Banco de Chile 4Q22 Financial Results

Conference Call

Operator

Good afternoon everyone, and welcome to Banco de Chile's fourth 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.

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. Thank you very much for attending this conference call, where we will review the main accomplishments achieved by our bank during the fourth quarter and the full year of 2022. In this call, we will also share our business analysis and our guidance for 2023.

Before reviewing the economic environment, I would like to share with you some of our main achievements during 2022.

Please go to slide number 2

2022 was an outstanding year for Banco de Chile when, we undoubtedly reaffirmed our leadership in the Chilean Banking Industry, not only in financial performance but also in many other key strategic aspects when compared to our competitors.

Even though we will go over our main accomplishments throughout this presentation, I'd like to briefly highlight some of them:

- On the financial side, we achieved a historical bottom line of 1.409 billion pesos, equivalent to an ROE of 31.4%, well above the industry's average. After adjusting the bottom line by the transitory and non-recurring effect of a higher inflation rate in the equity value, ROE would have been 19%, well above the rest of the peers but more in line with our historical figures.

- Our growth in operating income was accompanied by a historical efficiency ratio of 32% and robust asset quality figures, also positioning us better than our peers.
- 2022 was also a year where we strengthened our capital position even more by reaching a Basel ratio of 18%, well above both the regulatory threshold and our main competitors.
- Moreover, we increased our additional provisions to an unprecedented amount of $700 billion pesos, achieving a coverage ratio 3.7 times our non-performing loans, allowing us to be even more prepared to face negative cycles.
- Additionally, we took important steps in our sustainability pillars. Apart from permanent activities supporting the community, we made numerous environmental, social, and governance improvements, which allowed us to be the best bank in ESG Risk Ratings in Chile, according to Sustainalytics, and received several recognitions.
- Finally, we made important advances in our digital transformation process, which has been a critical piece to maintaining the best rate of customer service, improving productivity, and strongly contributing to promoting financial inclusion in Chile.

As I mentioned, we will develop these and other activities during this presentation. **But before that, I'd like to share our view of the Chilean economy. Please move to slide number 4.**

The Chilean growth has continued to weaken, as the chart on the top left clearly shows. Generally, this trend is attributable to three main factors: first, the removal of several temporary stimuli implemented during the pandemic, such as the 32% rise in fiscal spending and the withdrawal of more than US$50 billion from pension funds. Consequently, the absence of further fiscal and liquidity measures in 2022 contributed to reducing disposable income and domestic demand. A second factor has been the lagged effects of the tightening in the monetary policy rate, which rose by 1075 bps between July 2021 and November 2022. Finally, some idiosyncratic factors, especially those related to political uncertainty, have also reduced economic growth.

In this environment, the GDP fell by 1.6% YoY in the 4Q22, posting the first negative annual figure since 2Q20, as the upper left chart shows. This slowdown has been explained by the fall in commerce and Industry sectors, which fell by 8.4% YoY and 5.5% YoY, respectively. Other cyclical sectors, such as construction, have also been negatively affected. On the other hand, services have steadily risen, in line with greater levels of mobility due to the ease in sanitary conditions since last year.

On a sequential basis, as can be seen in the chart on the upper right, the slowdown has been also evident. In fact, the activity level posted in December of 2022, for instance, was 1.0% below the figure posted one year ago, reflecting that the economy didn't grow last year. The Imacec (monthly GDP figure) breakdown shows that all sectors declined sequentially during the year.

Despite the average unemployment in 2022 was 7.9% (130 bps below the figure posted one year ago), it is important to be aware of the deterioration in the labor market. For instance, the weak expansion of the labor force has reduced the number of unemployed people. Therefore, the lower average unemployment, when compared to 2021, is a consequence of demographic changes rather than a greater dynamism in the economy. Additionally, real wages continue to fall (-2.3% YoY in November, the latest available figure) due to the higher growth in CPI compared to the expansion in nominal wages. Finally, the informality rate has remained around 26%, above the level observed some years ago, suggesting a potential deterioration in the quality of jobs.

