Banco de Chile 1Q22 Financial Results

Conference Call

Operator

Good afternoon everyone, and welcome to Banco de Chile's first quarter 2022 results conference call. If you need a copy of the Management Financial Review, 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, Daniel Galarce, Head of Financial Control and Capital and Natalia Villela, Investor Relations Specialist.

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. Thank you very much for attending this conference call today.
It is a great honor for us to present the outstanding results posted by Banco de Chile during the first quarter of this year, a period that, once again, we continued leading the industry in different aspects. In order to present these achievements, we have divided this call into three main sections: first, an analysis of the macroeconomic environment that we faced, including our forecasts for this and the following year. Then, we will review the main accomplishments and advances in our key strategic areas, such as digital banking, efficiency and sustainability. Then we will finalize with a deep analysis of financial results.

Let me start with a general overview of the Chilean economy. Please go to slide number 3.

The economy expanded strongly in 2021, as the GDP went up by 11.7%, achieving the highest figure in our recent history. As we mentioned in previous conference calls, this was positively influenced by temporary factors and policies, such as the 33% pick up in fiscal spending and the more than US$55 Billion withdrawn from pension funds. The sum of these resources represented almost 30% of the GDP, becoming Chile one of the countries with the strongest economic response during this pandemic. Nevertheless, as these factors were only temporary, a slowdown in the overall activity has broadly been expected.

In this environment, recent figures have been confirming that the economy began a slowdown in November last year, which has translated into lower expansion rates at the beginning of 2022. Accordingly, the economy grew 7.9% in 1Q22 year-on-year, below the 12.0% seen in the 4Q21. The weaker activity is even more evident on a sequential basis, as the overall GDP fell by 0.4% in the 1Q22, posting the first contraction since the 2Q20. The downward trend of the activity can be seen in the chart on the upper left of the slide.

The weaker expansion has been led by the slowdown observed in the commerce sector, which has fallen 4.3% during the last three months, as the chart on the upper right displays. Generally, the lower expansion is mainly attributable to the reversal of several temporary factors that positively influenced domestic spending, such as monetary transfers and pension funds withdrawals. Therefore, the end of these factors, which coupled with the rise in inflation and interest rates, are fostering the slowdown in consumption even more. It is also worth mentioning that commerce climbed last year, growing at rates near 30%, as the chart shows, which was an unsustainable situation. Overall, the lower consumption is consistent with a normal adjustment of the economy towards its long-term fundamentals.

On the other hand, however, services have been recovering the ground lost during the pandemic, partially offsetting the sluggish commerce growth. In fact, services went up by 2.6% QoQ in 1Q22, being the only sector with a positive change during the period. This has been chiefly due to improved sanitary conditions, which have allowed greater levels of mobility and, consequently, normalization in several activities more intensive in social contact.

The labor market has continued posting better figures. In March, for instance, the unemployment rate was 7.8%, which was 260 bps below the level posted one year ago, and much better than the peak of 13.1% seen in 2020, as the bottom left chart shows. The lower unemployment rate has been due to the partial recovery in employment, which grew 8.0% YoY in 1Q22, which resulted in a total number of jobs that is only 3.5% below its pre covid levels, as you can observe in the chart on the bottom right. The labor force has also increased, although the participation rate remains below the level reached before the pandemic.

The positive trend posted by the domestic activity and several external factors has further increased the inflationary pressures in the Chilean economy. I'll refer to these factors and their implications for interest rates in the next slide.

Please go to the slide number 4.

The headline CPI has soared significantly during the last months, surpassing any expectations held just a few months ago. The overall CPI rose to 9.4% YoY in March, reaching the highest figure since 2008. This trend has been accompanied by an important pick-up in the core inflation, which rose to 7.4% YoY in March. Therefore, as can be seen in the chart on the top left, all CPI measures have been diverging from the policy target set at 3.0%. Other alternative figures, such as tradable and non-tradable indexes, have also increased to 11.5% and 6.9% YoY, respectively. These figures confirm that higher inflation has been a multifactorial phenomenon, led by different forces, local and external, that have contributed in the same direction. On FX, despite the strengthening seen during the quarter, the Chilean peso remains weak compared to previous years, contributing to inflation. This evolution can be seen in the chart on the top right.

