awards that we have received during 2021, reflect our commitment to continue being a sustainable bank that incorporates ESG principles at its key strategic pillars.

The remainder of the presentation focuses on our financial results this quarter. Please move to slide 14.

Net income was impressive this quarter, reaching $184 billion pesos, up from $162 billion last quarter and more than double the level posted the same period last year. Both ROE and ROA was very robust rising to 18.6% and 1.5%, respectively. Through our focus on generating consistent returns and maintaining a prudent risk approach, we have expanded the gap further with our peers in terms of our risk return relationship, as you can see on the chart to the right. This capital level without a doubt positions Banco de Chile as the best prepared to address the Basel III schedule of higher capital requirements.

Please turn to slide 15.

Operating revenues reported strong results this quarter, up 9.3% over the 2Q21 and 23% versus last year. This quarterly rise was due to both customer and non-customer income. In terms of customer income, we saw greater revenues from lending and deposit margins as well as fee-based products. Net interest income rose this quarter versus 2Q21, primarily due to the expansion of both the loan portfolio and non-interest bearing deposits, rising on a sequential basis 2.5% and 1.1%, respectively.

I'd like to take a brief moment to discuss the evolution of our fee income. As you can see on the chart on the right, recurrent fees continued to grow strongly, up 22% year on year thanks to the improved activity as well as an economy that has successfully adapted to the new normal. In the third quarter of 2021, most of Chile was out of lockdown and this had a positive effect on our transactional revenues. We especially saw strong income generation from transactional products and wholesale fees, especially from mutual funds.

In terms of non-customer income, results were primarily driven from the management of structural financial positions as a result of higher levels of inflation, which were partly offset by the effect of higher interest rates on our trading and investment positions.

For the remainder of the year and 2022, we are more optimistic due to the improvement in sanitary conditions in Chile that has permitted to lift mobility restrictions. Today Chile is more open than at any moment of the pandemic and this should continue to drive fee income and it should also continue to be reflected in terms of loan growth, especially consumer and commercial loans. On the next slides, we will go over the evolution of our portfolio and asset quality.

Please turn to slide number 16.

We are proud to report that total loans reached $33 trillion pesos, rising 2.5% when compared to the prior quarter, or 10% on an annualized basis. Year-on-year, the portfolio grew 6%. This expansion in loans permitted us to continue gaining market share as you can see on the chart to the right, where we gained 19 basis points over the last 12 months.

This quarter we witnessed better levels of activity in all lending products. Wholesale and SME loans were up sequentially 3.2% and 1.1%, respectively. In personal banking loans, we saw an increase of 2.5% quarter on quarter. The rise in the personal banking portfolio was driven by both consumer and mortgage loans, growing 3.6% and 2.3%. Despite the high levels of liquidity in Chilean households, the rebound is in line with the Central Bank's quarterly credit survey that reported strong loan demand and lower credit risk restrictions for consumer loans. However, it's important to note that mortgage lending interest rates have risen, in accordance to higher long term interest rates in Chile due to the internal conditions. As a result, we expect that this will lead to a slowdown in the demand for mortgage loans in the coming quarters.

Please turn to slide 17.

Through our solid brand name and our focus to provide our customers with the highest quality products and services, we have grown significantly our demand deposits to represent 36% of total assets and to lead the industry in terms of deposits per account as you can see on the charts on the left of this slide. This source of funding provides us with stable low-cost financing as an important part comes from retail counterparties.

On the chart on the bottom of this slide you can see the evolution of our mortgage loan funding gap. The stable evolution of our ratio of bonds to residential mortgage loans is particularly important in a context of rising interest rates, since liabilities reprice faster than assets which could negatively impact NIMs.

Also, in this environment of rising funding costs and weaker demand for long-term bonds from local institutional investors, it's a positive factor that our bond profile by currency or, in other words, foreign and local bonds holders, is less concentrated in foreign markets. This provides us with more room than other banks to increase our funding from external sources.

In terms of capital, we have by far the strongest CET1 capital base of 12.4%, with a substantial difference to our peers, as shown on the on the top.

