
United States
Bahamas
Mexico
Cayman Islands
Guatemala
Honduras
El Salvador
Nicaragua
Barbados
Costa Rica
Panama
Colombia

Chapter 2

Our Operational Environment

Building on our strength, support, positioning and a comprehensive portfolio of products and services, we operate in 12 countries in the region, strengthening local companies in the international market.

Let's ***Make Progress***

Banco de Bogotá

2. Our Operational Environment

International Context

Following the increase in the US Federal Reserve (Fed) rate in December 2015, the upward trend did not continue as anticipated due to the shocks emerging from the international economy. For the first few months of 2016, concerns were expressed over Chinese activity, and the rapid devaluation of the Yuan prompted multiple occurrences of risk aversion in the markets. Then, in June, the UK's referendum on EU membership gave rise to a new shock that again deferred the possibility of increases. Although US activity retained a moderate rate of growth, external factors altered forecasts regarding the Fed interest rate.

The start of the year was particularly volatile for markets around the world. The emerging currencies, shares and commodity prices reacted jointly to a number of episodes of risk aversion from China. As was the case in August 2015, this economy concentrated the markets' attention. The sharp devaluation of the Yuan and the weakness of some indicators of activity sparked uncertainty as to the course of the main emerging economy. Specifically, there were fears that a significant downturn in Chinese growth would impact the global dynamic and precipitate a new crisis. These concerns, which appeared imminent, died down as the months passed. But going forward, it would be a mistake to overlook the profound imbalances of the Chinese economy and the risks that these generate, such as high levels of indebtedness.

The second major shock was the referendum in the United Kingdom. The vote on June 23 represented a milestone in political and economic history. With the decision to abandon the European Union, the economic bloc loses one of its mainstays.

The impact of the United Kingdom referendum on the global economy has been less pronounced than expected.

The pace of US growth could be classed as acceptable, although uneven and less than that observed in 2015.

The economic changes were just as profound as those on the political front: the sterling pound dropped in value to levels unprecedented over the last three decades, and now analysts have a central scenario of a recession in the next 12 months. Moreover, the referendum promoted a significant episode of risk aversion. The shares of the European banks were among the assets most affected, but the devaluation also hit the emerging currencies and commodities. As the days passed, risk aversion leveled off and the impact turned out to be limited.

With the above-mentioned events setting the context, the pace of US growth could be classed as acceptable, although uneven and less than that observed in 2015. Consumption and the labour market continued to be the most robust sectors of the economy, always subject to rises and falls. In May, job creation was at its lowest for a number of years, with no obvious explanation for the extent of the fall. Initially, it was believed that the weak result was down to a structural change in the series, but the following data offset the fall. On the downside, it should be noted that inventories and investment continue to subtract points from GDP growth.

Before concluding, it is worth looking at the continuation of the expansive monetary policy in both the Eurozone and Japan. In both cases, deflation and the emergence of the above-mentioned external shocks prompted the central banks to expand their monetary stimulus. Japan introduced negative deposit rates in January, and in July the rate of Exchange Traded Funds (ETF) purchases increased. In addition, the government established the main principles of a fiscal stimulus of around 6% of GDP. As to the Eurozone, the European Central Bank (ECB) cut the two main monetary policy rates, increased the rate of asset purchases to EUR 80,000 million per month, and announced a new round of Targeted Long-Term Refinancing Operations (TLTRO). Moreover, the ECB is awaiting information on the effects of the Brexit to evaluate the practicability of new measures.

Colombia

In the first half of 2016, the growth of the economy fell off to 2.3% per year, compared with the 2.9% recorded for the same period of 2015. In the breakdown by sectors, the dynamism of industry (5.4%), financial institutions (4.2%) and construction (3.1%) is noteworthy. In contrast, the mining (-5.9%) and agricultural sectors (0.1%) stand out for their weak performance.

In particular, the growth of industry was upheld chiefly by oil refining returns, due to the resumption of operations at the Cartagena Refinery (Reficar). The poor performance of the mining sector was associated with the lesser production of oil and coal, consistent with a context of low prices for these products. Meanwhile, the agricultural sector was adversely affected by the El Niño phenomenon.