The surge in local inflation has pursued the Central Bank to continue its tightening process in the Monetary Policy. In March, the Board decided to raise the overnight rate by 150 bps to 7%. The Central Bank of Chile accumulated a total adjustment of 650 bps since July last year when the rate was only at 0.5% , becoming Chile one of the countries with the greatest adjustment in the monetary policy rate in the world. This evolution is displayed in the chart on the bottom left.

The forward guidance provided by the Central Bank anticipates further adjustments in the interest rate, despite the expected slowdown in the overall activity. Particularly, in the baseline scenario outlined in its March's Monetary Policy Report, the Central Bank signaled an interest rate of around 7.5% to 7.75% by the end of the year and the beginning of an easing process only in 2023. Nevertheless, this guidance of overnight rate was made under the assumption of several factors, such as lower commodity prices, a stronger Chilean peso, and the absence of a further fiscal stimulus. Consequently, given the evolution of both Chilean and global scenarios, we acknowledge the possibility of higher-than-expected increases in the policy rate this year. As the bottom right chart shows, this balance of risks explains the evolution of long-term interest rates in Chile.

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

We expect the slowdown to continue in the near future. Specifically, the combination between lower fiscal spending, the lagged effect of interest rate tightening, and the weak external growth, among other factors, should lead the economy into a sluggish expansion in the second half of 2022. We can't rule out the possibility of negative annual growth rates for some months during the second quarter of 2022. We are forecasting a 1.5% expansion rate this year and in 2023 a level slightly above 0%. In the long run we expect a level of around 2%. Therefore, it is reasonable to expect a "U shape" evolution for economic growth.

Our baseline scenario considers an inflation rate remaining above the policy target for the next couple of years. Despite the below-trend growth, the inflation rate should persist at high levels due to further pressures from commodity prices, global supply chain disruptions, and second-round effects, among others. For these reasons, we expect further interest rate hikes this year to reach a level of 8.25%.

Before moving to the banking sector, I'd like to emphasize the existence of some critical risks that need to be watched. First, since Chile is one of the most integrated countries into the global economy, a negative evolution of the external activity could have a material impact in the country, especially if the slowdown occurs in China or the U.S. Therefore, it is important to analyze the evolution of critical factors such as the pandemic and the geopolitical conflict in Europe.

Second, several political developments are worth monitoring, such as the contents to be included in the final draft of the constitution. Also, it is critical to see the result of the exit referendum to be held on Sept 4th, which will determine if the constitutional convention's proposal becomes the new constitution. Additionally, it is essential to pay attention to the implementation of potential reforms that have been announced by the government, especially in areas such as taxes, labor, and pensions.

Now. I'd like to discuss briefly the evolution of the Chilean banking industry. Please turn to slide number 6.

Loans in the Chilean banking industry in the first quarter grew only 1% in nominal terms quarter on quarter and showed dissimilar trends by product. Retail loans continued to support growth. Consumer loans grew quarter-on-quarter by 4.2% and mortgages rose 2.4% quarter on quarter. This was strongly supported by the steep levels of inflation seen during the quarter. We expect that, with rising inflation levels coupled with higher interest rates and more uncertainty, mortgage loan expansion should continue showing an important deceleration compared to the figures showed in previous quarters. Lastly, commercial loans decreased by 0.4%, strongly due to the current environment.

The industry posted strong results in the quarter, associated to the high levels of inflation, which positively benefits operating revenues together with credit risk charges that remain below historical levels. This was partially offset by higher operating expenses also due to the record high levels of inflation we have recently seen in Chile.

Now I would like to pass the call to Pablo, who will go into more detail about Banco de Chile's advances and the financial performance.

Thank you Rodrigo. I'd like to begin with our main accomplishments in our key strategic projects. Please go to slide number 8.

As we have mentioned in previous conference calls, we have developed a strategic project that focusing on three key areas. As you can see in the slide, they are digital transformation of the bank, permanent improvements in efficiency and productivity, and our increasing commitment to ESG. In the next few slides we will go over the advances of these initiatives, which are already bearing fruit.

Let me start the with the analysis of digital transformation. Please move to the next slide, number 9.

Cuenta FAN once again posted strong gains in customer acquisition, closing the period at 844 thousand new clients. Of these, we have cross-sold 24% to other products and services, which include current accounts, insurance products, investment solutions, credit cards, consumer loans, and mortgages.

We also reinforced the Digital Journey to become a Banco de Chile customer by launching our New Digital Current Account that can be opened 100% online, in less than 5 minutes in three simple steps. This is a full bank account with no limits with the possibility to open other products such as lines of credit, credit cards, investment products, among others.

