Banco de Chile 3Q22 Financial Results

Conference Call

Operator

Good afternoon everyone, and welcome to Banco de Chile's third 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 and 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. Thanks for joining this conference call today, where we will present and analyze the results and accomplishments posted by Banco de Chile during the third quarter of this year.

Before beginning the presentation, I'd like to say we are pleased with the several achievements of our bank during the quarter, demonstrating its unquestionable leadership in the Chilean financial industry. Some of them include the following:

- We posted the highest level of net income and profitability in the local industry.
- We remain the best capitalized bank in the country, confirming our superior position to face business challenges and Basel 3 phase- in transition in the future.
- Despite the macro slowdown, the quality of our portfolio remains strong, also attributable to our sound and prudent risk management.
- Additionally, we continued posting significant advances in key strategic areas for the long-term sustainability of our bank, such as digital transformation, focus on improving productivity, and ESG, among others.

We will go into further detail about these and other aspects in the rest of this call.

As usual, we have divided this presentation into three main sections. First, an overview of the macro environment that we face, including our forecasts for the next year; second, a review of the main advances in strategic projects; and finally, a deep analysis of our financial results.

Let me start with the macro section. Please go to slide number 3.

The Chilean economy is slowing down. After expanding by 11.7% in 2021, the GDP went up by 7.4% and 5.4% year-on-year in the first and second quarter of 2022. Available information for the third quarter shows a further decline, as the monthly GDP decreased by 0.4% year-on-year, becoming the first negative figure since mid-2020 when the economy was hardly affected by social restrictions implemented during the pandemic.

This slowdown shouldn´t be surprising, especially considering growth has remained well above the long-term capacity of the economy, which is nearly 2.5%. That said, it is worth mentioning that the downturn of the GDP has been driven by the normalization of several temporary factors that fueled the expansion last year. Among them, we can highlight the following:

- First, fiscal spending is expected to fall more than 20% in real terms this year. This reduction is mainly attributable to the withdrawal of several non-permanent subsidies, especially in 2021 Consequently, fiscal spending increased by 32% in real terms last year, clearly an unsustainable figure for the long run.
- Second, the tightening in the monetary policy is also beginning to affect the dynamism of domestic demand, as expected. Even though the Central Bank began to raise the interest rate last year, there is a delay between these changes and impacts on the overall activity.
- There has also been a negative impact of the higher inflation rate on disposable household income, reducing the dynamism in private consumption even more.

The slowdown is even more evident when we analyze the GDP sequentially, as seen in the chart on the top right. Despite the year-on-year growth rates posted in the first half of the year, which has been influenced by the weak comparison base from one year ago, the activity hasn't grown year to date. In September, for instance, the level posted by the Imacec (monthly GDP figure) was 1.0% below the level achieved in December of 2022. The breakdown shows this negative trend has been attributable to the fall of 10% commerce sector in September and the negative tendency in private investment. Services have recovered the lost ground during the pandemic, due to the greater levels of mobility because of the ease in sanitary restrictions.

Despite the lower growth, unemployment has remained stable. In the third quarter, the jobless rate was 8.0%, remaining well below the peak of 13% seen in the peak during the pandemic (mid 2020). This result is explained by the gradual recovery in employment, which grew 6.0% year-on-year in the third quarter, and the labor force expanded by 5.5% year-on-year in the same period. Nevertheless, both figures have been reducing their expansion rates, in line with the slowdown of the economy. The participation rate, measured as the share of the active population, remained at 59%, below the 63% observed before the pandemic.

All the expansionary measures implemented during the pandemic contributed to widening macroeconomic imbalances, such as the current account and fiscal balance. Nevertheless, there will be an improvement in the fiscal side this year. As a result of the greater dynamism in the local activity, tax collections posted a substantial rise this year, which, coupled with the adjustment in the fiscal spending, will drive a surplus this year, as the bottom right chart shows. This will be the first positive balance in a decade, and this improvement should also contribute to reducing the current account deficit. **These changes have affected prices and interest rates. Please flip to the next slide, number 4.**

Total inflation continued increasing during this year, in line with the trend observed in most countries. In September, the headline CPI went up by 13.7% year-on-year, the highest since the nineties. The breakdown reveals that local inflation has been driven by external prices and the weaker currency, which was reflected in the 17.1% rise in the tradable index, while the 10.3% year-on-year rise in the core index reflects pressures beyond the most volatile prices. Additionally, the non-tradable index (a measure that isolates the impact of foreign prices) increased by 9.6%. Since all the measures have remained well above the 3.0% target set by the central bank, it is clear that inflation in Chile is a generalized process rather than a situation explained by increases in only a few articles.

