Banco de Chile 2Q22 Financial Results

Conference Call

Operator

Good afternoon everyone, and welcome to Banco de Chile's second 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 and thank you for joining this call. Today, we will present the overall performance of Banco de Chile during the last quarter, as well as our analysis of the main macroeconomic trends, including our guidance for the near future.

Before going to the presentation, I'd like to say that we are very proud of the several achievements of our bank during the quarter, demonstrating our unquestionable leadership in different areas. On the financial side, for instance, we posted a historical bottom line of $432 billion pesos, widening the gap, even more, with our main peers. This characteristic, which has differentiated our bank over time, was also accompanied by superior levels of capital and strong risk indicators. In this quarter, we also had important advances in ESG, mainly in terms of further improvements in ESG ratings and the development of an ambitious and comprehensive bond framework. All of these topics will be deeply discussed throughout this presentation. When looking at the performance of our main peers, our recent achievements are even more significant, given the economic and business environment.

I'd like to begin with a discussion on the macro side. Please go to slide number 3.

The Chilean economy continues posting positive annual growth rates, as seen in the upper left chart. In the first quarter, the GDP went up by 7.2%, while in 2Q22 the activity increased by 5.7% YoY. On a broad sense, the YoY expansion has been driven by consumption and services, and on the other hand, mining has remained in negative territory.

On a sequential basis, however, the story looks different. The chart on the upper right shows that the overall activity level has remained relatively stable since the end of the last year. In fact, in June, the Imacec was 0.1% below the level posted in December last year, reflecting that the GDP hasn't grown year to date. The chart also reflects how the normalization in consumption has contributed to reducing GDP growth.

The labor market continued showing signs of gradual recovery. The unemployment rate in June was 7.8%, remaining below the peak of 13% observed in 2020 when the pandemic significantly affected the economy. Nevertheless, it is worth mentioning that the lower unemployment is the result of two effects: one is the gradual recovery of total employment, which increased by 9.9% in 2Q22, although it remains below its pre-covid level. Second is the reduction of the labor force, which has reduced the participation rate and, consequently, the level of unemployment.

There have also been several changes in the global economy, with significant impacts on Chile. Some of them have been reflected in the evolution of commodity prices, as the chart on the bottom right displays. Due to supply disruptions (related to the war in Eastern Europe), the oil price posted an impressive rise of 40% in the first half of this year. On the other hand, the copper price declined by 17% in the same period, influenced by the weaker GDP expectations, mainly in China. This combination of prices has led to a deterioration in Chilean terms of trade.

All these trends have had important impacts on nominal factors, mainly interest rates, prices and FX. Please move to the next slide, number 4.

In this environment, and in line with the trend seen in the rest of the world, prices continued to increase steadily. Specifically, the annual CPI went up to 12.5% in June, the highest figure since the 90s. It resulted from the 3.6% inflation posted in the second quarter, after the 3.4% rise in the 1Q22. All of the core measures have been going up, widening the gap with the policy target set at 3.0%. For instance, the index that excludes food and energy prices increased to 9.9% in June, also the highest in decades. Non-tradable and tradable measures have followed a similar trend, as they rose 15% and 9.5% YoY in June. All in all, the rise in core measures confirms that the inflation in Chile is a generalized process, not explained by the increase of a few articles.

The Chilean peso had a substantial decline, especially last month. In addition to the global strengthening of the dollar, and the deterioration in terms of trade, the Chilean peso has been affected by domestic factors, such as the persistence of political uncertainty. Consequently, the exchange rate fell 7.2% against the dollar in 1H22, becoming one of the currencies with the highest depreciation in the region. Given the magnitude of the adjustment and the higher volatility, the Central Bank announced an intervention equivalent to USD25 Bn in the FX market (to be implemented until September 30th), by using different tools, such as sales in the spot market as well as injection through FX derivatives. After the announcement, the Chilean peso strengthened, from almost 1.050 pesos per dollar to 900 pesos.

In this environment, the Central Bank has continued tightening the monetary policy. In the meeting held in July, the board decided to lift the rate by 75 bps, to 9.75%, achieving the highest value since the 90s. It is worth mentioning that this level exceeded the forward guidance provided in the Monetary Policy Report released a month ago, reflecting a material change in inflationary perspectives in a short period of time. According to the press release of the meeting, the board should continue raising the rate in the future.