In line with our goal of building a full digital ecosystem, we released a great new investment app that permits customers to invest not only in local stocks and mutual funds but also in international ETFs and stocks listed on foreign exchanges.

Additionally, in alliance with Scotiabank, we developed a service that facilitates to make quickly and easily money transfers between banking customers by only using the mobile telephone number. This service is now available for all banks in Chile at the Automated Compensation Center which provides payment processing services to all financial institutions registered and supervised by the CMF.

Lastly, I want to highlight some key digital advances. As you can see on the right, our customers are using more actively our digital channels. Monetary transactions through the app are up 34% over last year, 50% of consumer loans this quarter were taken online and we have also had an important increase in digital customers.

Please turn to slide 10

Our purpose is to create long-term value for shareholders and to be the best bank for our customers. For instance, this quarter we reinforced our efforts to put Banco de Chile at the top of mind by strengthening marketing activities such as supporting the music festival Lollapalooza.

As you can see on the chart on the top left, our Top of Mind reached 29%, one third higher than our closest competitor. Additionally, through our new customer service model, we have continued to out rank our peers in net promoter score according to the Procalidad survey. In addition, we are positioned as the most reliable and preferred bank in Chile according to the latest Adimark survey, as you can see on the chart to the right. By focusing to create the best bank for our customers, we are standing out from other banks. This is generating greater demand for our products and stronger relationships, which means more originations to loyal customers that value and promote our products.

Please turn to slide 11

Our consistent improvements in productivity have been supported through diverse initiatives, which were accelerated when we created the formal productivity and efficiency program. These incremental improvements, together with technological advances and the streamlining of our branch network, have optimized how the bank operates. This quarter we posted a groundbreaking 34.2% efficiency ratio. On the one hand, this level was influenced by the strong top line growth we posted in the quarter but on the other hand, we have been able to continue controlling expense growth in real terms close to zero. We recently implemented a new digital purchasing platform that introduces electronic auctions and tender processes to acquire goods and services for the bank that will further support our cost control management. This is just one more mechanism that we are applying to continue using our resources better.

It is clear that the efficiency we achieved this quarter benefited from extraordinary items that positively impacted our revenues, but I would like to emphasize that we did not stand still during this period. We are confident that through the continuous improvement of our efficiency program, increased automation and the use of new digital tools, we will be able to continue improving our sustainable efficiency indicators by consolidating the trend we have seen in many metrics, such as the cost-to-assets ratio, which are not influenced by the effect of inflation and, therefore, reflects gains in productivity.

Please turn to slide 12

This quarter we made several advances in ESG. We started a new series of our Program "Cuentas con el Chile", which is a program aimed to educate entrepreneurs, students and new residents to Chile in financial literacy. This new version of the program will include cybersecurity knowledge and inclusive methodology.

Regarding our diversity and inclusion initiatives, we signed an agreement with the non profit organization Women in Finance that promotes their participation in the banking industry and we held the 23rd edition of the Chilean Open Copa Banco de Chile wheelchair tennis tournament.

In connection with environmental actions, we launched the first national call for Glocal social innovation in alliance with Sustenta Pucón Foundation, which seeks to join entrepreneurs to provide solutions to economic, social and environmental challenges. We also recently entered into new agreements consume electricity only from renewable sources through the purchase of Energy Certificates. This has reduced our carbon footprint by 28%.

Moreover, we are especially proud to announce that we have created a Sustainability Committee composed of senior management and chaired by our CEO. This Committee aims to boost our sustainability strategy and initiatives, as well as define and monitor ESG KPIs .

Finally, we are glad to mention that we were recognized as the third most responsible company in the country in environmental, social and governance areas by Merco and we improved significantly our Sustainalytics ESG Risk Ratings to a "Low Risk Level". This score positions us as leaders in the Chilean banking industry in this matter with a large gap to our competitors. It's also important to highlight that we have an A rating in ESG MSCI, which is the highest in the Chilean banking industry.

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

The economic scenario continues to surprise. This quarter we witnessed another period of high inflation of 2.4%. This together with a sound business strategy that leveraged diverse market factors in our favor, allowed us to post a record bottom line $292 billion pesos, equal to an impressive return on average equity of 27%. We are especially pleased that this result positions us once again as leaders in profitability in terms of return on assets and in capitalization, as you can see on the chart to the right.