In this environment, the Central Bank continued tightening the monetary policy. In the meeting held in October, the board decided to lift the rate by 50 bps to 11.25%, reaching the highest rate observed under the current policy framework (the 3.0% inflationary target was set in 2003). Apart from raising the interest rate, the Central Bank adopted a neutral bias by mentioning that the tightening cycle was ended in that meeting, after raising the rate by 1075 bp since July of 2021. Consequently, the rate should be maintained at this level, probably until the second quarter next year. It is worth mentioning that the Chilean rate is one of the highest in the region, reflecting the Central Bank's strong commitment to the inflation target.

Likewise, long-term interest rates have continued increasing this year, following the trend observed since 2021. The main drivers of this trend include the higher monetary policy rate, the persistent inflation, and the recent upward trends in international rates, as seen in the chart on the top right.

Undoubtedly, the volatility has increased significantly since the beginning of the pandemic in an environment marked by lower growth, higher inflation, and a weaker currency. In such types of scenarios, sound financial buffers could make a material difference in terms of the ability to mitigate negative shocks, since they bring the possibility to implement measures that aim to protect the financial stability and to finance supportive countercyclical measures. In this context, as seen in the chart on the bottom right, it is worth mentioning that the Central Bank maintains international reserves by USD38 billion, which are equivalent to nearly 12% of the annual GDP. Since Chile has a flexible exchange rate regime, this amount of resources, plus the flexible credit line of USD17 billion maintained with IMF, provides sufficient resources to address potential economic disruptions. Additionally, also important to mention the existence of USD25 billion in fiscal reserves, composed mainly of sovereign wealth funds, which should allow countercyclical measures if the cycle worsens even more.

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

We expect the GDP to increase by 2.0% in the current year. Since the economy expanded around 6.4% in 1H22, this estimate is consistent with a negative growth for the rest of the year. This slowdown will be a consequence of several factors, including (i) the reduction in fiscal spending, as mentioned before; (ii) the lagged effects of higher interest rates; (iii) the subdued growth in several trade partners (mainly China); and (iv) the negative impact of higher inflation and lower liquidity levels on disposable income. These negative YoY growth rates should last until mid-2023, translating into a contraction of 1.2% in the whole year.

We expect inflation to fall in 2023, although at a gradual pace. Specifically, we foresee the headline CPI will decline from 13% this year to around 4.5% in the next year, as a consequence of lower pressures in non-tradable prices, due to the recession in Chile, as well as from the lower commodity prices. Nevertheless, it is reasonable to expect the CPI to remain above the target of 3.0% at least until 2024. In this environment, we expect the Central Bank to maintain the overnight rate until the first half of the following year and the beginning of a gradual easing process towards 6.0% by the end of 2023.

Finally, I'd like to mention some risks that could have a material impact on the economy if they occurred. Apart from the global sources of uncertainty relevant to Chile, such as the evolution of China and the geopolitical conflicts, it will be critical to pay attention to the constitutional discussion in Chile, especially in terms of the mechanism and contents to be considered in the draft of the new constitution. It is also relevant to the discussion and implementation of several economic reforms announced by the government, including modifications to both the tax and pension systems, among others.

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

The industry posted solid operating income and net income this quarter, driven mainly by the high levels of inflation. Nevertheless, if we consider the effect of inflation on the value of equity, the bottom-line growth would be much less. For example, return on average equity for the industry reached 20.6% this quarter but if this were adjusted by the effect of inflation on equity, profitability would decrease significantly.

With regards to credit quality, the industry continues to show deterioration in NPLs and consequently posting higher loan loss provisions, as can be seen in the chart on the bottom right of this slide. This is in line with expectations and our guidance of normalization as excess liquidity is reducing in Chile. Additionally, direct and second round effects of higher inflation and interest rates are factors that could negatively affect the payment behavior of customers and this could further be impacted by the subdued economic growth we are experiencing. Nevertheless, in our baseline scenario, we expect that asset quality will continue returning to pre-pandemic levels at a quicker rate, excluding the effect of additional provisions from the equation.

In terms of loans, we have continued to see a weak performance in the industry, with only inflation and CLP depreciation being the main drivers of growth. This lower dynamism is in line with the weak business and consumer confidence levels and stricter credit supply conditions from higher interest rates and tightening risk policies.

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. Please go to slide number 8.

