

# MOODY'S

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### Credit Opinion: Banco de Bogota S.A.

Global Credit Research - 04 Nov 2014

Bogota, Colombia

#### Ratings

Category	Moody's Rating
Outlook	Negative(m)
Bank Deposits -Fgn Curr	Baa2/P-2
Bank Deposits -Dom Curr	Baa1/P-2
Bank Financial Strength	C-
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa2
Senior Unsecured	Baa1
Subordinate	Baa3
<b>Parent: Grupo Aval Acciones y Valores S.A.</b>	
Outlook	Negative
Issuer Rating	Baa3
ST Issuer Rating	P-3
<b>BAC International Bank, Inc</b>	
Outlook	Stable
Bank Deposits	Baa3/P-3
Bank Financial Strength	D+
Baseline Credit Assessment	baa3
Adjusted Baseline Credit Assessment	baa3

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#### Key Indicators

##### Banco de Bogota S.A. (Consolidated Financials)[1]

	[2]6-14	[2]12-13	[2]12-12	[2]12-11	[2]12-10	Avg.
Total Assets (COP billion)	104,938.5	100,669.0	80,506.4	68,809.6	59,346.6	[3]15.3
Total Assets (USD million)	55,826.2	52,106.3	45,561.0	35,496.1	30,909.5	[3]15.9
Tangible Common Equity (COP billion)	5,396.4	5,075.2	4,573.5	3,539.4	761.2	[3]63.2
Tangible Common Equity (USD million)	2,870.8	2,626.9	2,588.3	1,825.8	396.5	[3]64.0
Net Interest Margin (%)	4.7	5.1	5.3	4.0	3.4	[4]4.5
PPI / Average RWA (%)	3.9	4.4	4.2	5.1	6.9	[5]4.9
Net Income / Average RWA (%)	2.0	1.8	1.9	1.9	2.1	[5]2.0
(Market Funds - Liquid Assets) / Total Assets (%)	-9.4	-11.8	-13.9	-11.5	-9.5	[4]-11.2
Core Deposits / Average Gross Loans (%)	110.3	127.7	121.1	119.3	154.0	[4]126.5
Tier 1 Ratio (%)	4.5	4.4	8.0	7.2	3.5	[5]5.5
Tangible Common Equity / RWA (%)	5.8	5.7	6.3	5.6	1.4	[5]5.0
Cost / Income Ratio (%)	53.5	58.6	60.2	55.9	43.4	[4]54.3
Problem Loans / Gross Loans (%)	1.4	1.3	1.2	1.3	1.6	[4]1.4

Problem Loans / (Equity + Loan Loss Reserves) (%)	7.2	6.7	6.2	6.8	10.9	[4]7.5
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Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel I; LOCAL GAAP [3] Compound Annual Growth Rate based on LOCAL GAAP reporting periods [4] LOCAL GAAP reporting periods have been used for average calculation [5] Basel I & LOCAL GAAP reporting periods have been used for average calculation

## Opinion

### SUMMARY RATING RATIONALE

On 29 July 2014, Moody's upgraded the long-term foreign currency deposit rating of Banco de Bogotá S.A. to Baa2, from Baa3, with a stable outlook following Moody's recent upgrade of Colombia's sovereign debt rating to Baa2, from Baa3. Moody's also upgraded the foreign currency senior unsecured debt rating of Banco de Bogotá to Baa1, from Baa2, but changed its outlook to negative, from stable following the revision of the foreign currency ceilings which effectively unconstrained Banco de Bogotá's foreign currency debt rating.

The outlooks on Banco de Bogotá's C- standalone bank financial strength rating (BFSR), its Baa1 long-term global local currency deposit rating and its Baa3 long-term foreign currency subordinated debt rating, remain negative. Banco de Bogotá's C- standalone BFSR maps to a baa2 standalone baseline credit assessment (BCA). At the same time, Moody's upgraded Banco de Bogotá's short-term foreign currency deposit rating to Prime-2, from Prime-3.

