MOODY'S INVESTORS SERVICE

OUTLOOK

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Contacts

Felipe Carvallo +52.55.1253.5738
VP-Sr Credit Officer
felipe.carvallo@moodys.com

Vincent Detilleux, CFA +55.11.3043.7312
Associate Analyst
vincent.detilleux@moodys.com

Marcelo De Gruttola +54.11.5129.2624
VP-Senior Analyst
marcelo.degruttola@moodys.com

Ceres Lisboa +55.11.3043.7317
Associate Managing Director
ceres.lisboa@moodys.com

» Contacts continued on last page

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

Banking System Outlook – Chile

Outlook changes to stable on improving earnings amid higher interest rates

We have changed our outlook for the Chilean banking system to stable, from negative, to reflect our expectations of improving core earnings generation over the coming 12 to 18 months, as bank margins benefit from higher interest rates and inflation, and lower household liquidity increases demand for higher-yielding assets. The operating environment for banks will be stable, as economic growth in Chile (A1 negative) remains below-average, strained by high inflation, withdrawal of policy stimulus, and uncertainty around the drafting of a new constitution. Strong risk management, ample diversification and conservative origination policies will keep delinquencies under control, even as they increase from record-low levels. Capital ratios will be stable with earnings retention sufficiently covering asset growth. With further pension fund withdrawals off the table for now, domestic liquidity will reduce, but a smaller pension fund market will continue to limit local market long-term issuances, while the military conflict in Ukraine will strain banks' ability to issue abroad.

OVERVIEW OF KEY DRIVERS

Operating environment	STABLE	=	GDP growth will continue to benefit from high commodity prices in 2022, but will remain below-average, strained by high inflation and withdrawal of monetary and fiscal policy support
		–	The process to draft a new constitution during 2022 will weigh on investor confidence and GDP growth prospects
		+	Unemployment has fallen drastically and is now below pre-pandemic levels
Asset risk	STABLE	=	Strong risk management, ample diversification and conservative origination policies will limit the increase in problem loans
		=	High household liquidity and ample reserves will mitigate asset deterioration in an environment of high inflation
		+	Loan growth will reach upper-single digits, reflecting high consumer confidence
Capital	STABLE	=	Strong capital replenishment will support capitalization
		+	New hybrid issuances will enhance loss absorption capacity of Chilean banks
Profitability and efficiency	IMPROVING	+	Higher rates, inflation and increasing demand for higher-yielding products will benefit margins
		+	Investments and accelerated digitalization will drive fee income and efficiency gains
		+	Provisioning expenses will begin to fall as policy uncertainties wane in H2 2022
Funding and liquidity	DETERIORATING	–	Benefits of increased core deposit funding and liquidity will wind down
		–	A smaller pension fund market and global volatility will add further pressure to funding
Government support	DETERIORATING	–	The Chilean government's capacity to provide support to banks will be more limited, in line with its deteriorating fiscal strength

● IMPROVING ● STABLE ● DETERIORATING

Source: Moody's Investors Service

Outlook changes to stable on improving earnings amid higher interest rates

Operating environment is stable. The Chilean economy recovered quickly from the pandemic-induced slump, on the back of pension withdrawals, government support programs and an accelerated vaccine rollout. In 2022, GDP growth will benefit from high commodity prices and reach around 3.0%, moderating after an unsustainable surge of about 12% in 2021, driven by extraordinary policy support. Unemployment fell sharply to 7.2% at the end of 2021, which has further supported consumption levels. However, high inflation and withdrawal of accommodative monetary and fiscal policy, along with uncertainty around the outcomes of the process to draft a new constitution during 2022, will weigh on investor confidence and GDP growth prospects, even with high copper prices. We expect real GDP growth of 1.2% in 2023, reflecting ongoing pressures from these factors as conditions normalize. Political and social risks around the rewriting of a new constitution could negatively impact Chile's economic and fiscal outlook in 2023 and beyond, resulting in a future growth path which could fall below the five-year average of 2.1% before 2020. Meanwhile, heightened levels of uncertainty around global economic growth following the shock from Russia's invasion of Ukraine (Caa2 review for downgrade), which has exacerbated global inflationary pressures and the tightening of international financial conditions, could lead to a further slowdown of growth.