However, the subdued growth is contributing to reducing the macroeconomic imbalances that widened during the pandemic. Specifically, as the chart of the bottom right displays, the trade balance has been improving, led by higher exports and lower imports, anticipating a lower deficit in the current account figures in the short term. This trend should anticipate a normalization in external accounts, which is a fundamental pillar for macro sustainability.

These adjustments in the business cycle have been accompanied by changes in different prices, as we will see in the next slide, number 5.

Following the global trend, the CPI had an impressive rise last year. Particularly, in 2022 the inflation ended the year at 12.8%, achieving the highest figure since 1991. This trend, as observed in the chart located on the top left, was the consequence of three main drivers: First, the higher global inflation, a factor that is particularly relevant for an open economy as Chile, where tradable goods represent more than 60% of the total CPI basket. A second factor was the depreciation of the Chilean peso, especially in the first half of 2022 as you can see in the bottom right chart. Finally, the substantial increase in domestic demand due to the stimuli implemented during the pandemic played a critical role in non-tradable pressures. Additionally, it is also important to be aware of the high indexation in Chile since several prices are set in UF, which could add further persistence to the CPI.

The upward trend in domestic prices led to an important adjustment in local interest rates, especially during the first half of the year. Part of the explanation behind this was the material adjustment in the overnight rate, which rose from only 0.5% in July of 2021 to a record figure of 11.25% in November last year, as the bottom left chart reflects. In fact, the monetary policy in Chile has been one the most tightened in the world in this cycle. Nevertheless, the long-term rate has been falling, anticipating a weaker growth in 2023 as well as a potential easing cycle in Monetary Policy over the next quarters.

Despite the weaker cycle, the Chilean peso has strengthened during the last months. Some external factors, such as better copper prices and the weakening of the dollar globally, in addition to idiosyncratic factors, such as the slight improvement in some risks, have contributed to strengthening the Chilean peso. Among the factors that have reduced uncertainty is the mechanism defined for the incoming constitutional process to be held this year, which will consider the participation of both elected people and constitutional experts in elaborating the proposal. This mechanism, coupled with some borders defined for the discussion, such as a strong separation of powers, reduce the possibility of institutional weakening in the country. It is well known that an appropriate design of counterweights can make the difference in the long term.

Now, I'd like to move to our forecast for this year. Please move to slide number 6.

We expect the Chilean GDP this year to fall by 1.4% after a 2.7% expansion in 2022. These figures result from a "U shape" trend in the activity, with negative annual expansion rates between 4Q22 and 2Q23, as a result of the normalization of the temporary factors that fueled the growth, as I mentioned previously. This forecast, consequently, is consistent with a gradual recovery in activity since the second half of this year.

This slowdown and the recent strengthening of the currency should contribute to reducing pressures on prices. In our baseline scenario, the overall inflation will fall from 12.8% in 2022 to 4.8% this year, with a potential convergence to the 3.0% policy target only by 2024. Given these figures, we see room for lower monetary policy interest rates in the near future. Despite the neutral bias that the Central Bank has adopted in the last monetary policy meetings, we believe that the conjunction of lower growth and inflation will leave room to reduce the interest rate to nearly 6.0% by the end of this year.

All these forecasts are subject to risks. In addition to global uncertainties, where Chinese dynamism is a key driver for Chile and geopolitical conflicts in Eastern Europe could produce some noise in international prices, we have to pay attention to the evolution of some local factors as well, especially those related to political and institutional aspects. Some of them include the evolution of some reforms that are currently under discussion in Chile, such as the tax and pension bills, as well the ongoing constitutional process. The evolution of these factors will be critical to the length and deepness of the recession that we currently face.

Before moving to BCH discussion, I'd like to briefly discuss the evolution of the local banking industry. Please flip to slide number 7.

