Chapter 2

Our Operational Environment

We are the Colombian bank with the greatest international presence. 12 countries

Our in-depth knowledge of the environment in which we operate allows us to assist our customers in their local and international expansion projects.

2. Our Operational Environment

International Context

The second half of the year was characterized by an improvement in global economic activity, mainly in developed economies. In the United States, the situation was particularly positive, with a strengthening of the majority of the activity indicators and a minor effect of fiscal contraction, despite the political problems surrounding the budget issue. In the Eurozone, growth continued to be weak and fragile, but it is a fact that the recession is behind us. Meanwhile, growth in China continued close to the target set by the government, and the possibility of a greater slowdown was reduced. However, the emerging economies as a group displayed varied behavior and, on balance, the semester closed with stability in the various countries. The divergence between the improvements of the developed economies and the stagnation of the emerging economies was more evident toward the end of the semester. This confirms that 2013 was a transitional year for the global economy, since although the worst of the crisis is over, there is still a way to go in terms of consolidating the recovery. According to the International Monetary Fund (IMF), the world economy grew 3.0% in 2013.

In the United States, economic activity improved. The Eurozone is experiencing weak growth.

The continued existence of a negative product gap in the developed countries and the low commodities prices explained why inflation remained below the targets. In the United States, as well as in the Eurozone, inflation fell to minimum levels and a prolonged period of low inflation is expected, which is one of the arguments for maintaining the monetary stimulus. In Japan, the aggressive monetary expansion program fulfilled its objective of avoiding a new deflationary episode. Inflation was on the down-trend for most emerging economies.

In terms of monetary policy, the main event was the initiation of a moderation of the rhythm of asset purchasing by the Federal Reserve (Fed). The investors' anticipation of this event generated important movement on the markets. The Fed made efforts in the second semester to ensure the liquidity adjustments did not adversely affect markets, by strengthening its language of communication and confirming low interest rates for a prolonged period. The European Central Bank acted in the same way, and also adjusted interest rates to a historically low level of 0.25% and began to consider the possibility of acting in terms of liquidity.

Among the emerging economies, the majority of countries maintained or reduced their interest rates, but the exception of some large countries such as India and Brazil meant that the monetary policy trend of these countries as a group was restrictive.

Colombia

After moderate growth in **economic activity** (3.3% annual growth) was recorded in the first semester of 2013, GDP grew significantly by 5.1% in the third quarter. In terms of aggregate supply, growth was driven by the construction and agriculture sectors, at 21.3% and 6.6% respectively. By contrast, the industrial sector was the only sector to contract (-1.0%), although by the close of the year, some signs of recovery in the medium term were visible.

Construction and Internal Demand drove the growth of the economy.

Simultaneously, internal demand drove the growth of the economy with progress of 6.0%, with the growth of gross fixed capital formation (11.0%) and public sector consumption (5.7%) standing out. External demand, meanwhile, deducted 0.8 percentage points (pp) from the growth of GDP as a result of the moderate growth of exports (1.9% vs. 5.5% for the same period in 2012).

In this context, contracting labor force trend remained positive with the creation of 543 thousand jobs nationally in one year. This resulted in a reduction in **unemployment** to the historically low rate of 8.4% at the close of the year. In January 2014, the unemployment rate was 11.1%, which is 97 bps less than that recorded in the same month of 2013.

Despite the recovery of the economy, **inflation** remained at low levels, even lower than the target range of the Central Bank of Colombia (2.0% to 4.0%), closing the year at 1.9%. The reduced price variation is explained in large part by the drop in inflation of food products (from 2.5% to 0.9%), which were affected by a supply shock. Likewise, a low variation in regulated products (1.0%) and tradeable products (1.4%) contributed to the year's results. February 2014 experienced an annual price variation of 2.32%, returning to the Central Bank of Colombia's target range.

With this macroeconomic balance, the issuer opted to keep the **intervention rate** stable at 3.25%, but a debate about the potential growth of GDP was ignited within the entity, which could have significant consequences for monetary policy. During the first two months of 2014, the Board of Directors of the Central Bank of Colombia decided to maintain the intervention interest rate at 3.25%.