Delinquencies will remain low. Asset risks will remain stable helped by banks' strong risk management, ample portfolio diversification and conservative origination policies. The average problem loan ratio fell to record lows of 1.3% of gross loans in January 2022. Still high household liquidity and ample reserves will mitigate asset deterioration as payment behavior normalizes. Banks face short-term asset quality risks stemming from inflation-indexed loans that increase debt loads as inflation absorbs a higher share of income. However, reserves for loan losses (obligatory and additional) remain at near record highs of 2.7x problem loans in January 2022. Loan growth will reach upper-single digits, well above the 3.1% 12-month increase through January 2022 and will be driven by sustained investment levels and consistent recovery in job markets.

Strong replenishment will support capital levels. Improving profitability will offset increases in capital consumption due to an acceleration in loan growth, helping banks across the system maintain capital at high levels. We expect tangible common equity to remain between 9.0% and 9.5% of risk-weighted assets over the next 12 to 18 months. Nevertheless, new hybrid issuances, such as perpetual bonds with conversion features and non-cumulative coupon suspensions under newly introduced Basel III norms, will enhance loss absorption capacity of Chilean banks.

Improvement in NIMs and increasing demand will support core earnings generation. Higher rates and inflation will benefit Chilean banks' net interest margins (NIMs), which reached 3.0% during 2021, up from 2.8% in 2020. Moreover, with no further pension fund withdrawals planned for now, consumer demand for higher-yielding loans will also benefit NIMs. Banks' conservative provisioning in 2020-21 will be sufficient to absorb any potential increase in bad loans, and as a result, increase in credit costs should be minimal. Investments and accelerated digitalization will drive fee income and efficiency gains, though high inflation will strain operating expenses.

Benefits to liquidity and funding from pension fund withdrawals will dissipate, and global turmoil will limit access to overseas funding. Pension fund withdrawals led to a drastic increase in core deposit funding among Chilean banks, a benefit that will gradually wind down as individuals seek to park their savings in more remunerative products, such as time deposits or mutual funds. Loan-to-deposit ratios remain among the highest in Latin America, at 122.3% as of December 2021 and will increase as loan growth accelerates. Market funding at 30.8% of tangible banking assets at the end of 2021 will remain high, as demand for mortgage financing begins to increase, backed by growing economic activity. Pension fund withdrawals have also limited the local market for long-term bank issuances. However, the military conflict in Ukraine will strain the usually strong access of Chilean banks to international funding. Liquid assets, which had reached a high of 25.9% of tangible banking assets in 2021 and 26.3% in 2020, will continue to move toward the historical average between 20%-22%, as the benefits from pension fund withdrawals dissipate.

Rising social demands weigh on government support capacity. Chile entered the coronavirus crisis with higher fiscal buffers and lower debt than its peers, which speaks to the higher capacity of the Chilean government to provide support. However, the government's debt/GDP ratio of 36% in 2021 had been rapidly rising before the crisis and will rise gradually over the medium term as the incoming administration seeks to expand Chile's social safety net while balancing a focus on fiscal sustainability. We believe the government's high willingness to support banks remains unchanged, even under the establishment of Basel III in the country, especially since buffers of capital-eligible debt with going-concern loss absorption by Chilean banks are still low.