Another important adjustment this year has been the steep decline in the overall liquidity. The chart on the bottom right shows the downward trend in the monetary base (or M0) and the M1 supply, equivalent to M0 plus total liquidity held in demand deposits. As expected, this trend has been attributable to the absence of further liquidity injections (as pension funds withdrawals and monetary subsidies provided by the government) and the rise in inflation, which reduces disposable income even more. All these trends have had several impacts on the banking system, as we will analyze later in this presentation.

Now, I'd like to go to the next slide, number 5, to discuss our macroeconomic forecasts for this and the next year.

We expect the economy to grow 1.7% in the current year. Since the economy probably expanded around 6.5% in 1H22, this forecast is consistent with negative growth for the rest of the year. This slowdown will be a consequence of several factors, including: (i) the fall in fiscal spending this year (due to the withdrawal of measures implemented during the pandemic); (ii) the lagged effects of the interest rates hikes implemented since mid 2021; (iii) the worse global conditions; and (iv) the persistence of political uncertainty at the local level. These negative YoY growth rates should last until middle of 2023, translating into a negative expansion for the whole year 2023 (we expect a -1.0%).

This slowdown should contribute to reducing inflation. We expect the headline inflation to fall from 11% this year to around 5.5% in 2023. Nevertheless, it is reasonable to expect it to remain above the target of 3.0% at least until 2024 due to the persistence of second-round effects and the high inflation in the world. These reasons support our view of a gradual normalization in the interest rate, from an expected value of 10.75% this year to nearly 6.0% in 2023, remaining in contractionary territory.

Before finalizing this section, I'd like to mention some risks worth to pay attention to. Apart from the global sources of uncertainty relevant for Chile, such as the evolution of China and the geopolitical conflict in Eastern Europe, it will be especially relevant to monitor the constitutional discussion in Chile. Apart from the result of the referendum scheduled for Sept 4th, it will be important to analyze the implementation of potential changes in the constitution by the congress, in a process that could last at least one year, despite the result of the referendum. It is also relevant the discussion and implementation of several reforms announced by the government, including tax and pension.

I'd like now to present the Chilean banking industry's main trends. Please move to the next slide, number 6.

The banking industry posted $218 trillion in loans this quarter, which represents an increase of 5.4% quarter-on-quarter in nominal terms, driven by commercial and mortgage loans, which grew by 6.2% and 4.4%, respectively. In real terms, however, loans only grew 1% quarter-on-quarter. This lower dynamism in real terms was in line with the conclusions of the 2Q22 Chilean Central

Bank Credit Survey, which noted that credit supply conditions are tightening and demand remains weak across all credit segments.

The industry posted solid nominal results, driven mainly by the high levels of inflation, which benefited operating income, as shown on the bottom left chart. Nevertheless, when considering the effect of inflation on the value of equity, net income growth would be lower. For instance, return on average equity for the industry reached 23.8% year to date and when adjusted by the effect of inflation on equity, this would decrease to 9.4%.

Regarding credit quality, the industry has begun to show a slight deterioration in loan loss provisions as well as in NPLs, as can be seen in the chart on the bottom right of this slide. Nevertheless, this trend is in line with the guidance that we mentioned in previous conference calls, since we are entering a scenario of lower liquidity levels, higher inflation and interest rates, factors that could potentially affect negatively customers' payment behavior. Therefore, we expect that cost of risk should continue its transition to pre pandemic levels.

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.

Thanks Rodrigo. I'd like to begin with the advances in our key strategic projects. Please go to slide number 8.

As we have reviewed in the past, our strategy focuses on three main areas. First the digital transformation of the bank, as this is key to continue competing effectively in the future. Second, a strong focus on driving efficiency and productivity and third, continuing our commitment to create the most sustainable bank. We will go over this on the next few slides.

Please move to slide number 9, where we will highlight some of our initiatives in digital banking and how they benefit financial inclusion.

Cuenta FAN, our main digital debit account, continues to have a positive trend and we originated over 926 thousand accounts since its launch by adding approximately 82 thousand new accounts during the 2Q22. Of the total accounts, we have cross-sold 24% to other products and services including current accounts, insurance products, investments, credit cards, consumer loans, and mortgages.

We are also launching a new checking account with digital onboarding for SMEs that makes it easier for entrepreneurs to take the next step and separate their personal and business accounts. This product does not require minimum sales or period of time of operation and charges no entrance or maintenance fees.

These digital initiatives along with the improvements introduced to our comprehensive investment app and the payment solution paga2, has led us to be recognized by The European as the most Innovative Digital Bank in Chile.

Please turn to slide 10.