The basis of our stronger and more sustainable bank has been achieved through our sound strategic pillars based on customer centricity, productivity and sustainability. To reach our mid-term goals, we have established six strategic focus areas of action. In the next slides we will go over some of the advances we have made in digitalization, productivity, and sustainability.

Please move to slide number 9, where we will highlight some of our initiatives in digital banking.

Our main digital debit account continues attracting new customers to the bank. As you can see on the upper side of the slide, we have a stock of over 974 thousand FAN accounts, adding approximately 79 thousand new accounts during the 3Q22 and over 385 thousand during the last 12 months. Even though this account is doubling our core customer base composed of debtors and/or current account holders, it is important to highlight that we did it without compromising our service as can be seen through our total Net Promoter Score that continues in levels of 75%. In fact, Cuenta FAN, which is a 100% digital account, has a higher level of customer satisfaction registering as NPS over 80%, which means that we are offering a great digital experience.

In line with our strategy, during this year we launched diverse new functionalities, digital products, and services to complement and improve our ecosystem as listed on the bottom left. Additionally, we have launched new functionalities to our app Mi Pago to make this app more comprehensive and useful for our clients. Some of the new features are the possibility to withdrawal funds from ATMs without a card, to pay at thousands of online and physical stores using QR codes, and make and receive transfers between select banks though the Paga2 functionality.

Please turn to slide 10.

As we mentioned earlier, productivity has been one of our key factors in our long-term strategy. In order to build the basis for a more efficient and productive bank in long run, we have carried out several projects during the last years, as can be seen in this slide.

First, as you can see on the upper side of the slide, in 2019 we started a structural cost reduction process. This led to the optimization of our branch network, the creation of an efficiency program and a Corporate Sourcing and Procurement Unit. Through these projects, we reduced the number of branches by approximately 30%, gaining a significant level of efficiency and digitalized procurement practices.

In 2021, we completed the first stage of our efficiency program and implemented a group of specialized and cross-functional teams to not only maintain but to also find areas of improvement to drive productivity further. These areas are working together with many others in the front and back office to improve productivity and implement new cost optimizations.

Through our Productivity Improvement pillar, we designed a Retail Banking Sales Excellence Plan to standardize commercial activities, a Campaign Management Optimization to increase the effectiveness of campaigns and Enabling Products for Digital Sales to improve our operational efficiency.

Finally, another pillar that is ongoing is the Cost Categories Optimization that aims to optimize the costs from suppliers through a strategic sourcing annual plan, supply and demand management opportunities and projects linked to future budgets.

Our effort on this matter is bearing fruit as can be seen on our efficiency ratio, which is the best among peers, with zero real expenses growth year-on-year as of September 2022.

Please turn to slide 11

We are constantly boosting our initiatives related to sustainability to generate value not only for shareholders but also for society. We believe that we can contribute to the development of the country and people in many ways. During 2022 we implemented diverse projects such as the launch of our first Sustainability Financing Framework to issue ESG related bonds, the Banco de Chile “Blue Commitment Program” to promote green financial products and held national contests to boost entrepreneurship aimed at students and SMEs.

In addition, in line with our culture transformation process, we held leadership trainings programs emphasizing gender equality and labor ethics and we advanced in the implementation of labor flexibility.

Finally, Banco de Chile employees carried out diverse volunteer activities mainly aimed at supporting social organizations, elderly people and reforestation. We are also proud to be once again the main partner of the annual Teleton fundraising campaign for Children with disabilities, taking place this weekend. We provide our infrastructure to raise funds and an important number of Banco de Chile employee volunteers. Banco de Chile has participated as the main partner of this campaign since the beginning, more than 40 years ago, which has become into one of the most important fundraising campaigns in Chile and even globally.

We are also very pleased that diverse institutions have recognized our Sustainable Strategy and that we have the best ESG ratings in the Chilean banking industry according to global research firms.

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

2022 has been profitable for the banking industry in nominal terms as you can see on the chart to the left, where we led the sector with over 30% nominal ROAE. A key differentiating factor, apart from our competitive advantages and strategic projects has been our strong governance practices and proactive management actions, that permitted us to take proper measures during the pandemic, while benefitting from an environment of high inflation, interest rates and liquidity.

However, it's important to be aware of the transitory impact generated by the high level of inflation on profitability in periods when the inflation is extraordinarily high. 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.

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. In our view, this measure provides a clearer perspective of real profitability, since it shows the full economic value that is generated by maintaining the real value of equity, after considering the negative impact of inflation on its nominal value.