Exhibit 2

Aggregate key indicators for the Chilean banking system

Core Scorecard Ratios	2016	2017	2018	2019	2020	2021
Problem Loans / Gross Loans	1.9%	2.0%	1.9%	2.1%	1.6%	1.3%
Tangible Common Equity / Risk Weighted Assets	9.1%	9.8%	9.4%	9.0%	9.7%	10.0%
Net Income / Tangible Assets	0.9%	1.0%	1.0%	0.9%	0.4%	1.1%
Market Funds / Tangible Banking Assets	27.9%	28.8%	30.2%	34.2%	37.1%	37.2%
Liquid Banking Assets / Tangible Banking Assets	22.2%	21.8%	20.2%	20.3%	26.3%	25.9%
Additional Ratios	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Loan Loss Reserves / Problem Loans	135%	129%	128%	124%	171%	191%
Problem Loans / (Shareholders' Equity + Loan Loss Reserves)	13.2%	13.7%	13.8%	15.4%	11.7%	9.4%
Tier 1 Ratio	10.9%	11.0%	10.6%	10.1%	12.0%	12.1%
Shareholders' Equity / Total Assets	8.2%	8.3%	8.2%	7.3%	6.7%	6.7%
Net Income / Average RWA	1.2%	1.4%	1.3%	1.3%	0.6%	1.8%
PPI / Average RWA	2.5%	2.7%	2.8%	3.0%	2.9%	3.7%
Cost / Income Ratio	54.5%	53.2%	51.3%	48.8%	49.6%	44.8%

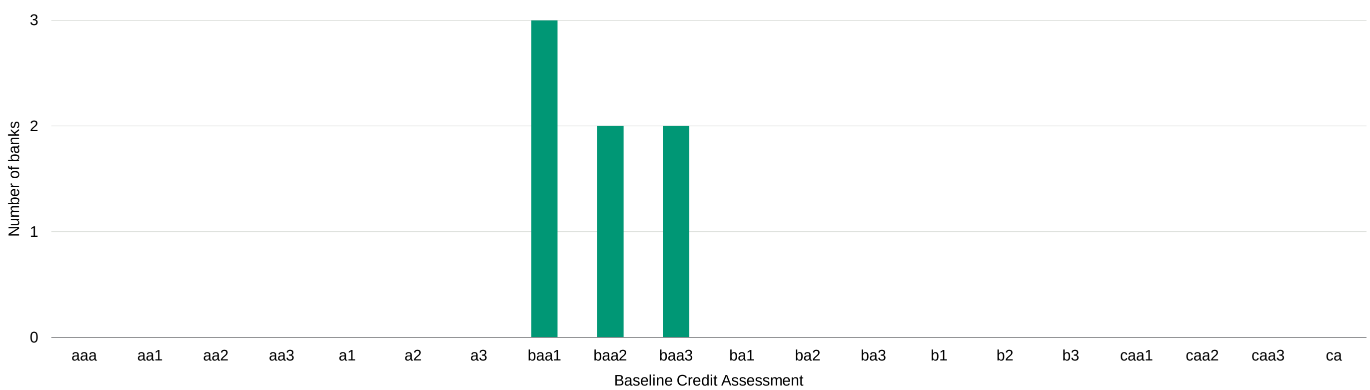
We have netted derivatives out of market funding.
Source: Moody's Investors Service

Rating Universe

We rate six banks and one cooperative in Chile. Our rated banks represent 75.4% of the system's gross loans and 80.0% of the system's deposits, as of January 202. Chilean banks' standalone Baseline Credit Assessments (BCAs) are distributed over a three-notches range from baa1 to baa3. The weighted-average Chilean banks' BCA is baa2, in line with the global weighted-average of baa2, and above the Latin American average of ba1.

Exhibit 3

Chilean banks BCA distribution as of 11 April 2022



Source: Moody's Investors Service

Exhibit 4

Rated Chilean financial institutions as of 11 April 2022 (by BCA)

Entity name	BCA	Adjusted BCA	Bank Deposit LT Rating	Bank Deposit ST Rating	Bank Sr/ Issuer Rating	CRA LT	CRA ST	Bank Issuer Outlook
Banco de Chile	baa1	baa1	A1	P-1	A1	A1(cr)	P-1(cr)	NEG
Banco Santander-Chile	baa1	baa1	A1	P-1	A1	A1(cr)	P-1(cr)	NEG
Banco de Crédito e Inversiones	baa1	baa1	A2	P-1	A2	A1(cr)	P-1(cr)	POS
Coopeuch	baa2	baa2	Baa1	P-2	-	A3(cr)	P-2(cr)	POS
Banco BTG Pactual Chile	baa2	baa2	Baa2	P-2	-	Baa1(cr)	P-2(cr)	STA
Banco del Estado de Chile	baa3	baa3	A1	P-1	A1	A1(cr)	P-1(cr)	NEG
Itaú CorpBanca	baa3	baa2	A3	P-2	-	A2(cr)	P-1(cr)	NEG

