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## Research Update:

# Banco de Bogota S.A. y Subsidiarias 'BBB-/A-3' Ratings Affirmed; Outlook Remains Stable

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## Research Update:

# Banco de Bogota S.A. y Subsidiarias 'BBB-/A-3' Ratings Affirmed; Outlook Remains Stable

## Overview

- Colombia-based universal bank, BBogota, maintains its strong market position in Colombia and Central America. The bank's diversification by business activities and geography has led to solid and stable profitability levels.
- BBogota's moderate risk-adjusted capitalization remains as its main rating weakness.
- We are affirming our long-term 'BBB-' and short-term 'A-3' issuer credit ratings on the bank.
- We expect BBogota will maintain its conservative underwriting practices to avoid deterioration in its asset quality metrics. Profitability should remain strong--supported by its important presence in Central America--and moderate risk adjusted capitalization.

## Rating Action

On Aug. 27, 2014, Standard & Poor's Ratings Services affirmed its long-term 'BBB-' and short-term 'A-3' issuer credit ratings on Banco de Bogotá S.A. y Subsidiarias (BBogota). At the same time, we are affirming our 'BBB-' rating on BBogota's senior unsecured debt. The outlook is stable.

## Rationale

The issuer credit ratings (ICRs) on BBogota continue to reflect its "strong" business position underpinned by its sound market shares in Colombia and Central America, "moderate" capital and earnings, "adequate" risk position, "average" funding and "adequate" liquidity. The stand-alone credit profile (SACP) remains at 'bbb-'.

Our bank criteria use our Banking Industry Country Risk Assessment (BICRA) economic and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. Our anchor for BBogota is 'bbb-', reflecting our view of the weighted-average economic risk in the countries to which the bank is exposed through its total loans--Colombia (representing more than 65% of total loans), Costa Rica, Panama, Honduras, El Salvador, Guatemala and Nicaragua. We score BICRAs on a scale of '1' to '10', ranging from the lowest-risk banking systems (group '1') to the highest-risk (group '10').

Our weighted economic risk score for these countries is '6.3'. Given that the majority of BBogota's exposure is, and will remain in Colombia, the bank's

anchor is based on the country's economic risk score of '6' and an industry risk score of '5'. Colombia's economic risk reflects the country's low-income levels, which constrain its economic resilience, and reflect our "high risk" assessment for credit risk in the economy, as households have lower capacity to take out credit lines and are more vulnerable to economic downturns. On the other hand, Colombia has low inflation, moderate fiscal and current account deficits, a floating exchange rate, and a strong political consensus on key economic policies. These factors should maintain policy stability and economic resilience in the coming years. Colombia still has manageable economic imbalances--in our view, relatively fast credit expansion and rising housing prices pose an "intermediate risk" for the financial system. Still, the country's banking sector has sound asset quality and good underwriting standards, especially in the mortgage market. Our industry risk score of '5' reflects no significant distortions in the financial system, banking industry's stability, and a satisfactory deposit base that has remained fairly stable even during periods of market turmoil. On the other hand, we believe there is room for improvement in Colombia's regulatory framework and track record, in particular with regard to capitalization rules. On the positive side, transparency in the financial system is very good and compares favorably with many of its peers in the region.

Our assessment of BBogota's "strong" business position is based on its well-established bank franchise in Colombia and Central America. Additionally, BBogota's above-average diversification of business activities and countries leads to strong business stability. As of March 31, 2014, BBogota remains as the second-largest commercial bank in Colombia, holding a 13% market share in terms of loans. This market position is even higher when considering the corporate and commercial segment--which is its core business--where the bank holds 18% of the market. This business segment represents around 80% of the bank's loans located in Colombia; however, this participation drops to 62% when we incorporate BBogota's lending in Central America through its core subsidiary BAC International Bank Inc. (BIB; BBB-/Stable/A-3). This subsidiary has a significant participation in the consumer and mortgages business lines, improving BBogota's overall business diversification. We expect BIB to represent 35%-40% of BBogota's core earnings, in the next two years. In this sense, BBogota's geographic expansion strategy has been successful, as it supports its business stability.

BBogota has improved its diversification by business activities and strengthened its presence in Central America. On December 2013, the bank completed the Banco BAC de Panama S.A. (formerly BBVA Panama; BBB-/Stable/A-3) and Grupo Financiero Reformador (not rated). Acquisitions. As of March 31, 2014, BBogota's loan portfolio was composed of corporate and commercial loans (62% of total loans), consumer loans (24%), mortgages (9%), leasing (4%) and microlending (1%). BBogota's exposure in Central America is highly oriented to the consumer and mortgage segments, which represent 59% of total loans. Looking forward, we expect BBogota's loan portfolio to grow about 18% in 2014 and 20% in 2015, while loans in Colombia will remain at about 65% of the bank's total loans.