We have continued to drive productivity across all areas of the bank by implementing incremental improvements. This progress in operational efficiency together with all the technological advances that we have implemented and through the streamlining of our branch network, has allowed us to become one of the most efficient banks in Chile. This quarter we even broke the prior's quarter record and posted a leading efficiency ratio of 28% and 31% year to date. Although, our efficiency has been mainly due to strong top line growth, our determination to continue controlling expenses further enhanced these levels, which grew below inflation. In fact, in real terms our year-to-date expenses decreased by 2.5% during the quarter. This has been the result of cost improvements through innovations such as our digital purchasing platform that introduces electronic auctions and tender processes to acquire goods and services. Likewise, we continued streamlining and automating diverse back-office and middle-office processes, which is making a difference in the use of resources. We are sure that through these actions we can continue to show positive productivity gains as we have seen in our total operating costs to total assets indicator, which isolates the effect of inflation on operating revenues while providing a clearer measure of productivity, that improved significantly over the last years reaching 1.7% as of June.

Please turn to slide 11

During the second quarter, we kept boosting our initiatives related to our commitment to be the most sustainable bank in Chile. Particularly, we are excited to mention we developed a Sustainability Financing Framework to issue Green, Social or ESG bonds. The framework will allow us to finance projects that generate positive impacts in diverse areas such: green buildings, clean transportation, energy efficiency, renewable energy, financial literacy, social housing and access to basic infrastructure. We will also be able to use the proceeds to finance SME´s and women-owned enterprises, which is in line with our commitment to the entrepreneurship and the development of Chile and its people.

As mentioned, we are promoting financial inclusion through online and free of maintenance fees digital accounts. However, we are aware that while digital adoption keeps increasing, for many customers it's still very important to have branches or ATMs close by. In line with this, we are actively promoting access to finance through diverse projects such as the partnership with municipalities to install ATMs where people need them; *CajasChile*, which is a partnership with mini markets located across Chile in cities, towns and rural areas that provides financial service transactions for people living in these areas where there is little or no banking alternatives. We also have the largest private bank ATM network and one of the largest branch footprints in the country.

We are proud to mention that as a recognition of our efforts to be a sustainable bank, we have obtained the best ESG ratings in the Chilean banking industry from MSCI and Sustainanlytics, confirming our leadership on this matter.

Please turn to slide 13 to begin our discussion on our results.

This year has been record-breaking in terms of nominal results for all comparable banks, as you can see on the chart to the left that shows the traditional ROAE measure. Nevertheless, it is very important to be aware of the impact generated by the high level of inflation on profitability figures in periods when the inflation is extraordinarily high, as it has occurred since the end of 2021.

In this context, it’s very important to note that since 2009 the nominal effect of inflation under Chilean GAAP, similar to IFRS, does not take into consideration the full impact of inflation on our income and balance sheet. When we consider the effect of inflation on equity, in order to recognize the loss in purchasing power, this reduces the profitability of banks significantly.

Given the material impact of high levels of inflation, we want to share some figures that potentially address this bias. The chart on the right shows inflation–adjusted ROAE from the main Chilean banks considering the impact of inflation on equity, by deducting the effect of price-level restatement of capital in the income statement. We believe this measure provides a more comprehensive perspective of real profitability, since it shows the effective economic value that is generated by maintaining the real value of equity, after considering the negative impact of inflation on its nominal value.

Even under this scenario, Banco de Chile remains as the bank with the highest profitability, which is attributable to our superior competitive advantages, a consistent long-term strategy and the successful implementation of several strategic projects, as we discussed earlier in this presentation. Finally, it is also worth mentioning that our level of profitability, adjusted by the effect of CPI on capital, is even higher than our historical levels of nominal ROE of around 18%, which clearly shows the solid results obtained during the year.

Please turn to slide 14.

We posted for the third quarter in a row a record nominal bottom line of $432 billion, 164% above the same period last year and almost 50% above the first quarter. As mentioned, inflation played a major role but this was boosted by our sound business and risk management that drove customer income and maintained both credit and operational expenses low. Noteworthy is how we have managed to out-perform all our peers, with substantial gains in net income, as you can see on the chart to the right.

Despite that an important portion of this growth has been a direct result of the temporary rise in inflation, we expect only a slight slowdown in revenue generation in the second half of the year, as CPI is anticipated to begin to slowly decrease during the next months. Depending on the permanent impacts of recent events in Chile and evolution of the pandemic, we believe that our long-term ROE should return to the levels we posted prior to the pandemic, towards around 18% in the coming years. However, we expect 2022 ROAE to be well above this level, as a consequence of the described temporary effects on NIM.

Please turn to slide 15.