Meanwhile, the Central Bank continued to intervene with discretion in the **foreign exchange market** through the direct

Angela Espinosa, Corporate Manager, Banco de Bogotá; José Solano, Civil Engineer. Hidralpor; Alto Porce's Hydroelectric purchase of dollars. As a result, 2013 became the year of greatest exchange intervention, with the acquisition of USD 6,769 million, representing an annual growth of 16.4% to USD 43,636 million (11.7% of GDP) in international reserves. However, the entity moderated its purchasing rhythm at the close of the year, acquiring only 70% of the USD 1,000 million of the program stipulated for the fourth quarter.

The local **exchange rate** dropped by 9.0% and closed the year at COP 1,927, affected by the Fed's announcement regarding the moderation of the monetary stimulus. However, the weakening of the Colombian peso was mitigated in part by the flow of foreign currency that continued to enter the country. For the whole year, direct foreign investment reached USD 16,832 million, while foreign portfolio investment amounted to USD 4,692 million. The growth of 43.4% in this last category is explained in large part by income tax adjustments for foreign investors. For February 2014, the average exchange rate was COP 2,040.5, with a monthly devaluation of 4.1%.

Central American Economic Environment

The close of the year in Central America was characterized by modest recovery of activity as a whole, but with varied behavior within the region. **The Monthly Index of Economic Activity** (**IMAE** in Spanish) of Central America presented an average growth of 4.0% in the second semester (to November), while in the first half of the year it grew 3.5% on average.

Costa Rica (3.8%), Guatemala (3.8%) and Panama (7.9%) stand out for their high and accelerated growth rates, while El Salvador improved, but continues to have a low growth rate (1.4%). Nicaragua (2.9%) and Honduras (2.2%) experienced moderate growth rates.

The International Monetary Fund (IMF) predicts a slowdown in growth for the region in 2014, to 4.2% compared with 4.5% in 2013. Once again, Panama is expected to be the leader in terms of growth, with an estimated rate of 7.2%, much higher than Latin America, while Nicaragua and Costa Rica would experience growth within a range between 4.0% and 4.5%, and Honduras and Guatemala are expected to grow within the range of 3.0% to 3.5%. El Salvador is expected to be the country with the least growth (1.6%).

In terms of **inflation**, 2013 closed with a rate of 3.8%, less than that observed during the middle of the year (4.5%) and in 2012 (4.0%). This means the favorable scenario of relatively stable or reduced commodities prices is maintained. Nicaragua experienced the greatest inflation of the group (5.5%), and El Salvador, whose monetary policy is limited by dollarization, reached the lowest level of the region (0.8%). The inflation of the remaining countries was as follows: Panama 3.7%, Costa Rica 3.7%, Guatemala 4.4% and Honduras 4.9%.

For 2014, the IMF expects inflation of 4.7% for the region, accompanied by stable or reduced commodities prices that will make it possible to maintain low levels of inflation in the region.

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In terms of the **Monetary Policy Rate**, during the second semester of the year, the main events were the interest rate drop of Costa Rica by 25 bps, placing it at 3.75%, and of Guatemala by 25 bps, placing it at 5.0%. In the first case, the drop is part of a trend of the current monetary policy that goes back several years, while in the second case, the increase is reverted by the same amount as was presented in the first half of the year.

Honduras has remained at 7.0% since May 2012. The reserve conditions remain unaltered compared to the previous period.

Beyond the inherent stability of currencies with fixed exchange rates (the Panamanian Balboa) and dollarization (El Salvador), the 5.0% devaluation of the Nicaraguan Córdoba (25.3 Córdobas/Dollar) stands out for 2013. In Honduras, devaluation was less at 3.2% (20.6 Lempiras/Dollar) and occurred during an exchange rate band program.

In Costa Rica[5] (495.01 Colones/Dollar), and Guatemala (7.84 Quetzales/Dollar), the currencies were revalued by 1.4% and

[5] Exchange rate at closing acquisition. The sale's exchange rate was listed at 507.80 Colones/Dollar, revaluing by 1.3%.