2022 was a profitable period for the banking industry, posting stronger nominal results than the prior year. However, inflation was the main driver for this result and as you will see later in the presentation, the true profitability adjusted by the loss of purchasing power due to high levels of CPI which Chile has experienced, is substantially lower than 21% for the Banking industry in 2022. The cost of higher CPI is also reflected in asset quality, where for the last four quarters in a row, the industry has seen an upward trend in loan loss provisions, as shown on the chart to the bottom right.

Loan growth in real terms has also weakened, as shown by the chart on the bottom left. Inflation, and several sources of uncertainty have impacted demand. For 2023 we expect a weak real growth of around 1%, driven by mortgage and consumer loans.

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

PABLO MEJIA

Thanks Rodrigo. Please go to slide number 9.

The strong results that we have consistently achieved have been the product of our sound strategic pillars based on customer centricity, productivity and sustainability. To reach our mid-term targets, we have established six core priorities. In the next slides will review some of the advances we have been making.

Please move to slide number 10, where we will highlight some of our digital banking initiatives in 2022.

Our strategic ambition at Banco de Chile is to deliver the best customer experience and to provide the best digital banking platform to clients in Chile. During 2022, we strengthened existing platforms and continued implementing innovative digital solutions.

We are proud to highlight that our Cuenta FAN account has reached over 1 million clients as of December 31, 2022 by adding approximately 350 thousand customers. Another relevant aspect is that despite the quick growth of this product, where we grew our customers by almost 50% this year, we did it without affecting our customer's satisfaction levels.

Among our advances in 2022, we launched three new digital products to promote customer onboarding and financial inclusion: Digital Current Account, FAN Clan and FAN Emprende.

- The new Digital Current Account was launched in the first half of the year and is a full bank account with the possibility to open other products such as lines of credit and credit cards.
- FAN Clan is a free digital account for teenagers between 14 to 17 years with the purpose to build strong relationships early in the customers life cycle.
- FAN Emprende is a digital account for SMEs that has no entrance or maintenance fees and gives access to exclusive benefits for small businesses.

All three of these products are in line with our aspiration of growing our clients and promoting financial inclusion.

Furthermore, among other initiatives, we released several upgrades and innovation in our apps. As shown on the right side of the slide, we launched an improved investment app that allows our clients to invest easily worldwide and we made an alliance with other important institution to facilitate the monetary transactions between the clients of both banks using telephone numbers and QR codes. In addition, we made important upgrades in our main app Mi Banco such as withdrawing funds from ATMS without the need of physical card, online loan simulations, and approval of consumer loans. Likewise, we added new functionalities on our app for enterprises Mi Banconexion.

Finally, we are honored that our advances in digital banking, together with our permanent focus on providing the best customer experience, led us to be recognized by The European as the most

Innovative Digital Bank in Chile and by the digital newspaper focused on the financial industry and Chilean consumers called Chócale, as having the Best Digital Banking Solution in the country.

Please move to slide 11

We continued implementing changes and initiatives to reduce expenses and improve our operations in line with our efficiency and productivity objectives. We introduced a new purchase model which uses an electronic auction and tender processes to increase competition among potential providers while ensuring transparency and cycle times. Additionally, we made several negotiations to fulfill all banking functions proactively through an Annual Purchase Plan, which generated savings of approximately US$ 20 million. Finally, regarding our cost reduction process, we have developed optimization projects that covered diverse aspects such as our branch footprint analysis, savings in energy costs while optimizing and consolidating service purchases at a corporate level.

On the Productivity side, through the Retail Sales Excellence Plan we increased consumer credit loan originations by 45% year-on-year while maintaining our account mangers headcount flat. This impressive figure was fruit of a set of improvements such as the standardization of commercial processes, the digitalization of sales and refocusing the intelligence of commercial campaigns.

Due to the successful implementation of the Productivity projects on our Retail Business, the Bank decided to extend and adapt these initiatives to the SMEs Banking that promptly achieved good results as the increase of 25% in originations per account manager. Thanks to these and other actions previously implemented, we ended the year with the best efficiency ratio among peers in Chile.

