Banco de Chile 1Q23 Financial Results

Conference Call

Operator

Good afternoon everyone, and welcome to Banco de Chile's first quarter 2023 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 everyone. Thank you very much for attending this call, where we will review the main accomplishments of Banco de Chile during the first quarter of this year.

We are very proud of the overall performance of our bank during the first quarter of the year. Once again, Banco de Chile led the industry in terms of profitability by posting a solid 22% ROE, thanks to its bottom line of $266 billion pesos. The bank also maintained its sound capital position, reflected in a 17% and 12.8% in Basel and CET 1 ratio, respectively, while asset quality indicators remained healthy. These figures, coupled with our permanent leadership in customer service, only confirm the unquestionable leadership of Banco de Chile in the country.

As we've made in previous earnings releases, we have divided this call into four main sections. In the first part, we will analyze the macroeconomic and financial environment we faced and our forecasts for this year. Second, we will refer to our key strategic advances and accomplishments. After this we will present a detailed analysis of our financial performance; and finally, we will move to a Q&A section.

Let me start with the macroeconomic analysis. Please go to slide number 3.

Despite the recession that we have faced, as the upper left chart shows, the economy began the year in a better shape. Particularly, the lower-than-expected decline of the local activity, together with the improvement in some key drivers for Chile, such as copper prices, allow us to expect a better than forecasted performance of the economy for this year.

In the last quarter of 2022, the GDP declined by 2.3% year-on-year, mainly attributable to the substantial adjustment in domestic demand, which dropped by 7.6% year-on-year, principally driven by the 4.7% decline in private consumption. Even though it was the first negative year-on-year rate since 2021, it is worth mentioning that the slowdown began earlier in 2022, due to the normalization of several temporary factors that fueled the activity during the pandemic. In fact, as you can see in the chart on the upper right, the activity level remained flat during all of 2022, with a figure in December below the level seen at the end of the previous year. All in all, this confirms that the GDP didn't expand sequentially in 2022.

Nevertheless, available information from the first quarter suggests that the bottom of this negative cycle was left behind us. According to Imacec figures, the GDP reduced its pace of decline to 0.9% year-on-year in 1Q23, from the 2.3% year-on-year observed in the previous period. An improvement on a sequential basis explained this, as the activity expanded at an annualized rate of 3.9%, achieving its first positive figure since late 2021. This marginal improvement has been explained by a greater contribution from non-mining activities, mainly services.

In the labor market, there has been a gradual increase in the unemployment rate, as can be seen in the chart at the bottom left. In the first quarter, unemployment rose to 8.8%, 100 bps above the figure posted one year ago. It is important to mention that this rise was driven by an acceleration in the labor force, which increased by 3.5% year-on-year, surpassing the 2.4% year-on-year expansion in total employment. Higher unemployment resulted from a faster recovery in participation rate, rather than a deterioration in the number of jobs in the economy.

Another positive event has come from external accounts, suggesting an important narrowing of the current account deficit posted last year. As the chart on the bottom right displays, the trade balance posted a surplus of US$7.5 billion in the 1Q23, achieving the best figure in 16 years. This improvement was a consequence of two opposite forces: first, a rise in total exports, which increased by 11% year-on-year (to US$27 billion), led by the recovery in mining and industrial exports. Second, on the opposite side, imports fell by 16% year-on-year, to US$19.5 billion, as a consequence of the 32% year-on-year decrease in consumer imports and the 11% year-on-year fall in capital imports.

As I said before, the slowdown in Chile has followed the normalization of several factors, mainly those related to economic policies. Please go to slide number 4 to analyze them.

This slide highlights the role of tighter monetary and fiscal policies. In the chart on the upper left, you can see how substantial the adjustment in the fiscal policy has been. Notably, in 2022, the fiscal stance was reduced by almost 9 points of the GDP, measured as the change in the overall balance. This adjustment resulted from the surplus of 1.1% of the GDP in 2022, due to the 23% decline in fiscal spending and higher revenues from the dynamism in 2021 and the extraordinary contribution from lithium. Consequently, Chile was one of the countries with the strongest fiscal adjustment in the world. The monetary policy followed a similar path as seen in the chart on the bottom left. Between mid-2021 and November 2022, the overnight rate posted an unprecedented rise of 1075 bps, from 0.5% to 11.25%, also achieving one of the highest adjustments in the world.

The tightening in monetary and fiscal policies has made an important contribution to reducing the excess liquidity of the economy. As can be seen in the chart on the upper right, the level of M1 money supply has decreased significantly since the end of 2021. As a result of this trend, the M1 posted a 24% year-on-year decline in 1Q23, after falling by 27% and 23% year-on-year in 4Q22 and 3Q22 respectively, converging to levels more consistent with its pre-pandemic tendency.