The most recent information points to an additional slowdown, which confirms our central scenario of growth that while lower than the previous year, is still acceptable, given the challenging external context and the less favorable conditions from an economic policy standpoint, with higher rates of interest and lower public spending.

In line with the economic slowdown, in the first half-year, urban unemployment was seen to increase slightly, with the average of 10.5% up on the 10.3% recorded the previous year. Job creation also dropped, with an average of 54,000 new jobs per annum recorded in the first half-year, in comparison with 311,000 in the same period of 2015.

Conversely, inflation continued to rise, affected by the greater intensity of food shocks and the foreign exchange devaluation. In the former case, the effects of El Niño on food prices was marked, while in the latter, high foreign exchange pushed up the price of imported products to a greater degree than was expected. Indeed, in July inflation rose to 9.0%, the highest level since late 2000, while basic inflation stood at 6.6%, highlighting that there are other underlying pressures acting on prices beyond supply shocks. That is, economic demand continued to be sufficient to allow more widespread increases in inflation.

However, in August inflation slowed significantly after overcoming the impact of the transportation strike on food prices. In the rest of the year, inflation should keep on falling as the above-mentioned shocks continue to dissipate. By the close of the year, we estimate that inflation will drop off to around 6.3%, but thereafter indexing will slow the convergence thereof to the Central Bank of Colombia's long-term target (2%-4%).

In regards to the foreign sector, vulnerability fell as the deficit in the checking account declined, although it remained extensive. In the first quarter of 2016, the deficit in the checking account dropped to -5.6% of GDP, in contrast to the -7.0% of GDP observed in the same period of the previous year. This moderation was driven primarily by the lower factor income and balance of services deficit. In the case of factor income, the result reflects the downturn in the oil industry. As regards the balance of services, the adjustment was in response to fewer imports, in line with the slowdown in internal demand. More recent figures show that at June, the commercial deficit fell and, if this trend is to continue, it will contribute to correcting the deficit in the checking account.

This deficit in the checking account was financed through the financial account surplus (5.4% of GDP). This account is notable for the increased influx of capital from Foreign Direct Investment, despite the fall in investment into the petroleum sector (-75% per annum), which was more than offset by the flows aimed at the electricity sector (Isagen). The issuance of bonds on international markets by the public sector also contributed to the result for the financial account.

In keeping with external imbalances, foreign exchange was devalued. In the first half year, the Representative Exchange Rate averaged COP 3,128, in contrast with the COP 2,482 observed in the same period in 2015. In February, the Representative Exchange Rate reached a maximum of COP 3,435, amidst oil prices nearing USD 26 a barrel. Since then, foreign exchange righted itself and closed the half year at COP 2,916 on account of the oil price recovery. In August, the Representative Exchange Rate closed at COP 2,934.

Although growth is lower than the previous year, ***it is acceptable, taking into account the challenging external context.***

In response to the previous context, the Central Bank of Colombia continued with the contractive monetary policy initiated in September 2015, with increases in the reference rate of 175 bp in the first half-year, and 25 additional bp in July, taking it to 7.75%. With less activity, inflation that could be expected to reach a maximum in July, and falling expectations, the Central Bank of Colombia opted to keep the interest rate benchmarks stable in August, bringing the cycle of rate adjustments to a close. We expect the rate to remain unchanged for the rest of the year, and that it will probably be subject to cuts at the start of 2017.

On the other hand, the sharp devaluation in the Colombian exchange rate prompted the Central Bank of Colombia to intervene fleetingly in the foreign exchange market through call options for the decumulation of international reserves. After having adjusted the threshold for activating that mechanism on multiple occasions, with an announcement for the first operation that was not fully demanded and a recovery of the Colombian peso against the dollar, the foreign-exchange intervention became inactive. In the end, the Central Bank of Colombia only sold USD 411 million on the market and insisted that if necessary, it would reactivate the mechanism by using the intervention available to that end.