Finally, our fully loaded Basel III ratio decreased slightly from last quarter due to our portfolio growth, reaching 16.2% as of September 2021. It's important to highlight that we have room to improve this ratio if we implement internal models for credit risk weighted assets that are permitted by the regulation. Nevertheless, we are confident that our strong capital base allows us to be well prepared to advance in the transition to full implementation of Basel III.

Next, I want to go over how we have managed risk and our current asset quality figures. Please turn to slide 18.

Loan loss provisions this quarter reached $93 billion pesos, slightly higher than the level recorded in the second quarter of this year but below the level posted the same quarter one year earlier. This figure includes $50 billion pesos in additional provisions. Excluding additional provisions, our models recorded only $43 billion pesos in cost of risk, demonstrating once again the strength of our portfolio. This composition of low cost of risk from models, higher additional provisions coupled with our low and stable NPL ratio of only 0.92%, further confirms this. The elevated level of liquidity in Chile is producing in part these unusual indicators, which are well below long-term levels. As this excess liquidity is used, we expect that our asset quality figures should return to more normal levels of around 1.1% for cost of risk.

When compared to peers, our asset quality and prudent risk management culture is evident. We out rank all of our peers in the relationship of risk and return thanks to these policies. Today we have accumulated $460 billion in additional provisions with a coverage ratio of almost 4 times. As we have seen this quarter, our superior risk strategy has permitted us to take advantage of growth opportunities by gaining more market share than all of our main competitors without fear of affecting our solid asset quality and capital levels.

Please turn to slide 19

As mentioned earlier, our strict focus on cost control together with strong revenues this quarter permitted us to post a solid efficiency ratio of only 40.1%, well below the levels posted in the past and the average in the industry. Total expenses, as shown on the chart to the right, reached $218 billion this quarter and includes an extraordinary bonus of approximately $5 billion that we provided our staff in gratification of excellent performance we have accomplished in 2021, which would not have been possible without their commitment and dedication during this difficult period. Despite this additional expense, we outperformed our main competitors this quarter, and we continued to show a better track record in our expense evolution as shown on the chart on the bottom right.

Specifically, as you can see on the chart on the bottom left, expenses remained relatively flat quarter on quarter and a slight rise year-on-year. Excluding the extraordinary bonus, the main drivers for this cost management performance is due to our focus of implementing effective controls to use our resources more effectively and automate back and front office processes.

Please turn to slide 20

As mentioned in prior calls, we think it is relevant not only to look at net income when analyzing how the industry operates and generates value for shareholders, but also comprehensive income, which takes a more complete view of the performance of financial institutions. As you can see, we performed well, with a year-to-date comprehensive income figure of $542 billion pesos, in line with net income. On the charts to the right, you can see the breakdown of OCI for us and our main peers.

One of the key differentiating factors of our business strategy is our emphasis of generating consistent recurring revenues. We are confident that this focus at Banco de Chile generates the greatest economic value for shareholders in the long-run.

Please turn to slide 21

Before ending this part of the presentation and taking your questions, I want to highlight a few key ideas.

First, the successful vaccination program and economic policy responses have worked and reactivated quickly the economy. We expect that employment figures should continue improving and this should help drive loan growth. Under this scenario we expect GDP growth for 2021 to be around 11%, with a level of inflation of almost 6%. Consequently, Chile will continue posting the highest average growth in the region.

This more dynamic economy and higher inflation will assist our bottom line with adequate levels of risks. In the medium term, we believe that NPLs to loans should creep up slowly when fiscal support programs come to an end. This should result in a more reasonable cost of risk level of around 1.1% in the medium term, in our baseline scenario.

Depending on household liquidity, we expect that consumer loans should be more dynamic in 2022. However, mortgage loans will probably grow at a slower rate. For this year, we expect that total loan growth should be near 7% and slightly below this level next year. We are also confident that we should continue to pick up market in our base case scenario.

Finally, we have successfully been able to face this challenging environment with robust results and outstanding achievements in several areas. We are certain that our strong competitive advantages will allow us to continue create value to all of our stakeholders.

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