Undoubtedly, all these trends contribute to reducing the wider macroeconomic imbalances seen during the pandemic. This normalization of the economy is a key source of stability in the long run, which has also contributed to the recent strengthening of the Chilean peso, as the chart on the bottom right displays.

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

We expect a gradual improvement in the Chilean economy beginning the second half of this year. Specifically, the combination of several factors, such as the higher growth in China and better copper prices in the rest of the world, as well as the downward trend in inflation and the more supportive monetary and fiscal stances in the future, allow us to move from a negative year-on-year growth in the first half to positive figures in the second semester of the year. We changed our GDP forecast to -0.4% for 2023 from -1.4% in the previous conference call.

On inflation, we foresee a headline CPI of 5.0% by the end of the year, down from 12.8% in 2022. The main drivers for this trend include the stronger currency, compared to 2022, and the normalization of domestic demand. In this environment, we expect the Central Bank to reduce the interest rate from 11.25% to nearly 7.5% by the end of this year. However, given the important indexation in the Chilean economy, we acknowledge upward bias in these estimates.

Finally, it is worth mentioning the existence of several sources of risks that could affect our forecasts. Given the strong integration of the Chilean economy, it is important to monitor the evolution of the main trade partners of Chile, such as China and the U.S., as well as the copper price. Locally, the evolution of structural reforms such as the constitutional process, new tax and pension bills, and the development of sectorial discussions, including the lithium proposal from the government, are worth paying attention to.

Now, I'd like to discuss the main banking industry trends. Please turn to slide 6.

The banking industry posted net income of 1 trillion pesos this quarter, equal to an ROAE of almost 15%, as you can see on the chart on the top left. This lower result was primarily due to the effect of lower inflation that reduced operating income as shown on the chart in the middle of this slide and the negative effect of repricing on liabilities for certain players, given their balance sheet mismatches. This was further impacted by a rise in cost of risk, as you can see on the chart to the right, that went from 1.1% in 1Q22 to 1.4% in 1Q23.

Real loan growth has been less dynamic due to higher interest rates and the weaker economic. Total loans contracted 2.4% year-on-year. Commercial loans decreased the most by falling 4.5% year-on-year, followed by consumer loans which decreased 2.5%. Only mortgage loans showed positive levels of growth. We expect that loan growth will gradually normalize as long as the economy recovers in the second half of the year.

Finally, it is important to note that the Chilean banking industry's assets, in contrast to other geographies, the balance sheet of local banks is mainly concentrated in loans, representing 61.5% of total assets. Instead, overall financial instruments including derivatives represent 17% of total assets, while the held to maturity portfolio only represents 3.8%. Consequently, the local banking industry is less exposed to the financial events that have recently affected some banking players worldwide.

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

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

The strong results that we continue to post has been a product of our sound strategic pillars based on customer centricity, productivity and sustainability, which we deploy through six core priorities. Through these initiatives we have been able to surpass all our mid-term targets as shown on the right. In the next slides will review the advances we have been making in digital transformation, productivity and sustainability.

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

As part of our commitment to being the digital benchmark in the Chilean banking industry, we've implemented a range of initiatives this quarter for our personal, corporate, and SME segments.

In personal banking we are proud to have successfully launched a digital onboarding platform for US$ dollar checking accounts, making it possible for customers to apply for credit cards online. Additionally, we introduced a new feature for over 8,000 customers who attended the Lollapalooza Music Festival in Chile, allowing them to top up credit for purchases at the event using our mobile app and avoid long queues.

For our corporate and SME segments, we've also enabled 100% online account opening for US$ dollar checking accounts, providing greater convenience. Furthermore, we launched the online origination of the new FOGAPE government guarantee loans called Chile Apoya and introduced virtual factoring for pre-qualified clients, enabling them to manage their accounts receivables online. As a result, we're proud to be the leader among private banks in terms of total operations and total volume of loans granted through the Chile Apoya Program, granting over $270 billion pesos to support SMEs.

Lastly, we're pleased to mention that we now offer digital onboarding for a range of segments, from teenagers to adults and enterprises. These initiatives have streamlined the account opening process, reducing the time and effort required for customers to become our clients. Overall, we've attracted almost 1.2 million new clients through our digital accounts, increasing our customer base, transforming the banking experience, and promoting financial inclusion.

Through these advances, we have placed Banco de Chile as the leader in different brand attributes in the digital world, as you can see on the bottom of this slide. When banking customers are asked which bank has the best apps, website, security, we rank first with an important gap to our competitors.