The negative outlook on Banco de Bogotá's standalone BFSR reflect the bank's very low fully adjusted Tier 1 capital ratio which decreased about 400 basis points in September 2013, following the introduction of more stringent deductions of related minority interest and intangibles. While as of June 2014, Banco de Bogotá's fully adjusted consolidated Tier 1 ratio remains at a comparably low 4.5%, there have been two credit positive events in the last two months, which could lead to an estimated 250 basis point increase in capitalization. The most important one was on 14 October 2014, when the bank announced its intention to do a COP1.5 trillion capitalization and new capitalization regulation issued in early September which will allow Banco de Bogotá to not have to deduct all related minority interest, if related parties agree to deduct it themselves.

Banco de Bogotá's capitalization is nevertheless supported by its resilient levels of returns underscored by ample margins (NIM of 4.7%) and an efficient cost structure (operating efficiency of 54%), versus a lower expected organic loan growth of 15%. Throughout Banco de Bogotá's various acquisitions, it has maintained good asset quality (PDL ratio of 1.4%), within its domestic franchise and its Central American subsidiary BAC International Bank, Inc. (BAC, D+/baa3 stable, Baa3 stable), as well as in the acquired portfolios from Banco BAC de Panamá and Reformador.

The bank's baa2 standalone BCA is constrained by a high growth profile and acquisitive strategy and the bank's operating environment in Colombia and Central America. The bank's shareholder has expressed commitment to funding future acquisitions with fresh new capital, which would otherwise affect capitalization further.

The Baa1 local currency deposit rating is one notch above the bank's standalone BCA, in line with Moody's assessment of very high systemic support for Banco de Bogotá's deposits and senior issuances given its important market shares in terms of deposits.

### Rating Drivers

- Limited loss absorption capabilities under stress scenarios
- Proactive and institutionalized risk management policies ensure low levels of problem loans
- Resilient levels of returns underscored by ample margins and an efficient cost structure
- Core deposit funding and ample liquidity
- Well-established banking franchise in Colombia and Central America

### What Could Change the Rating - Down

Moody's is evaluating the evolution of the bank's capitalization and loss absorption capacity, which stands today amongst the lowest of the Colombian banking system and the region.

The announcement of another major acquisition would prompt a reassessment of the bank's standalone ratings.

### **What Could Change the Rating - Up**

An improvement in ratings is less likely at this juncture.

### **Rating Outlook**

Banco de Bogotá's standalone BFSR, local currency deposit and foreign currency senior unsecured and subordinated debt ratings have a negative outlook. At the same time, its foreign currency deposit rating has a stable outlook.

### **DETAILED RATING CONSIDERATIONS**

Detailed considerations for Banco de Bogotá's ratings are as follows:

#### **Bank Financial Strength Rating**

##### **LIMITED LOSS ABSORPTION CAPABILITIES UNDER STRESS SCENARIOS**

Banco de Bogotá's consolidated fully adjusted Tier 1 ratio of 4.5% as of June 2014 is the lowest amongst rated Colombian banks, as well as among regional peers. Banco de Bogotá's consolidated unadjusted Tier 1 ratio of 7.5% is also low when compared to the minimum Tier 1 ratio of 4.5%.

Banco de Bogotá's Tier 1 ratio offers a limited loss absorption even when taking into consideration the bank's low problem loans and composition of loan portfolio.

The bank's fully adjusted Tier 1 ratio reached this level as a result of more stringent deductions of related to intangibles, which were exacerbated by the incorporation of goodwill from the acquisitions of BAC Credomatic in 2010, and BAC de Panamá and Reformador in 2013. Moody's adjustments for the bank's Tier 1 capitalization ratios are related to the deduction of grandfathered goodwill, and risk-weighting government securities at 50%, in line with the Colombian government's Baa2 bond rating.