Under this perspective, as you can see in the chart on the right side of this slide, we generated ROAE well above our main peers and even higher than our pre-pandemic figures demonstrating our superior competitive advantages and a consistent customer-centric long-term strategy.

Please turn to slide 14.

We posted another strong bottom line this quarter of $340 billion pesos, 89% above the same period last year. Inflation and interest rates were the main drivers of these results supported by our solid risk management that kept both credit and market risks low. Especially relevant is how we performed in comparison to our main peers. The chart to the right shows how we significantly surpassed all of them.

On a sequential basis, net income generation decreased in line with our expectations of a reduction of inflation during the second half of this year. CPI is predicted to begin to slowly decrease during the next quarters to return in the medium term to the Central Bank target of 3%. We believe that our long-term ROE should go back to the levels we posted prior to the pandemic, near 18%, as long as inflation converges to normal levels aligned with the Central Bank's target range and interest rates -particularly in shorter terms- return to neutral figures of around 4.5% to 5.0%. However, this level of ROE depends on the long-term impacts from the pandemic and politics that have affected the economy in areas such as inflation, interest rates, workforce, as well as the evolution of the reforms that are being discussed.

For, 2022 ROAE will be well above this level and 2023 is also expected to be higher as interest rates and inflation will remain elevated and the excess of customer deposit volumes liquidity will be ending its process of normalization.

Please turn to slide 15.

Total operating income rose by an impressive 47% year-on-year, primarily from a rise in non-customer income and in customer income.

The strong increment in non-customer income has been achieved by proactively managing our UF denominated assets position, that allowed us to benefit 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. We also have benefited greatly from the favorable shifts in interest rates and inflation on contribution of temporary gaps held by our treasury when managing balance sheet and currency mismatches. As of September 2022, our UF net asset gap in the banking book was approximately $8 trillion pesos, translating into a sensitivity of about $80 billion pesos for every 100 basis point change in inflation, all things equal, or approximately 20 basis points in NIM.

In turn, the important expansion showed by our customer income is primarily explained by the higher contribution of demand deposits to our funding cost as interest rates have risen significantly over the last 12 months, partially offset by the expected reduction in DDA volumes that we have been anticipating in past conference calls. In addition, Fees during the period also contributed positively to the rise in customer income, growing 14% year-on-year. This was due to higher transactional income from credit cards up 43% from last year due to higher volumes, a 20% increase in checking account administration fees because of a larger customer base as well as the effect of inflation on fares and a 5% rise in insurance premiums in line with the normalization of consumer loan originations, as well as higher fees from all of our subsidiaries, among others.

Net interest margin this quarter rose to 5.8%, up from 3.4% a year earlier and in terms of total operating margin we recorded a ratio of 6.9% this period, both figures were significantly higher than all of our peers, as shown on the right. We attribute this not only to our sound long-term strategy that has generated a track record of attractive returns but also to our superior corporate governance that set policies and effective controls for management and helps to assure long-term sustainability of the bank.

Please turn to slide number 16.

Total loans grew 9% year-on-year to $36.1 trillion pesos and 1% on a sequential basis. Except for consumer loans, most of this has been driven by market factors. It’s important to highlight that 36% of commercial loans and almost 100% of mortgage loans are denominated in UF. Likewise, around 17% of commercial loans are denominated in foreign currency, mainly in USD.

Consequently, inflation and exchange rates behaviour play a huge role in this loan growth figure. Isolating these market factors, loan origination remained weak, in line with the poor consumer and business confidence levels, higher interest rates and economic uncertainty we are facing as well as our prudent approach to credit risk. This slowdown is easily seen on the chart on the bottom, where growth is in negative territory, as CPI reached very high levels during the last 12 months.

Nevertheless, our consumer loans continued to show good dynamism, growing 17% year-on-year and 2.6% quarter-on-quarter. This positive performance is mainly due to strong origination figures, thanks to solid value propositions that accelerated business growth. Among other initiatives, we incorporated new commercial developments that permitted us to deploy more successful commercial campaigns aimed at both increasing consumer loan origination and enhancing credit card transactions by reinforcing loyalty programs.

More specifically, as mentioned last quarter, the Retail Banking Sales Excellence program has driven consumer loan growth by boosting the productivity of our sales force through four key pillars. First, we are improving the effectiveness of risk models to increase the amount of credit offers available for our customers and improving the approvals being done at the branch level using preapproved loans and by improving risk attributions. Second, leveraging digital tools to enhance analytics. Third, expanding our business intelligence and building new propensity models, which is a set of approaches to building predictive models to forecast behavior of a target audience by analyzing their past behaviors. Lastly, developing commercial discipline through the implementation of management and training procedures, branch per branch. The successful execution of this program has improved KPIs, especially originations per account manager. As a result of this program's success, we are in the first stages of implementing the program for the SME segment. We have seen positive results so far, especially with important improvements in productivity measured by sales per account manager.