Please turn to slide 10

To maintain our leadership in the industry, we have focused on establishing continuous processes to review and optimize costs and expenses. In 1Q, we began executing our 2023 annual sourcing plan, which reviews a relevant set of cost categories to optimize both contracts and demand processes. This methodology involves scouting the market to identify new suppliers and innovations in goods and services, evaluating their fit and impact on our operation. By implementing this plan, we aim to achieve a cost optimization of approximately 10% of the total expenses addressed.

Alongside our sourcing efforts, we are analyzing a selected set of opportunities for cost reduction that require specific views for analysis. One of them is the opportunity related to extending our footprint rationalization as we have more information to understand customer behavior after the pandemic. Other key areas of analysis include IT investment processes, where we will increase rationality in our decisions to allocate and prioritize funds, and energy usage where we seek not only to reduce expenses but also to boost our commitment to being a sustainable bank. We are also in the initial stages of renewing our ERP software system, a 12-month project aiming to renew a 20-year-old system and enable faster and more automated procure-to-pay processes. The new ERP will allow us to shift time spent on manual data entry activities into supplier billing assurance and control.

Productivity is another key strategic pillar for us. We continuously seek to identify and implement measures that allow commercial staff to allocate more time to sales activities and increase the use of digital channels for both sales and services. One of the most relevant levers for increasing productivity has been digital process adoption by customers and employees, as well as process improvement and standardization.

In the retail-banking segment, we have adapted our successful commercial excellence plan to other client segments, such as SMEs, to drive growth. In the SMEs segment, monthly originations have significantly improved the average loans per executive by 50%, and we are currently working to increase the number of customers with pre-approved loans to continue growing online originations.

Our productivity projects, following the same principles of digital process adoption and work standardization, will extend through FY23 and target the functions of Deposits, Cash Management for SMEs and Wholesale Banking, and Branch Customer Service.

Thanks to our consistent improvement in productivity, Banco de Chile is one of the leaders in efficiency in the industry, achieving a 37.6% efficiency ratio during 1Q.

Please turn to slide 11

During the first quarter, we continued to prioritize our commitment to contributing to the development of our country and its people through a variety of initiatives. Corporate volunteering is an important part of this effort, and we are proud to have supported people affected by forest fires, promoted accessibility at the Lollapalooza Music Festival, and worked with NGOs to assist the elderly. Our initiatives are designed to support those who are most in need while also promoting practices that benefit society as a whole. Additionally, we continued to offer support to clients affected by the devastating forest fires by providing options for rescheduling consumer and mortgage loans online and at our branches. We have also committed to funding the reconstruction of a school in Santa Juana, which was destroyed by the wildfires, to support the education of children in the affected communities.

Supporting SMEs is a key priority of our ESG strategy, and during the quarter, we led a national entrepreneurship competition that brought together thousands of enterprises. We also hosted an event for small agro-ecological producers and sustainable businesses.

We made strides in governance as well, increasing the diversity of our board of directors with the appointment of three women at our Annual Shareholders Meeting.

Finally, we provided a variety of training sessions on Sustainable Finance and the impact of Climate Change on the banking sector to our C-level executives, managers, and analysts. This training is part of our strategy to incorporate ESG risks and opportunities into our business model. Through our efforts to promote sustainable practices both within and outside our organization, we aim to create a positive impact in our society and ensure long-term success for all stakeholders.

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

As previously mentioned, our net income has started to normalize in line with lower inflation, as shown on the chart to the left. In the first quarter, we reported net income of $266 billion pesos, equivalent to a ROAE of 21.6%, a significant decline from the high levels seen in the previous year. Despite this decrease, we continue to outperform our main peers in terms of profitability, as illustrated in the charts to the right. This solid financial performance is a testament to our successful long-term customer-centric strategy and our focus on creating a sustainable bank.

While we expect our long-term ROE to be around 18%, we anticipate that ROE will remain above this range in the short-term, hovering around 20% in 2023. This is due to the temporary boost in our NIM resulting from the current high inflation and elevated short-term interest rates.

Please turn to slide 14.

Operating revenues grew 3% year-on-year and down 13% when compared to 4Q22. Both resulted from a sharp decrease in inflation, partially offset by steady expansion of customer income. On a year-on-year basis, we witnessed a strong rise in customer income as a result of stronger demand deposit contribution given a scenario of high interest rates, moderate improvements in lending spreads and loan growth and continuous increase in fee-income. It's important to note that the 5% year-on-year growth figure in fees had to do with a change in the accounting treatment of income from collection services for overdue loans, which are recognized in the other operating income instead of fee income as used to be starting this quarter. Adjusting for this reclassification, fees would have grown 9% year-on-year. The annual increase was mainly driven by transactional services, up 17% mainly from credit cards and checking account commissions given higher transactionality, as well as an 18% rise in insurance brokerage in connection with a rise in written premiums in line with a more dynamic consumer loan portfolio.