More stringent deductions of related minority interest affected the bank's capitalization because although Banco de Bogotá only has a 38.2% ownership of Corporación Financiera Colombiana S.A. (Corficolombiana, unrated) and a 46.9% ownership of AFP Porvenir S.A., these are nevertheless consolidated. This is so because the remaining majority ownership of these entities is held by related parties, namely those entities belonging to the bank's holding company, Grupo Aval. As such, Banco de Bogotá must deduct the minority interest in both entities held by related parties from its consolidated Tier 1 capital.

Going forward this deduction could be minimized by new regulation which will allow Banco de Bogotá to not have to make these deductions fully if its related parties decide to deduct the minority interest themselves. Also, in October 2014, Banco de Bogotá announced its intention to do a COP1.5 trillion capitalization. Both these could add about 250 basis points to the bank's Tier 1 ratio.

During the fourth quarter of 2013, a COP1.3 trillion capitalization allowed the bank to counter the effect of the COP1.1 trillion goodwill incorporated from the acquisitions of Banco BAC de Panamá from BBVA and Guatemala's Grupo Financiero Reformador.

##### **RESILIENT LEVELS OF RETURNS UNDERSCORED BY AMPLE MARGINS AND AN EFFICIENT COST STRUCTURE**

Banco de Bogotá's stable generation of core earnings results from an ample net interest margin (4.7% as of June 2014) related to a low cost funding base and a growing and diversifying loan portfolio, both closely referenced to the benchmark interest rate and the 90-day CDT rate (DTF).

Banco de Bogotá has also successfully integrated BAC, with further beneficial effects on core earnings and their predictability, based on the business diversification that BAC's retail business brings to the bank's portfolio.

The bank also runs an efficient operation, with a cost/income ratio of 53.5% as of June 2014, down from 58.6% as

of year-end 2013. This can be explained mainly by the bank's ability to generate stable earnings, underscored by its core funding profile and cost sharing benefits related to the Grupo Aval network.

The bank's profitability is ample and largely in line with that reported prior to acquisitions with preprovision, pre-tax income (PPI) as percent of average RWAs is 3.9% and net income as percent of average RWAs is 2.0%, as of June 2014, versus 4.2% and 2.0% as of year-end 2012.

During the first half of 2014, Banco de Bogotá reported consolidated net income of COP687 billion, down 9.1% from the same period a year earlier, versus an important expansion of its portfolio 23.9% during that same time period as a result of acquisitions. While the bank's net interest income did expand at a more substantial pace of 9.4% to COP2.2 trillion, operating costs and provisioning costs expanded faster at 13.7% and 17.9%, respectively.

#### PROACTIVE AND INSTITUTIONALIZED RISK MANAGEMENT

Banco de Bogotá's conservative management and credit policies have resulted in healthy asset quality indicators and delinquency ratios that have traditionally been among the region's lowest. During the first half of 2014, the bank's 90+ days past due loans as percentage of gross loans of 1.4% and as a percentage of loan loss reserves plus shareholders' equity of 7.2% deteriorated in line with higher than expected past due loans in Reformador, from 1.3% and 6.7%, respectively. Banco de Bogotá's portfolio has high concentration, measured by top 20 exposures against fully adjusted Tier 1 capital (2.6x as of March 2014) and core earnings (2.2x), which could expose the bank to potentially rapid asset quality deterioration, but from very low levels of past due loans.

Banco de Bogotá also has a diversified loan book with 67% of its loans directed to corporate loans and leases, followed by personal loans with 11%, residential mortgages with 9%, credit cards with 9% and car loans with 3%, as of June 2014.

Banco de Bogotá has a high growth profile and acquisitive strategy in select markets in Latin America and the Caribbean. The announcement of another major acquisition would prompt a reassessment of Banco de Bogotá's ratings. Furthermore, in Colombia and Central America the bank faces tough competition.

Banco de Bogotá's supervisory board and senior executives maintain weekly discussions on risk management, largest credits outstanding, investment portfolios, and price and liquidity risk. Internal limits and operational risk are discussed quarterly. Risk management is institutional and supported by independent risk areas and good risk information systems. The bank's credit and market chief risk officer is independent from business line management yet has no veto power.