Finally, with the delay to the tax reform process for the second half-year, which is necessary to cover the absence of oil income, two of the three main risk assessment agencies changed the foreign-currency sovereign debt outlook from stable to negative, though the BBB rating was retained; that is, two levels above investment grade. The risk assessment agencies' actions were in response to the deterioration in the fiscal and external accounts in an environment of lower oil prices. The central scenario of the risk assessment agencies takes into account the approval and implementation of this reform, but they will remain vigilant to make sure that it assures fiscal sustainability.

Central Bank of Colombia ends the cycle of interest rate increases in the face of a lower growth dynamic and moderation of inflation.

Colombian Financial System

Worthy of note is the sound performance of the GDP of the Financial and Other Services sector in the first half of 2016, which includes the results of the Financial System; this sector occupied second place, with growth of 4.2%, after the industrial sector (5.4%).

The Colombian Financial System has been governed by the best international standards of regulation and supervision.

The Colombian Financial System has been governed by the best international standards of regulation and supervision, and in 2016 it has continued to make progress in that direction. Thus, the figures for the Financial System from January 2016 are comparable to those recorded in 2015, in that they are prepared on the basis of the same technical accounting framework; namely, the international Financial Reporting Standards (IFRS).

Meanwhile, the regulation of the Financial Superintendence takes into account the recommendations of the Basel Committee as regards the regulatory capital framework, which guarantees the stabilization of the financial system and protection of public resources by asking Financial System entities to ensure that their regulatory capital is of high quality and capable of absorbing losses, that capital allocation is in line with the entity's exposure to risk, and that pro-cyclicality is mitigated by way of capital buffers.

Medellín Branch's Collaborators

The strength of the Risk Management Systems has been fundamental to provide business continuity at times of economic slowdown such as the present. The Financial Superintendence of Colombia, by way of Public Notice 051 / 2015, issued instructions for the implementation of the Stress Testing Scheme (STS) and the reporting of information on results, with a view to strengthening risk management based on international standards. The business models of the different entities have been developed in accordance with the regulatory requirements.

Given that the defense of consumer interests is a priority and that a harmonious relationship is sought between financial entities and their consumers, there is a robust regulatory framework in place in Colombia for consumer service, which establishes standards for bringing complaints before a consumer ombudsman within the entities.

The financial inclusion indicator continues to improve thanks to the technological advances that provide consumers with access to the products and services offered by financial entities. This inclusion has allowed more people to access a savings or credit product, thus improving the good use of their finances on account of financial education. As to transactions, the use of mobile applications has prompted a considerable increase in the number of monetary transactions carried out by consumers.

The main challenges of the Financial System as regards Financial Inclusion are: 1. To continue promoting the use of the internet and mobile applications to access financial system services; 2. To encourage the use of banking correspondents; 3. To increase the use of savings products, especially in rural areas; 4. To promote the payment of remittances through account deposits; 5. To foster the use of insurance products by leveraging new technologies.

Financial services evolve toward digitalization through technological advances and new business strategies: The evolution of technology associated with greater uptake by individuals lends the financial strategy a focus of attention for the creation of new tools at the cutting edge of the market, in order to provide effective solutions to consumer requirements.

For the first half of 2016, the Banking System increased its Assets by 11.2%, achieving a total of COP 522 trillion. Meanwhile, the Financial Lease and Loan Portfolio was subject to an annual variation of 12.1%, giving an absolute increase of COP 39.6 trillion. In particular, the Commercial and Consumer Loan Portfolio posted growths of 11.9% and 11.4%, respectively. The indicators of Quality and Coverage were located at levels of 3.0% and 150.7%, respectively.

For their part, deposits posted a 11.1% growth, mainly explained by the increase in Savings Accounts, which grew by COP 10.4 trillion (7.2%), and the CDs, which rose by COP 23.4 trillion (23.9%).