Source: Moody's Investors Service

Moody's related publications

Credit Opinion:

- Banco del Estado de Chile: Update to credit analysis, 1 April 2022
- Government of Chile – A1 negative: Regular update, 18 February 2022
- Itaú CorpBanca: Update to credit analysis, 1 February 2022
- Coopeuch: Update to credit analysis, 31 January 2022
- Banco BTG Pactual Chile: Update to credit analysis, 16 December 2021
- Banco de Chile: Update to credit analysis, 24 November 2021
- Banco de Crédito e Inversiones: Update to credit analysis, 29 October 2021
- Banco Santander-Chile: Update to credit analysis, 26 October 2021

Russia-Ukraine Crisis:

- Financial Institutions – Global: Deteriorating global economic conditions broaden risks for the financial sector, 7 April 2022
- Banks, securities firms, finance companies – Global: Ripple effects from Ukraine crisis are creating harsher business conditions, 7 April 2022
- Russia's invasion of Ukraine will exacerbate Latin American inflation and curb economic growth, 5 April 2022
- Global Macro Outlook 2022-23 (March 2022 Update): Economic growth will suffer as fallout from Russia's invasion of Ukraine builds, 17 March 2022
- Cyber Risk – Global: Broad sanctions against Russia raise risks of financially motivated cyberattacks, 11 March 2022
- Credit Conditions – Global : Russia-Ukraine conflict adds new hazards to global credit and exacerbates existing risks, 11 March 2022

Sector and Issuer Research:

- Credit Conditions – Latin America: Russia's invasion of Ukraine will exacerbate inflation and curb economic growth, 5 April 2022
- Global Macro Outlook 2022-23: Economic growth will suffer as fallout from Russia's invasion of Ukraine builds, 17 March 2022
- Macroeconomics – Global: Geopolitical developments pose new risks to global supply-chain recovery, 14 March 2022
- Cyber Risk – Global: Broad sanctions against Russia raise risks of financially motivated cyberattacks, 11 March 2022
- Credit Conditions – Global: Russia-Ukraine conflict adds new hazards to global credit and exacerbates existing risks, 11 March 2022
- Political Risk – Chile: FAQ on policy risks and credit effects across sectors as Boric administration takes office, 9 March 2022
- Banking – Cross Region: Shockwaves from military conflict in Ukraine will be felt globally, 4 March 2022
- Credit Conditions – Latin America: Companies, utilities and banks can withstand period of higher inflation, 23 February 2022
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- Banco Santander-Chile - Q4 2021: Strong core earnings and higher provisions reflected continued business recovery despite rising risks, 4 February 2022

» Emerging Markets – Latin America & Caribbean: Tourism will recover unevenly through 2024 but region offers solid business prospects, 7 December 2021

» Itaú CorpBanca: Itaú's larger stake in Chilean subsidiary paves way for capitalization, a credit positive, 10 November 2021

» Chile: Banking System Profile, 15 September 2021

» Chile central bank's interest rate hike is credit positive for banks, 16 July 2021

Macro Profile:

» Chile: Macro Profile - Strong, 18 October 2021

Methodology:

» Moody's Bank Rating Methodology, 9 July 2021

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Banking System Outlook definition

The Banking System Outlook reflects our view of credit fundamentals in the banking sector over the next 12-18 months. Banking sector outlooks are distinct from rating outlooks, which, in addition to sector dynamics, also reflect issuers' specific characteristics and actions.

The outlook does not represent a sum of upgrades, downgrades or ratings under review, or an average of rating outlooks.

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Contacts

Felipe Carvallo +52.55.1253.5738
VP-Sr Credit Officer
felipe.carvallo@moodys.com

Marcelo De Gruttola +54.11.5129.2624
VP-Senior Analyst
marcelo.degruttola@moodys.com

Vincent Detilleux, CFA +55.11.3043.7312
Associate Analyst
vincent.detilleux@moodys.com

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Associate Managing Director
ceres.lisboa@moodys.com

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