Banco de Bogotá is ultimately family-owned, which increases Moody's evaluation of the bank's risk profile. However, no major issues in terms of corporate governance have been observed in the bank. The bank's related party loans represent 16.5% of fully adjusted Tier 1 capital up substantially from 8.2%, as of June 2014.

#### CORE DEPOSIT FUNDING AND AMPLE LIQUIDITY

Because of its ample core deposit base in all the markets in which it operates, Banco de Bogotá does not rely on either interbank or capital markets funding. Most of the bank's funding is deposit-based and sourced domestically from customers in local currency, limiting its sensitivity to contagion risks in times of stress or to a negative shift in market sentiment in the event of a sovereign crisis. Banco de Bogotá maintains good liquidity management practices underscored mainly by a deposit-based funding diversified between Colombia and Central America and a comfortable liquidity position.

The bank benefits from a broad client base of low cost core deposits (110.3% of gross loans) and ample liquidity (28.5% of total assets), for a liquidity ratio [(market funds - liquid assets)/total assets] of -9.4%, as of June 2014. Colombian and Central American government securities, which are rated on average Ba1 in local currency, compose the bank's liquid holdings. The bank's retail deposit base though is low at 15% of total deposits, as of June 2014.

Banco de la República offers Colombian banks a Transitory Liquidity Support program for repurchasing loans and securities for up to 15% of deposits, which could aid the bank in a hypothetical liquidity stress.

#### WELL-ESTABLISHED BANKING FRANCHISE IN COLOMBIA AND CENTRAL AMERICA

Banco de Bogotá has a solid market presence evidenced by its leading lending and deposit market shares in Colombia and Central America where it is the second largest bank. Banco de Bogotá maintains a considerable geographic diversification within a macroregion of a GDP of USD576 billion (2013). The bank's operations are

mainly in its home market of Colombia (66% of gross loans), but with substantial presence in Panama (9%), Costa Rica (9%), Guatemala (6%), El Salvador (4%), Honduras (4%) and Nicaragua (3%), as well as a small credit card book in Mexico, as of March 2014. Although the credit ratings of some of these countries are below Colombia's Baa2, there is relatively low correlation among their respective operating environments, adding to the geographic diversification that shields Banco de Bogotá from potential earnings volatility in its home market.

Founded in 1870, Banco de Bogotá is the oldest bank in Colombia and has a large footprint of 1,467 branches and 3,286 ATMs in Colombia and Central America, as of June 2014.

The bank is majority owned by Grupo Aval, which in turn is owned and controlled by Dr. Luis Carlos Sarmiento Angulo, maintains. Grupo Aval has extensive and dominant holdings in the financial sector, where smaller corporations are targeted by Banco de Occidente, payroll-linked consumer loans and subsovereign financing are targeted by Banco Popular and consumer and mortgages targeted by Banco AV Villas. Grupo Aval banks represent about a third of the Colombian banking system, as of year-end 2013. Grupo Aval is a second line of risk management for its different banks and seeks to enhance synergies and technology use, and provides services to each bank at cost.

On 19 December 2013, Banco de Bogotá acquired Banco BAC de Panamá for USD505 million via its Panamanian subsidiary, Leasing Bogotá S.A. Panamá (Leasing Bogotá, unrated). Banco de Bogotá is now seeking to merge Banco BAC de Panamá into BAC Credomatic, to be completed through end-2014. On 23 December 2013, Banco de Bogotá acquired Reformador for USD411 million through Credomatic International Corporation (unrated), a subsidiary of BAC Credomatic.

#### Assigned Rating vs. Scorecard Outcome

As a point of reference, Moody's assigns a C- standalone BFSR to Banco de Bogotá, which is one notch below the scorecard-implied rating of C (see table below). Moody's believes the one notch difference incorporates the operating and competitive dynamics in Colombia and Central America, which are not fully reflected in the BFSR scorecard tool.