Nevertheless, we are aware that these high levels of net income are temporary, but we are fully committed to creating a sustainable bank that generates superior results based on a consistent and responsible long-term strategy. Depending on the potential impacts of the political landscape and the evolution of the pandemic, we believe that our long-term ROE should be in the range of 16% to 18%, even though this year we expect it to be well above this range.

Please turn to slide 15.

Operating revenues grew over 40% year-on-year mainly due to non-customer income as a result of the strong rise in inflation versus the same period last year. In fact, inflation revenues contributed more than half of the year-on-year growth of operating revenues. This figure was obtained by positioning the bank appropriately to benefit from the higher-than-normal levels of inflation and in rates. On the other hand, it is worth highlighting that customer income continued growing 26%, contributing to the year-on-year rise in operating income, thanks to the greater contribution of demand deposits to our cost of funds, in an environment of significantly higher local interest rates, and improved business activity that boosted fees amid lower covid mobility restrictions.

As a result, net interest margin grew from 3.4% in the 1Q21 to 4.9% in the 1Q22, a rise of 151 basis points. An important part of this rise was due to inflation, as shown in the chart at the bottom. Nevertheless, income from interest excluding inflation grew strongly thanks to the effective and prudent management of our currency and maturity gaps, together with our demand deposits positioning, that allowed us to capitalize more than competitors. Later in the presentation, we will go into detail on our superior funding mix and how we compare to our competitors.

Fee income generation was also very dynamic this quarter contributing $19 billion to the increase in operating revenues, equal to a rise of 17% year-on-year. This strong increment was consequence to a rise in transactional services from debit and credits cards and ATMs as well as higher account maintenance fees due to the expansion in our customer base. We also saw a positive increase in fees generated from Mutual Fund Management and Stock brokerage subsidiaries (Banchile Inversiones). Finally, insurance brokerage also performed well, in line with the greater business activity in consumer loan origination.

In terms of financial income from treasury operations, we recorded good results thanks to the proactive management of our trading and investment portfolios that benefited from changes in key market drivers, such as higher inflation, interest rates and inflation expectations.

As you can see in the charts to the right, we have superior revenue generation. We out rank all of our peers in terms of Net Interest Margin with a wide gap to our closest competitor. Additionally, we have an impressive evolution of our operating margin net of risk, as shown on the chart at the bottom right. We surpass all of the competition and even widen gap to our main competitors in the last couple of quarters, clearly demonstrating our excellent and consistent business strategy.

Please turn to slide number 16.

Loans reached $34 trillion pesos, up 8% in nominal terms from last year but remained flat when compared to the 4Q21. Mortgage and Commercial loan originations have slowed due to the weak economic environment and political uncertainty. Specifically, mortgages grew 9% year-on-year and only 1% quarter-on-quarter. It's important to note that mortgages are almost completely denominated in UF, hence growth was fueled by the strong rise in inflation and not origination. As per commercial loans, we also saw a slowdown in both the wholesale and SME segments, which in total grew 6% year-on-year and decreased 1% quarter-on-quarter.

On a positive tone, consumer loans showed better growth despite the environment, rising 12% year-on-year and 4% quarter-on-quarter. As opposed to mortgages, almost 100% of consumer loans are denominated pesos, so this rise has been driven by greater originations thanks to reinforced commercial campaigns that have boosted demand for consumer loans within higher income customers segments.

Please turn to slide 17.

Our superior funding structure has been key in the rising rate cycle, rewarding us with higher asset and liability management margins. First, I would like to highlight that our funding structure has remained relatively stable, despite the strong hikes in short term interest rates and its potential impact in demand deposit balances. In fact, the percentage of funding from DDAs continued at unprecedented levels, representing 33% of assets, as you can see on the chart on the top left, down slightly from 36% recorded in the 4Q21. It's also relevant to mention that we lead our peers in terms of demand deposits to loans, benefiting us more from this balance sheet position. This financing not only provides us with a lower cost of funds but also supports part of our structural inflation gap. Today the UF asset gap in the banking book is in the range around $7 trillion pesos, which means that for every 100 basis point positive change in inflation, we earn about $75 billion pesos in net interest income or approximately 20 basis points in NIM.