Total operating income increased sharply by 72% year-on-year, primarily from a 218% rise in non-customer income but was further driven by a rise of 28% in customer income.

We achieved a strong rise in non-customer income by proactively managing and increasing our UF denominated assets position, which enabled us to profit from higher-than-normal levels of inflation, based on gains related to the contribution our structural UF net asset exposure that hedges our equity from inflation and we also benefited from favorable impacts of shifts in both interest rates and inflation on temporary gaps by our treasury when managing balance sheet and currency mismatches. Additionally, we recorded positive results in debt securities and trading portfolio acquired at convenient cost of funds based on higher accrual generated by the effect of inflation on UF-denominated securities. As of June 2022, our UF net asset gap in the banking book was approximately $7.8 trillion pesos, translating into a sensitivity of about $78 billion pesos for every 100 basis point change in inflation, or approximately 20 basis points in NIM.

We also recorded a sharp expansion in customer income primarily from the higher contribution of demand deposits to our funding cost as interest rates have risen significantly over the last 12 months, benefitting us by over $100 billion pesos in terms of lower cost of funds, partially offset by the reduction in DDA volumes that we anticipated in previous calls. Additionally, fees grew by 6% year-on-year due to higher transactional income as a result of a more dynamic business activity in the 2Q22 when compared to the same period last year.

To a lesser degree, higher transactions in the Sales & Structuring area also contributed increasing customer income, based on deals closed with customers looking for covering from higher volatility in FX and interest rates, among others.

Net interest margin this quarter rose to 6.2%, surpassing all of our competitors in terms of total operating margin, as shown on the bottom right. We are confident that our sound long-term strategy should continue to generate attractive returns not only on the short term, but also in the longer term.

Please turn to slide number 16.

Total loans reached $36 trillion pesos, up 11% in nominal terms from last year and 4% on a sequential basis. Except for consumer loans, an important portion of this has been driven by market factors such as inflation and the peso depreciation rather than loan origination. As a reminder about 34% of commercial loans and almost 100% of mortgage loans are denominated in UF. Likewise, around 18% of commercial loans are denominated in foreign currency, mainly in USD. So, as you can see on the charts to the right, commercial and mortgage loans expanded 10% year-on-year but in real terms, these loans decreased because CPI increased more than 10% during the last 12 months. Nevertheless, the overall trend in commercial and mortgage loans is completely in line with the latest Central Bank loan survey that highlighted stricter credit conditions and weaker demand for loans.

On a more positive note, consumer loans grew powerfully at 18% over the same period last year. Different to the rest of the portfolio, consumer loans are chiefly denominated in pesos, which means that this growth was due to origination and not to other market factors. We continued to strengthen and adapt the value propositions to the new trends and customer expectations, which accelerated business growth. We also implemented diverse projects that optimized our branch network, improved our service model, incorporated business intelligence and implemented new commercial strategies. This enabled us to deploy successful commercial campaigns in the 2Q22 aimed at both increasing consumer loan origination while enhancing credit card transactions by reinforcing loyalty programs. It is worth noting that the expected normalization of liquidity levels should positively contribute to increase demand for consumer loans, partially reducing the impact from the GDP slowdown expected for the following quarters.

I would like to highlight that we recently developed the "Commercial Systematics" program, which is bearing fruit. This initiative focuses on boosting the productivity of our sales force through four key pillars. First improving risk procedures to rise credit approvals at the front office through preapproved loans and by improving risk attributions. Second, leveraging digital tools to develop advanced analytics. Third, expanding our business intelligence and building new propensity models. Lastly, developing commercial discipline through the implementation of management and training procedures. Through the successful implementation of this program, we have seen important improvements across the business unit’s KPI, the most important one being an increase in originations per account manager. As a result of this program’s success, we are in the process of rolling out something similar in the SME segment.

Please turn to slide 17.

Funding has been key in this economic cycle. Thanks to our strong position in demand deposits and prudent and consistent positions taken in the asset side of the balance sheet, we have been rewarded with higher margins. First, I want to emphasize that the evolution of deposits has evolved in line with our expectations as shown on the chart to the top right. As a result of the sharp increase in interest rates and inflation, as we foresaw last quarter, we have seen a reduction in demand deposits from clients that have either used the funds that they accumulated during the pandemic or invested in time deposits or mutual funds. Since interest rates are expected to remain high for a while, we expect that DDA should continue decreasing. This reduction in DDAs should be experienced across the entire industry. Along these lines, we maintained our leadership position in demand deposits to loans, as shown on the chart on the bottom left.