#### Global Local Currency Deposit Rating (Joint Default Analysis)

Banco de Bogotá's Baa1 long-term global local currency deposit rating is one notch above the bank's baa2 standalone BCA. The one notch difference reflects Moody's assessment of very high systemic support from Colombia, given the bank's important market shares. The systemic support indicator for Colombia is one notch above the Colombian government's Baa2 rating.

#### Foreign Currency Deposit Rating

The bank's Baa2/Prime-2 long-/short-term foreign currency deposit rating and Prime-2 short term foreign currency deposit rating, are constrained by Colombia's country ceilings of Baa2/Prime-2.

#### Foreign Currency Debt Rating

Moody's assigns a Baa1 long term foreign currency debt rating to Banco de Bogotá's five-year USD600 million senior unsecured notes due 15 January 2017 (coupon of 5%). The assigned debt rating is based on Banco de Bogotá's local currency deposit rating of Baa1.

Moody's assigns a Baa3 long term foreign currency subordinated debt rating to Banco de Bogotá's ten-year USD500 million subordinated debt issuance due 19 February 2023 (coupon of 5.375%).

### Rating Factors

#### Banco de Bogota S.A.

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (70%)						C-	
Factor: Franchise Value						C+	Neutral
Market share and sustainability	x						
Geographical diversification			x				

Earnings stability				x			
Earnings Diversification [2]							
<b>Factor: Risk Positioning</b>						<b>C-</b>	<b>Neutral</b>
<b>Corporate Governance [2]</b>				x			
- Ownership and Organizational Complexity	--	--	--	--	--		
- Key Man Risk	--	--	--	--	--		
- Insider and Related-Party Risks	--	--	--	--	--		
<b>Controls and Risk Management</b>		x					
- Risk Management			x				
- Controls	x						
<b>Financial Reporting Transparency</b>		x					
- Global Comparability	x						
- Frequency and Timeliness		x					
- Quality of Financial Information			x				
<b>Credit Risk Concentration</b>	--	--	--	--	--		
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
<b>Liquidity Management</b>			x				
<b>Market Risk Appetite</b>			x				
<b>Factor: Operating Environment</b>						<b>D</b>	<b>Neutral</b>
<b>Economic Stability</b>				x			
<b>Integrity and Corruption</b>				x			
<b>Legal System</b>				x			
<b>Financial Factors (30%)</b>						<b>B</b>	
<b>Factor: Profitability</b>						<b>B+</b>	<b>Weakening</b>
PPI % Average RWA (Basel I)	4.58%						
Net Income % Average RWA (Basel I)		1.89%					
<b>Factor: Liquidity</b>						<b>B</b>	<b>Neutral</b>
(Market Funds - Liquid Assets) % Total Assets	-12.39%						
Liquidity Management			x				
<b>Factor: Capital Adequacy</b>						<b>C+</b>	<b>Weakening</b>
Tier 1 Ratio (%) (Basel I)			6.55%				
Tangible Common Equity % RWA (Basel I)		5.89%					
<b>Factor: Efficiency</b>						<b>C</b>	<b>Neutral</b>
Cost / Income Ratio			58.23%				
<b>Factor: Asset Quality</b>						<b>B+</b>	<b>Neutral</b>
Problem Loans % Gross Loans		1.30%					
Problem Loans % (Equity + LLR)	6.53%						
Lowest Combined Financial Factor Score (9%)						<b>C+</b>	
<b>Economic Insolvency Override</b>						<b>Neutral</b>	
<b>Aggregate BFSR Score</b>						<b>C</b>	
<b>Aggregate BCA Score</b>						<b>a3</b>	
<b>Assigned BFSR</b>						<b>C-</b>	
<b>Assigned BCA</b>						<b>baa1</b>	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.

[2] - A blank score under Earnings Diversification or Corporate Governance indicates the risk is neutral.

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