0.8% respectively. In these two countries, the central banks acted by purchasing dollars, but in lesser amounts than during the first semester. As such, the balance was varied in terms of the exchange rate.

Colombian Banking System

Internationalization and Strength Characterize the Colombian Banking System

The good performance recorded by the Colombian economy and the growth potential of the Central American markets have served as a basis for the internationalization of the Colombian Banking System (through entry of foreign banks and through local banks that have sought to expand their business in international markets). The support of the oversight bodies of the various countries where the bank operates, and the comprehensive supervision of the Financial Superintendency of Colombia, make it possible to integrate internal control policies that strengthen the relationship between the banks and their affiliates abroad. They also guarantee stability in the financial system and ensure the rights of financial consumers are upheld.

Colombia has maintained adequate business management, ensuring the strength and security of the sector, backed by a Solvency Ratio of 14.5%, which fulfills the regulatory minimum of 9% and the new capital requirements in force since August 2013.

The banking system continues to satisfactorily fulfill its role as intermediary through attracting the resources of savers and channeling them through loans. In this way, the system portfolio presented positive growth, permitting a further strengthening of loans accompanied by quality indicators (2.79%) and coverage indicators (160.6%), which afford piece of mind to the real and financial sectors. In this regard, the net loan portfolio reached COP 251.2 trillion, presenting an annual variation of 13.9%, where the growth of mortgage portfolios (28.1%) and commercial loans (12.7%) stand out. This behavior was supported by a stable non-performing loans portfolio and provisions with continuous growth. As a result, a greater share of loans in the national economy was achieved.

Meanwhile, deposits continued to behave favorably and ended the year at COP 258.2 trillion, showing an annual growth of 15.5%. In particular, the current account grew 18.1%, the savings accounts grew 17.9%, while Term Deposits grew 10.6% annually. These accounts showed balances of COP 46.7 trillion, COP 129.1 trillion and COP 74.5 trillion respectively at December 2013.

The system's equity grew 15.4% to end December 2013 at COP 54.3 trillion. In terms of financial indicators, the system's ROE was 13.1%, while the ROA was 1.8%.

The less volatile behavior of the financial market during the second semester of 2013 compensated to some degree the losses experienced by some banks within the system during the second quarter of the year, given the decrease in profits obtained from investments. As such, the banking system profits ended 2013 at COP 6.5 trillion (1.2% less than the previous year).

Our Share in the Colombian Banking System

At December 2013, Banco de Bogotá had increased its share in Assets (14.8%), Gross Loans (13.6%), Commercial Loans (17.8%), Microcredit (4.0%), Mortgages (2.9%), Term Deposits (14.6%), Commissions (13.8%), Equity (21.2%) and Profits (21.8%).

Central American Banking System

Sustained Growth of the Financial Market

The Central American banking system continues to constantly and positively evolve (11.6%)[6], allowing the increase of a diversified range of products and services on the market.

The profitability indicators have improved in the region, and the risk levels reflected in the **Loan Quality** (1.73%) and **Coverage** (141.6%) indices[7], remain conservative, accompanied by a growth in loan placements of 11.3%[8].

[6] Total growth of assets of the Central American banking system at December 2013. Source: SECMA.
[7] Figures at December 2013 from the Central American banking system. Loan quality (non-performing loans/ total loans) improved, moving from 2.11 in December 2012 to 1.73 in December 2013. Coverage (provisions/ non-performing loans) improved, moving from 124.1 in December 2012 to 141.6 in December 2013. Source: SECMA.
[8] Annual growth of total loans for the Central American banking system at December 2013. Source: SECMA.