We also accomplished important advances in ESG, as we will discuss in the next slide, number 12.

During 2022, we had taken important steps towards strengthening our sustainability strategy. We have been actively reinforcing the development of social, environmental and governance initiatives, some of which are presented on this slide.

We developed a Sustainability Financing Framework to issue ESG related bonds and to finance projects with positive impacts. In addition, we created a Sustainability Committee led by the CEO to boost our ESG strategy and launched the “Blue Commitment” program to promote our green products.

Last year we also continued boosting our social and environmental initiatives such as our financial education courses, tournaments to promote entrepreneurship, volunteering programs to support social organizations, care and support of elderly people and reforestation. Those programs directly benefited over 44 thousand people. It is also worth mentioning that we have the largest corporate volunteering program in Chile, in which almost 10 thousand employees participated as volunteers at Teleton 2022.

Finally, through our permanent focus on improving diverse ESG aspects of our business, we were recognized as Best Bank for Financial Inclusion by The European and the Third Best Company in ESG in Chile according to the Corporate Reputation Business Monitoring company called Merco, based in Spain, among others. In addition, we are very proud to have received a tremendous upgrade in our ESG Risk Ratings by Sustainanalytics to low risk, placing us first among banks in Chile.

This recognition demonstrates that we are advancing on the right direction as a responsible institution that contributes to the development of the country and its people.

Please turn to slide 14 to go into detail about Banco de Chile financial performance.

2022 has proven exceptionally profitable for the banking industry in nominal terms, as evidenced by the chart to the left, where we led the sector with over 30% nominal ROAE. Our competitive advantages, consistent strategy and strong governance practices have been key for our success. Accordingly, we took the proper actions during the pandemic that has translated into the record results we are witnessing today in this 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. Since 2009, the nominal effect of inflation under Chilean GAAP, similar to IFRS, does not take into consideration the full impact of inflation on income or the balance sheet. When we consider the effect of inflation on equity, to recognize the loss in purchasing power, profitability becomes more aligned with long-term figures.

The chart on the right demonstrates the 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, as 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.

Even under this approach, our adjusted Return on Average Equity was far greater than those of our competitors, and surpassed our pre-pandemic track record, showing our impressive competitive edge and consistent long-term strategy.

Please turn to slide 15.

Our financial performance in the fourth quarter of 2022 and over the course of the entire year was exceptional. As shown on the chart on the left, net income reached $347 billion pesos in the 4Q22, 21% higher the same period last year and, for the full year we grew 78% over 2021. This bottom line surpassed all our main competitors in both the absolute figure as well as growth, as shown on the chart on the right.

This strong bottom line was composed of both temporary and core factors driven by our sound and consistent strategy. Our balance sheet positioning and superior competitive advantages permitted us to benefit greatly from the non-recurring rise in inflation as a result of our UF gap position. Higher nominal interest rates also played a major role in this result due to the higher contribution of demand deposits. Other core factors that supported bottom line came from higher loan originations and a dynamic fee business all being boosted even more by the persistent strong levels of asset quality.

Please turn to slide 16 on operating revenues, where we will go into more details.

Our operating revenues experienced a rise of 15% when comparing the fourth quarter to the same period last year and grew 42% year-on-year. The latter grew 74% in non-customer income and 28% in customer income.

In terms of non-customer income, we generated greater revenues from our UF structural gap position due to the high level of inflation we experienced this year and to a lesser extent, higher income from the management our Trading and Debt Securities portfolios given positive changes in both interest rates and inflation. The rise in customer income was the result of stronger demand deposit contribution given a scenario of high local and foreign interest rates and to a lower degree by a moderate increase in average balances. Likewise, lowered liquidity among individuals also resulted in the reactivation of higher margin lending products such as consumer loans.

Putting aside the temporary revenues that we generated in 2022, the charts to the right show how our overall operating income compared to our competitors. As you can see on the right of this slide, we have outperformed our peers in NIM, fees and total operating margin. We believe part of this better performance responds to our consistent approach to risks, which is supported by our prudent corporate governance standards.