Cali Branch's Collaborators

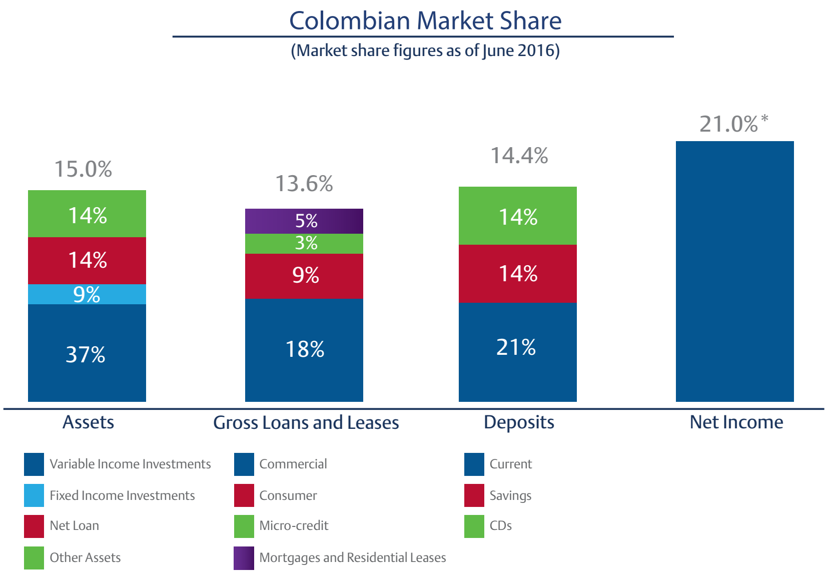
Western Regional Management's Collaborators

Our Share in the Colombian Banking System

At the close of the first half of 2016, we secured a 15.0% share of the Assets segment of the Colombian Banking System; of 36.7% in Variable-Income Investments; and 8.6% in Fixed Income Investments. The Loans and Financial Leases, Commercial, Consumer and Mortgage and Residential Lease portfolios had shares of 13.6%, 18.1%, 9.2% and 4.7%, respectively.

In addition, our share of total Deposits within the System is 14.4%, with Checking Accounts representing the greatest contribution (20.9%), followed by Savings Accounts (13.8%) and CDs (13.6%).

Finally, regarding Net Income and Equity, our Bank had a share in the System of 21.0% and 22.1%, respectively.



*Share does not include COP 2,200 billion income resulting from the fair-value measurement of investment in Corficolombiana, due to its deconsolidation.

Beyond borders

Banco de Bogotá's support of businesspeople engaged in exports lies on the pillars of strength, support, positioning and a comprehensive portfolio of products and services.

The export-led dynamic and growing foreign investment flows have played a leading role in the development of production chains in the country. Motivated by the considerable potential of our clients, Banco de Bogotá took its first step in extending its international coverage in 1967 when it opened its first branch in Panama.

We opened our New York branch in 1974, and followed that up four years later with the establishment of Banco de Bogotá Nassau in The Bahamas, both of which are mainstays of the global financial system. In 1980, the Banco de Bogotá International Corporation was founded in Miami, which we converted into the Banco de Bogotá Miami Agency in 2001 to strengthen our service portfolio.

And we did not stop there. Extending our operation to countries on the continent became a priority for the local companies, along with maximizing commercial partnerships between Central America and Colombia to boost the regional market. Thus, in 2010 we acquired BAC Credomatic, the biggest Central American financial conglomerate.

Following this historic acquisition, which constitutes the largest foreign operation carried out by a local bank to date, our international profile took on a new dimension. Then, the purchase of the Grupo Financiero Reformador de Guatemala and BBVA Panamá in 2013 not only reinforced BAC's competitive position in the region, but strengthened our ties in Central America.

Colombia, the United States, Mexico, Costa Rica, El Salvador, Nicaragua, Panama, the Cayman Islands, the Bahamas, Barbados, Guatemala and Honduras are the 12 countries where our valuable brand and strong network of branches and subsidiaries have reached to date.

Banco de Bogotá's support of entrepreneurs with international business and export interests lies on the pillars of strength, support and positioning that we have been pursuing for decades. We firmly believe in the capacity of our clients to keep on conquering markets, and seek to assist them in their placement in these markets with our comprehensive portfolio of services, to continue to build Colombia's future together in so doing.

Today, Banco de Bogotá has a presence in twelve countries in the region.