In terms of non-customer income, we generated lower revenues from our overall UF gap position because of a 105 bps decrease in inflation during the period versus the same period last year, in conjunction with decreased directional UF exposure managed by our treasury in relation to the same period last year. This effect coupled with lower results from the management of our trading and investment portfolios, which was primarily explained the excellent performance achieved in the first quarter last year when we benefited from the positive impact of interest rate movements on the financial positions held at that point. Instead, these factors were to some extent offset by greater net financial income from our securities brokerage subsidiary.

The charts to the right show how our performance has compared to our peers. In terms of NIM, we posted 4.5% this quarter, significantly higher than all our competition. A similar situation occurred in terms of our overall operating income, as you can see in the chart on the bottom right of this slide. Our significant comparative performance responds to our consistent business strategy and our approach to timely managing risks, including market risk, all of which is supported by strong corporate governance standards.

Please turn to slide number 15.

Banco de Chile is a universal Bank that serves clients from all segments in retail and commercial banking. As you can see on the chart, we have 63% of our loans concentrated in the retail segment and the remaining 37% in the wholesale segment. This distribution has remained relatively stable as compared to 4Q22, but it is important to highlight that during the pandemic our growth was concentrated in low risk and low margin products, leading to a significant change in loan mix. Nevertheless, we expect that our expansion in the coming periods will begin to change the mix back to those levels seen prior to the pandemic. It's also relevant to mention that our diversification is especially positive in different economic cycles as one portfolio commonly offsets the negative performance of another.

Accordingly, total loans grew by 8.2% compared to the previous year and 0.9% compared to 4Q22, as shown on the chart on the right. The year-on-year increase was driven by retail loans. Mortgage loans expanded 11% during the 12-month period, primarily fueled by inflation. In real terms, residential mortgage loans had a negative growth rate, as a consequence of weaker demand due to high long-term interest rates and inflation perspectives.

Consumer loan expansion on the other hand was driven by originations and posted a significant annual rise of almost 16%. This growth was in line with the lower liquidity levels of some customer segments. Originations were strengthened by successfully implementing campaigns to promote the use of our credit cards and commercial strategies that have increased productivity and sales. Nevertheless, we expect that consumer loan growth should slow to levels slightly above inflation by year end due to the economic situation and customer debt levels.

Commercial loans increased only 5.1% on a yearly basis, which was largely supported by an expansion in Trade Finance, influenced by both the normalization of international trade after the pandemic and renewed value offering for factoring and leasing products among companies. Likewise, during the first quarter 2023 we have had a very active participation in the new FOGAPE Chile Apoya program, which pursues to support SMEs and middle market companies to access financing through government guarantees. As of March 31, we have originated approximately $210 billion in FOGAPE Chile Apoya loans, which also supported the modest increase in commercial loans.

From the concentration perspective, it is worth noting our commercial loan portfolio is well diversified in a wide array of economic sectors, as you can see in the chart on the bottom left. As such, we do not have significant dependence or concentration risk in any industry, which enables us to mitigate potential effects derived from economic contraction on real estate and construction or the ongoing situation affecting the private health industry.

For 2023, we expect commercial loans to grow in line with inflation, with consumer and mortgage loans driving loan growth. We expect that commercial loans will continue to grow below inflation as long as economic and politic uncertainties remain and depending on the evolution of the economic downturn we are currently experiencing.

Please turn to slide number 16 to discuss our solid balance structure.

We have a diversified and healthy asset and liability structure, as you can see on the chart on the top left. Our business strategy is focused on commercial banking, our main source of revenues is derived from loans, which represented 67% of our total assets as of March 2023. It is important to highlight that total financial instruments represent 15.6% of total assets and our exposure to held to maturity financial instruments is particularly low representing only 1.6% of total assets, and well below our peers as you can see on the chart to the right. It's also relevant to note that 51.3% of our financial assets have durations of less than one year, explained by positions in Central Bank's notes or PDBC and certificates of deposits issued by local banks, both utilized for liquidity management purposes. This structure has provided an important source of stability in our results, given its lower sensitivity to changes in market interest rates and, more importantly, based on an adequate funding, as we have seen in several part of world. In cycles as we are facing now, fundamentals and prudential risk management criteria make a critical difference between banks.