In addition, over the last years, we have pursued to optimize our funding structure in relation to maturity gaps. As such, we maintain a more stable funding structure than peers when we compare our mortgage funding gap, as shown on the chart on the right of this slide. This has been the result of a consistent strategy aimed at matching longer-term assets and with longer liabilities, such as bonds placed locally and overseas. All of this should permit us to take advantage of rising rate more than our peers, as seen in the evolution of NIM and operating income.

We also have positioned the bank as the most capitalized among our competition, as you can see on the next slide number 18.

Our Total and Tier I capital ratio are significantly above the competition at 17.8% and 13.2%, respectively. These figures are a result of our long-term strategy, which is based on responsible growth that are linked to consistent capital management policies and an adequate risk return relationship. We are convinced that a strong capitalization is a key factor not only for the sustainability of the bank, but also for the capacity of generating attractive dividends and profitability to our shareholders.

This capitalization together with our superior credit risk ratings and debt placements in both local and overseas markets has permitted us to fund our business competitively. We are optimistic that our strong improvements and leading ESG position, as we discussed earlier in this call, will further support growth using alternative funding instruments.

These high capitalization levels also position us well for the implementation of Basel III in Chile that will require higher levels of capital than under Basel I. We are confident that we have sufficient capital to implement smoothly Basel III in our bank.

Please turn to slide 19.

Expected credit losses reached $99 billion pesos in the 1Q22. A relevant portion of this figure is due to $70 billion pesos of additional provisions that we established this quarter in line with persistent uncertainty of the economic and political environment. Also, we are aware that the extraordinarily low levels of delinquencies observed in our loan portfolio are strongly influenced by transitory factors that mitigate the real deterioration in the fundamentals of the Chilean economy. That said, excluding additional provisions, we only recorded a cost of risk of 0.35%, significantly below our long-term expected level of around 1.1%. This figure was also significantly lower than all of our peers, demonstrating the soundness relative of our portfolio.

Additionally, we continued to exceed our peers in many other risk indicators as shown on the right of this slide. We have accumulated $610 billion in additional provisions, providing us with a coverage ratio of 4.4 times and we recorded the best delinquency ratio of only 0.87%. We are confident that our conservative strategy should support us in negative economic cycles but should also assist us in taking advantage of growth opportunities when they appear.

Please turn to slide 20.

Cost control has been a major focus at Banco de Chile. In fact, this is one of the three main pillars of our long-term strategy. In this environment, our efficiency and productivity plan and initiatives have consistently been bearing fruit. This quarter our expenses grew in line with inflation, up 7% year-on-year, or flat in real terms. This is consistent with costs that are indexed to inflation. For example, salaries are adjusted at least on May and November each year and many administrative services are priced in UF. However, similar to prior periods, the fastest growing expense items are those related to IT, in line with the developments and infrastructure we have implemented to boost our digital capabilities and automation of our operational processes to improve productivity.

As a result, our efficiency ratio posted an impressive level of 34.2%, well below the industry and peers, as you can see on the charts at the bottom of this slide.

We are determined to continue improving our cost structure and using our resources better to sustain high levels of efficiency. As we mentioned before in this presentation, it’s clear that the ratio that we have posted this quarter is highly affected by top line growth. However, we are confident that the incremental gains we have made during the last years should lead to sustainable efficiency improvements compared to the levels we posted before the pandemic.

Please turn to slide 21

Before moving on to questions, I just want to go quickly over some key take aways and provide some guidance.

We are expecting GDP for 2022 to slow down from last year to around 1.5% and loans in the industry to grow around inflation in nominal terms this year. For Banco de Chile, we are focusing our growth on consumer and SME commercial loans and we aim to pick up market share in these segments.

In terms of results, I want to emphasize that we had a very strong bottom line that was obtained by anticipating some market drivers and adjusting our balance sheet accordingly to benefit more from the rise in rates and inflation, but always managing our market and financial risks prudently. This together with our commercial activities, credit risk policies and strict cost control allowed us to post a historical record bottom line, exceeding all of our competitors. Along these lines, we expect our NIM to normalize as long as inflation will decline in the future. In terms of cost of risk, we estimate a level around 1.0% to 1.1% this year and our goal for efficiency is in the range of 38% to 40% for this year. These drivers are consistent for a quarterly ROAE to slow down to around 20% by the 4Q22, translating into an accumulated full year level above 20%. Once again, these figures demonstrate that Banco de Chile is the strongest bank in Chile and a great investment for shareholders.

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