Please turn to slide number 17.

Total loans grew by 7.2% as compared to the previous year and 1.7% versus the third quarter of 2022. A large portion of this expansion is attributable to market factors, as inflation had significant uptick this year, particularly since 100% mortgage and 37% of our commercial loans are denominated in UF. The difference in nominal versus real growth becomes clear in the charts to the right. Nevertheless, Consumer loans continued to exhibit higher dynamism by growing 17.5% year-on-year and an impressive 6% quarter-over-quarter. This positive outcome is primarily due to strong loan origination figures, which were driven by effective marketing strategies and solid value propositions. We have also seen an important improvement in originations by account manager as direct consequence of our successful Retail Banking Sales Excellence program. This has been implementing best practices across the organization, boosting productivity levels through four key pillars:

1. Improving the effectiveness of risk models to increase preapproved loans and adjusting risk attributions at the branch level to boost efficiency
2. Leveraging digital tools to enhance analytics
3. 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.
4. Developing commercial discipline through the implementation of management and training procedures, branch per branch.

Through this program we have been able to increase not only in our originations of consumer loans that grew 45% year-on-year but also our market share in this product that grew 76 basis points, to 17.4%. A similar program is being implemented in the SME segment and we are already seeing strong improvements in originations with a rise of 25% this quarter when compared to the same quarter in 2021.

For 2023, we expect that loans in the industry should grow in line with expectations for inflation and that loan growth should be driven by consumer and mortgage loans. We expect that commercial loans will continue growing below inflation due to low business confidence, political uncertainties, and the recession we are currently experiencing. Our loan portfolio should follow a similar trend of moderate growth.

Please turn to slide 18.

We have adjusted our balance sheet structure accordingly for the changes we are expecting with regards to falling interest rates and inflation. Consequently, this led to a change in our funding strategy by proactively placing UF bonds in the local market and increasing this source of funding 8% year-on-year and 5% in the quarter. This increased the duration of our liabilities, reduced the price risk in the banking book by decreasing our exposure to inflation (as shown on the chart on the bottom right) and refinanced scheduled amortization of outstanding bonds. The timing of the issuances was especially relevant given the expectations that the local bond market may become very active in debt placements in light of financing needs from the scheduled amortization of FCIC financing beginning 2024 and the expected behavior of DDA, among others.

With regards to demand deposits, we continued to see a normalization this quarter in terms of this source of funding, decreasing by 6.4% during this quarter and 27% year-on-year from the unsustainably high levels of 2021 due to the pension fund withdrawals and relief programs. As can be seen on the chart on the upper right, the relationship of demand deposits to time deposits has been moving quickly towards a more normal level, given the extraordinarily high levels of short-term interest rates implemented to control inflation and normalized liquidity levels in the economy.

Nevertheless, we expect that our current level of demand deposits, equal to 36.5% of total loans is relatively in line with our long-term levels from this source of funding. We expect that DDAs will remain relatively flat throughout 2023 when compared to December 2022. We are also confident that our premium customer base should continue to support our strong funding mix.

Additionally, during 2023 we will keep on assessing funding alternatives depending on market dynamics, evolution of demand deposits, time deposits and loan growth. Likewise, we cannot rule out that we will continue to reduce price risk exposures in the banking book, for instance in terms of the inflation gap, all of which will determine the steps we will take to finance our balance sheet.

Please turn to slide 19 to discuss our superior capital levels versus our peers

As shown in this slide, our profitability track record has consistently outperformed our peers, including return on average equity, despite our larger capital base. We finished the year with a Basel ratio of 18.0%, significantly higher than our peers as shown on the chart on the top left and the positive trajectory of our CET1 over the past few years has meaningfully surpassed both of our main competitors as shown on the chart on the bottom left.