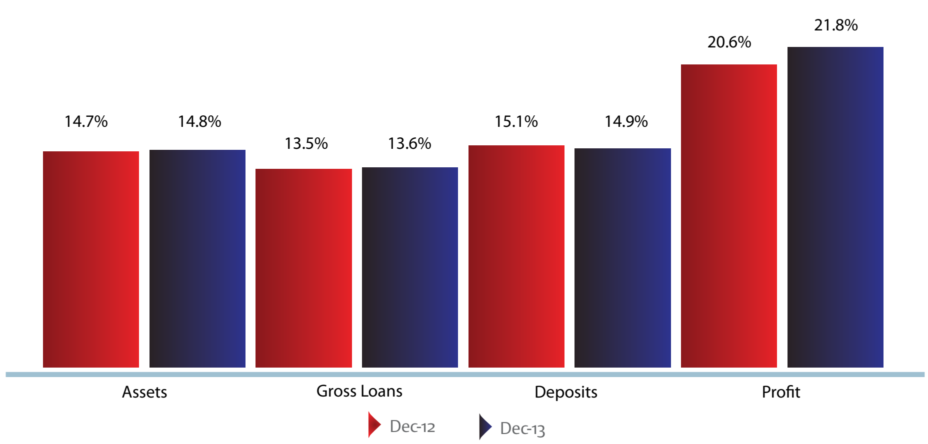
As such, the Central American Banking System is a healthy system that has allowed the banks to grow, not only at the domestic level, but also at the regional level.

Our Share in the Central American Banking System

After closing the acquisitions carried out in Central America, BAC Credomatic attained an 8.5% market share of Assets, 9.1% of Gross Loans, Deposits of 8.3% and Profits of 13.6%. This places BAC Credomatic at the top of the regional ranking in Q3 of 2013.

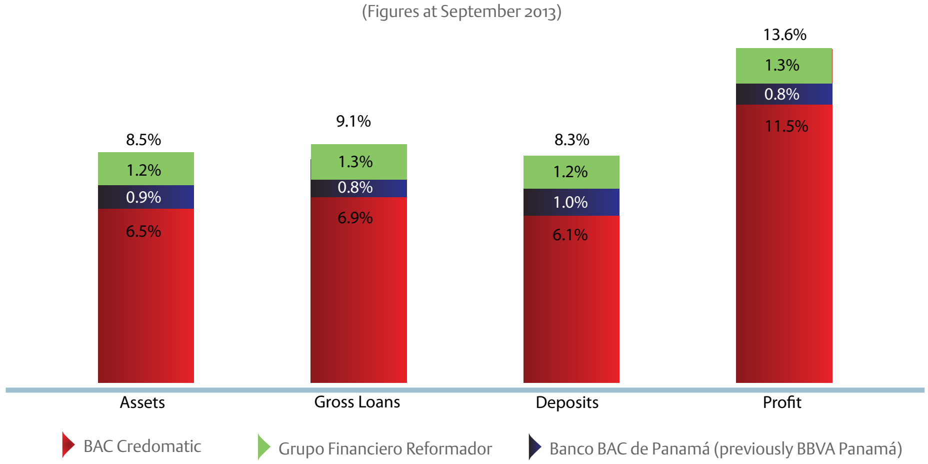
With a wide regional offering, BAC Credomatic continues to consolidate its market share.

Market Share in Colombia



Market Share in Central America

(Figures at September 2013)



Thanks to our presence in Central America, our customers can count on centralized management of treasury for the whole region.

From left to right: Eduardo Moreno, BAC Credomatic Regional Manager; Diego Salamanca Leano, Manager of Treasury, Avianca; Alejandro González Malaver, Director of Corporate Banking, Banco de Bogotá.

"For years now, Banco de Bogotá has been a strategic ally to Avianca, and accompanied it through important moments, always ready to adapt to the company's needs and requirements. Its coverage through Central America, via its network of branches in each country, with a unified web platform, as well as the complementary portfolio of products and services at the forefront of banking technology and security, were the decisive factors that inspired our confidence to select BAC Credomatic, an affiliate of Banco de Bogotá, to manage our Treasury in Central America. For Avianca, this has meant an optimization of processes, and consequently, a reduction in costs as a result of being able to centralize treasury operations."

Diego G. Salamanca L - Manager of Treasury, Avianca