Please turn to slide 17.

Funding has been other key element during this economic cycle. Thanks to our outstanding level of demand deposits and our prudent positions taken in the balance sheet, we have been compensated with strong margins.

First, it's important to note that the evolution of deposits has progressed in line with our expectations as shown on the chart to the top right. The Central Bank has continued increasing interest rates, which has decreased demand deposits volumes from customers and increased time deposits. We expect this trend to continue until we reach more normal levels of liquidity in terms of deposits to loans of around 33%. Nevertheless, we are confident that we have the best quality of customers, focused on upper income retail segments and top tier companies. This mix should permit us to maintain a leading position in demand deposit funding as liquidity returns to normal levels in the medium term.

Second, this source of funding and short-term time deposits denominated in pesos, support part of our structural inflation gap on our balance sheet. Given the lagged response of nominal interest rates to inflation, we benefit from a positive trade off when funding our UF net asset position with these liabilities. As a result, we gradually and responsibly increased our UF exposure in the banking book over the last quarters, reaching a GAP on the balance sheet of around $8 trillion pesos, up from $7.3 trillion one year earlier.

We have the strongest capital ratios amongst our peers as shown on the next slide number 18.

Our total capital ratio reached 18% as of September 2022, well above the industry and we also outranked our peers in this ratio and CET1 with a level of 13.3%, as shown on the charts to the left.

Despite our larger capital base, we have consistently posted a superior ROE versus our competition as shown on the chart to the right. This is a unique situation and has been accomplished by our long-term consistent customer-centric strategy that focuses on driving results through responsible growth and sound credit and market policies.

Additionally, we are very comfortable in this capital position and have ample room to implement Basel III requirements smoothly and at the same time provide attractive dividends to our shareholders.

Please turn to slide 19.

We posted this quarter net credit charges of $106 billion pesos, up from $89 billion pesos in the 3Q21. Additional provisions represented 33% of the total, substantially less than last year. This is in line with the normalization of liquidity in Chile that is translating into more normal levels of NPLs and expected credit losses from models as shown on the table in the left side of this chart.

When compared to our peers, we continue to have the soundest portfolio as shown on the chart on the bottom left, with a significant gap to the next closest competitor. On top of this, we also have the highest coverage ratio of 3.7 times and the most additional provisions amounting to $685 billion pesos. This positions us extremely well for the uncertainties that lie ahead to maintain cost of risk at acceptable levels if the economic environment worsens beyond our baseline scenario.

Finally, I want to emphasize on the chart on the bottom right, that revenue generation widens even more from our peers when we include in this indicator cost of risk thanks to our superior performance, clearly demonstrating our excellence managing our business.

Please turn to slide 20.

Expenses this quarter rose by 20% over last year. Most of this rise is due to the high inflation levels we have faced since most of our expenses, including salaries, are indexed to CPI. Other factors that explain the expansion are higher provisions for variable compensation; and a one-time bonus granted to part of the staff to recognize their commitment to the company in the achievement of our excellent performance in 2022.

In terms of efficiency ratio, we reached this quarter 33.2%, well below the industry and our peers, as shown on the charts on the bottom. As mentioned earlier in the presentation, this excellent cost control and efficiency has been feasible through our sound productivity plan and initiatives. We are convinced that the progress we have made will allow us to post long-term efficiency levels below 45% when inflation normalizes.

Please turn to slide 21 for key takeaways

First, we expect a transitory recession between 4Q22 and the 2Q23. In our baseline scenario we do not expect to have a material impact in our results due to a riskier environment. Our strategy has been focused on growing responsibly to drive results. This in the short-term has grown our bottom line more than our competition by fully taking advantage of higher inflation and interest rates to generate higher operating revenues. Additionally, the high levels of liquidity in the industry have permitted to keep cost of risk low. Looking forward, we expect to return in the long-term to ROEs closer to 18% and in the short-term to post ROEs above this level.

Before moving on to questions, I want to stress that we posted the best bottom line in the industry, the best ROE amongst our peers with the best capitalization levels. All of this is not by chance but is due to a sound strategy, top tier corporate governance and first-class competitive advantages.

This should continue to permit us to post solid results in the future and provide a great invest for our shareholders.

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