This position of high returns, high net income and high CET1 is truly unique, as shown on the chart to the right. We have achieved this through our customer-centric business strategy and the appropriate balance between risk and return. This has allowed us to grow our portfolio and bottom line sustainably. Additionally, we have been able to continue providing an attractive dividend without affecting this leadership position, all the while maintaining the largest gap of capital over the regulator limits to easily comply with Basel III regulations.

Please turn to slide 20.

Undoubtedly, core expected Credit Losses are in a process of normalization. This quarter expected credit losses reached $123 billion pesos, down from 138 billion pesos posted one year ago with a lower amount of additional provisions established. For the full year, we posted $435 billion pesos of expected credit losses, up 22% from one year ago. This rise is attributable to the normalization of asset quality after a period of high liquidity that maintained risk indicators transitorily low. As shown on the chart on the bottom left, NPLs rose from a very low level of 0.85% in the 4Q21 to a still lower than prepandemic level of 1.08% this quarter, a rise that was significantly lower than those posted by our main peers. Excluding the decrease of $65 billion pesos in additional provisions, the Retail Banking segment contributed the most to expected credit losses with an annual increase of $31 billion pesos while the Wholesale Banking segment rose $13 billion pesos due to high inflation and a weaker economy that is affecting individuals and businesses alike.

Nevertheless, the quality of our portfolio and our risk management culture is evident when compared to our peers, as you can see on the charts on this slide. Not only we do have the soundest portfolio, we also have the highest coverage ratio of 3.7 times and the most additional provisions amounting to $700 billion pesos, as shown on the charts to the right. This clearly positions us better than our peers if the economy worsens beyond our baseline scenario.

Lastly, it's important to stress the relevance that controlling risk has on our bottom line. This is truly a key competitive advantage where we have demonstrated a superior track record to our peers, as shown on the chart on the bottom right. Since 2021, we have continued to widen the gap with our peers, despite our significantly larger coverage ratio, demonstrating our excellence in managing our business.

Please turn to slide 21.

Expenses have grown this quarter 19% nominal over the same period last year and 14% nominal in 2022 over 2021. This rise is primarily due to the high inflation that reached 12.8%, which has an impact on most of expenses line items, including salaries, advisory services and IT expenses that are indexed to CPI. We also recorded higher variable compensation due to our strong results during 2022. Nevertheless, the annual rise in real terms reduces significantly to only 2.8% as a consequence of our cost control efforts bearing fruit.

In terms of efficiency ratio, we reached a ratio of 33.1% this quarter and 31.9% for the full year, both significantly below the levels recorded in 2021. When compared to our peers, we continue to lead and widen the gap in efficiency, as shown on the chart to the right.

We are confident that through our firm focus strengthening cost controls, boosting productivity and using technology to improve how we manage our business, should continue to allow us to post strong normalized efficiency levels that are better than we recorded in the past. Nevertheless, it is fair to mention that our current level of efficiency has clearly been driven by market factors, such as inflation and interest rates, that transitorily increased operating revenues. However, we are confident that we will continue to reach sustainable levels below 45% in the medium term.

Please turn to slide 22

The last few years have been turbulent. Despite this, we have managed the bank well throughout this cycle, posting historic results in 2022, that are well above all our competition.

- We outperformed in Total Profitability measured by ROE and ROA and at the same time in capitalization.
- We posted the highest NIM, Fee Margin and operating margin.

- We recorded the best Asset Quality indicators and set the highest level of Coverage to face possible uncertainties that could have occurred or that may lay ahead.
- Not only that, we also posted the best efficiency ratio in the industry, taking away this recognition that has historically been held by our main competitor.

Overall, we believe that through our superior customer centric strategy together with our uncompromising approach to manage risk are the main pillars of our solid track record.

This is especially relevant as we are currently in a recession. We expect that a recovery should begin in the second half of 2023 and we are well positioned to take greater advantage of this environment than our peers.

Our short-term guidance sees NIM decreasing from the unsustainable high rates to a level around 4.3%, Cost of Risk should normalize this year at around 1.2%. Efficiency should reach a level around 40% and ROAE should converge to a range around 18% while also maintaining a solid capital base.

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