This source of funding and short-term time deposits denominated in pesos, support part of our structural inflation gap. Given the lagged response of nominal interest rates to inflation, we have benefited from a positive trade off when funding our UF net asset position with these kinds of liabilities. In this environment, we decided to gradually and responsibly increase our UF exposure in the banking book over the last quarters. As such, our net asset UF gap in the banking book reached $7.8 trillion pesos as of June 2022, up from $5.3 trillion in 2019. .

We are the most capitalized bank amongst our peers as shown on the next slide number 18.

Our Basel III ratio reached 17.4% as of June 2022, significantly higher than the average of the industry. When compared to our peers, we out ranked all of them in our CET1 ratio of 12.9%, as displayed on the chart on the bottom left of the slide.

More importantly, we have been able to post these figures with a level of profitability that none of our competing banks have managed to attain as shown on the chart to the right. This position of the highest profitability with the best capitalization is truly unique and is a direct result of our long-term consistent strategy that focuses on growing responsibly with strict policies to manage risk exposures in order to generate appropriate returns.

Additionally, we are in a comfortable position to implement fully-loaded Basel III requirements smoothly, based on our solid CET1 capital level and our capacity of generating high and consistent returns overtime, which in turn will permit us to continue delivering attractive dividends for our shareholders.

Please turn to slide 19.

We posted this quarter expected credit losses of $106 billion pesos, up from $74 billion pesos in the same period last year. Once again, a large percentage of these provisions were related to additional allowances that we established in line with persistent uncertainty of the economic and political environment. NPLs also remained below historical levels, posting only 0.97% this quarter, down from 1.05% a year earlier. This was strongly due by transitory factors that reduced the real deterioration in the fundamentals of the economy. However, we have begun to see a slight increase non-performing loans over the last few months, in line with a gradual and expected process of normalization.

Saying that, cost of risk including additional provisions reached 1.21% but this is significantly lower when we exclude the additional allowances. In fact, we recorded only 0.74% cost of risk when excluding these allowances and a delinquency ratio of only 0.97%, as you can see on the chart on the bottom left, both significantly below our peers.

Finally, I want to emphasize that we have superior revenue generation. As shown on the chart on the bottom right, we out rank our competition with a wide gap for the fourth quarter in a row, clearly demonstrating our excellent and consistent business strategy.

Please turn to slide 20.

This has been another record-breaking quarter in terms of our efficiency ratio. We reached this quarter a ratio of merely 28%. Not only that, our total operating expenses actually decreased in real terms year-on-year. In nominal terms, costs grew 11%. This level of efficiency and cost control has been possible through the productivity plan and initiatives that we have been continuously implementing over the years and are bearing fruit. It’s also relevant to remember that many costs are indexed to inflation, and to lesser extent to foreign currency. For example, salaries are adjusted at least twice per year by inflation and many IT cost are indexed to USD.

We are committed to continuing to improve our cost structure and to make better use of our resources to maintain a high level of productivity. As mentioned at the beginning of this presentation, it's clear that the level of efficiency we reported is heavily impacted by transitory revenue growth, we are however convinced that the incremental progress we have made in recent periods should lead to sustainable productivity improvements compared to levels we had prior to the pandemic after these revenues normalize.

Please turn to slide 21

Before moving on to the questions, I would like to briefly discuss the main points presented today and provide some guidance.

First, we expect an economic slowdown for GDP beginning in the second half of this year and this should persist during the first half of 2023. Inflation for the second half of the year should be similar to the levels we saw in the first 6 months of 2022, with more short-term rate hikes from the Central Bank of Chile.

As a result, we are expecting GDP for 2022 to slow down to around 1.7% and loans in the industry to grow around inflation in nominal terms. For Banco de Chile, we are pursuing to grow in consumer and SME commercial loans and we aim to pick up market share in these segments this year.

In terms of results, we posted again the strongest bottom line in the industry because of our superior balance sheet management and successful strategic initiatives that have driven stronger figures than our peers.

We expect fully year 2022 ROAE of approximately 28%, with a NIM of 5.2%, an efficiency ratio near 35% and a cost of risk of around 1.2%. In the long-term, we anticipate ROE to converge to pre pandemic levels of around 18%, which is consistent with NIM to be around 4% to 4.5% and cost of risk without additional provisions to reach 1.1%, and cost to income around 42%.

Finally, to close, I want to emphasize that we posted the strongest results in the industry with higher capital and additional provisions., as shown on the chart to the right. As such, we believe that this further proves our superior sound business model and competitive strengths that continue to position us as the strongest bank in the country and a great investment for our shareholders.

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