On the liabilities side, deposits are the main source of funding, representing approximately 51% of our assets. As for bonds, they represent 17% and are mainly used to finance our mortgage portfolio. This is especially important to reduce liquidity risk as bonds is a more stable source of funding versus time deposits. For that reason, during the first quarter we continued to place bonds in the local market in order to replace scheduled amortizations while taking advantage of convenient market conditions.

Also, our ratio of demand deposits to time deposits continues to move rapidly towards a more normal level, given the extraordinarily high levels of short-term interest rates implemented to control inflation and the normalized levels of liquidity in the economy.

Along these lines, we maintain a high level of liquidity compared to our main competitors and well above the limits imposed by the regulator as shown on the chart on the bottom right. As for the Liquidity Coverage Ratio, we recorded in the same period 283%, 183 percentage points above the limit, and in the case of our Net Stable Funding Ratio, we reached a level of 136% in March 2023, 66 percentage points above the limit.

It is also relevant to mention that we will continue to evaluate financing alternatives according to market dynamics, the evolution of demand deposits, time deposits, and loan growth.

Please turn to slide number 17.

Banco de Chile is the most capitalized bank in the industry. As of March 2023 our Basel III ratio was 17%, well above the limit of 9.56% applying for us, as shown in the table on the right. Regarding CET1 we reached 12.8% this quarter, 80 basis points lower than December 2022. This drop is mainly explained by a dividend distribution that was higher than the dividend provisioned in equity as our shareholders decided to distribute 100% of the net distributable earnings for the FY2022 instead of the 60% already provisioned. Nevertheless, the trend over the last few years has significantly surpassed both of our main competitors, as shown in the chart on the bottom left and well above the limit established by the regulator. With these levels of capital, we are easily complying with fully loaded Basel III regulations. Finally, I want to highlight that the regulator has reassessed the systemic risk buffer for the banks, maintaining our ratio at 1.25%, as was the case of most our peers.

Please turn to slide number 18.

In the first quarter of this year, expected credit losses reached $106 billion pesos, representing a 13.8% decrease as compared to the 4Q22, without establishing additional provisions. When compared to the same period last year, we see a slight increase of 7% as a result of the normalization of asset quality after a period of high liquidity that temporarily kept risk indicators unsustainably low.

Consequently, as we anticipated in previous calls delinquencies have been gradually increasing since 1Q22, from a very low level of 0.9% to 1.2% in this quarter, as shown on the chart the bottom left. This increment is a normalization to longer term levels. It’s also important to note that the trend for Banco de Chile has been lower than that recorded by our main competitors.

When compared to our main competitors, as shown in the charts on the right, we not only have the soundest loan portfolio, but also the highest coverage ratio of 3.3 times considering the additional provisions of $700 billion pesos. This leaves us well positioned to face negative cycles.

Lastly, we want to highlight the relevance and effectiveness of our risk management. As shown in the chart on the bottom right of the slide, we have continued showing a large gap with our competitors, ending 1Q23 with an operating margin, net of risk of 5% almost doubling their ratios.

Please turn to slide number 19.

Expenses have increased this quarter by 13% in nominal terms compared to the same period last year and decreased by 1% in nominal terms compared to 4Q22. The annual increase is mainly due to the high inflation that reached 12% year-on-year, which has an impact on most expense concepts, including salaries, rent, external services, among others. It is important to mention that the important advances in efficiency that we have achieved in recent times have allowed us to afford the significant growth in our disbursements destined to implement the advances in digitalization, IT infrastructure and cybersecurity that is necessary to address the profound transformation process that the banking business is undergoing.

Regarding the efficiency ratio measured as operating expenses to operating income, achieved 37.6% in 1Q23. When compared to our competitors, we continue to lead the gap in efficiency, as shown in the chart on the bottom right.

We are confident that through our cost control strategy, increased productivity, and use of technology we will continue to post solid efficiency levels in the medium term.

Please turn to slide 20

Before we move on to the Q&A session, I would like to quickly summarize the key takeaways and provide some guidance.

After a period of strong growth and record levels of inflation, the Chilean economy is gradually adjusting back to more normal levels of activity. We anticipate a mild recession until the second quarter of 2023, followed by a recovery in the second half of the year. Lower expected inflation levels should lead to an easing cycle mid-year, with an overnight rate of around 7.5% and inflation at 5%. By 2024, we expect the monetary policy rate to reach 4.5% with inflation hovering around 3%.

In this environment, we believe that our bank will continue to stand out from our peers. Our prudent and consistent strategy, together with our strong management team, has positioned us for another year of strong results and leading profitability, while we continue to pursue our long-term goals.

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