Our assessment of BBogota's capital and earnings remains "moderate." As we expected, BBogota's shareholders completed a capital injection in December 2013 to avoid a significant drop in its capitalization levels following acquisitions in Guatemala and Panama. BBogota's paid capital increased by Colombian peso (COP) 1.3 billion (\$680 million) through a private offering of 20,634,919 new shares. As of Dec. 31, 2013, the risk-adjusted capital (RAC) ratio was 5.3% before adjustments and 5.1% afterward. We expect the RAC ratio to be at about 5.5% in the next two years. Our financial forecasts incorporate the following base-case scenario assumptions:

- Colombian GDP annual growth of 4.5% in 2014 and 2015;
- Loan portfolio growth of about 18% in 2014 and 20% in 2015;
- Relatively stable goodwill, as we don't expect additional acquisitions in the next two years;
- Sound profitability metrics in the next two years, with return on assets (ROA) at about 1.5% and improving efficiency--measured by non-interest expenses to operating revenues--at 55%-60%. We expect annual credit loss provisions to represent 10% of operating revenues on average in 2014 and 2015.
- Nonperforming assets (NPAs = past due loans greater than 90 days plus foreclosed assets) to total loans ratio below 3% during the next two years, fully covered by reserves, and gross charge-offs representing about 1% of total loans.
- We expect a dividend payout ratio of about 45% in 2014 and 2015.

In our view, BBogota's moderate risk-adjusted capitalization will remain pressured by the heavy weight that goodwill has within its total adjusted capital (TAC; estimated at 35%-40% for 2014 and 2015), and by the significant costs related to equity in the banking book, due to the bank's equity investments in its subsidiary Corporación Financiera Colombiana S.A. (Corficolombiana; not rated), which we include in our estimated risk-weighted assets.

BBogota's quality of capital and earnings remain "adequate" reflecting its sound profitability metrics, which are better than those of other regional and global peers. The absence of hybrid capital instruments within our estimated TAC also supports our assessment. In our view, BBogota's profitability levels are linked to the bank's efforts to improve efficiency in the next two years.

BBogota's "adequate" risk position is based on the bank's conservative credit-risk management, which has led to its sound asset quality metrics, including low credit losses. The bank's adequate risk diversification remains as a supportive factor of its overall risk position. BBogota's will likely slow its loan portfolio growth with respect to 2013, we expect it to be 18% and 20% in 2014 and 2015, respectively. These rates will remain above our expectations for the Colombian banking system's average 14%-15%. In our view, BBogota's conservative underwriting practices will remain unchanged, which keeps its asset quality metrics stable. We don't expect significant changes in BBogota's loan portfolio composition in the next two years.

BBogota maintains adequate diversification by individual debtor. As of March

31, 2014, the bank's top 20 customers represented 11.2% of its loan portfolio and has remained relatively stable. These top 20 borrowers represent about 50% of BBogota's total equity, which is better than that its regional peers who have higher concentrations. In our view, BBogota will continue to gradually boost its participation in the consumer and mortgage segments. Therefore, we do not expect significant changes in terms of risk concentrations.

During the past several years, BBogota's loan recoveries have been larger than its charge-offs, resulting in negative net charge-offs. At year-end 2013, the bank's net charge-offs represented negative 0.2% of total loans (averaging negative 0.4% during 2011 and 2012). Even without considering recoveries, the bank's credit losses have been less than 1% in the past four years. On the other hand, BBogota's NPAs (to total loans were 2.35% as of Dec. 31, 2013, which was slightly below our expectations, and we expect this ratio will be below 3% in the next two years. NPAs should remain fully covered by reserves.

We assess BBogota's funding as "average" and liquidity as "adequate." The bank has numerous available funding sources, including its customer deposit base, which represented 77% of its funding base as of March 31, 2014. As of March 31, 2014, BBogota's deposit base was composed of savings deposits (34%), demand deposits (27%) and time deposits (39%). The bank's additional funding sources are multilateral and international bank loans (14%), repos (6%), and bonds (4%).

BBogota has a low 15% participation from retail deposits in Colombia; however this participation improves on a consolidated basis, after we incorporate the significant participation of retail deposits at BIB. The bank's top 20 deposits represent 16% of total deposits, which is adequately diversified, in our view. These factors lead to a stable funding ratio (SFR) consistently above 100%. As of March 31, 2014, SFR was 111%, averaging 114% in the last three years. We expect SFR will remain above 100% in the next two years.

BBogota's liquidity is "adequate" reflecting satisfactory cash management and local regulatory standards. The local regulator monitors the system's liquidity on a biweekly basis through two ratios: a calculation of a liquidity gap and a ratio of liquid assets to liquidity requirements, which are measured in seven, 15, 30, and 90 day periods. A negative gap in the seven- or 30-day period will trigger immediate regulatory actions. BBogota's broad liquid assets to short-term wholesale funding was 2.2x as of March 31, 2014, and has remained above 2.5x in the last three years. In our view, this reflects BBogota's conservative liquidity management, in light of the absence of a lender of last resort in some Central American countries, such as Panama and El Salvador.

We believe there's a "moderately high" likelihood of extraordinary government support to BBogota, stemming from our view about its high systemic importance in the Colombian financial system through large market participations in terms of deposits and in the retail segment. However, our ICRs don't reflect any notches of government support.

## Outlook

The stable outlook reflects our expectations that the bank will maintain its strong market position in Colombia and Central America and its conservative risk profile consistent with the ratings through fairly good asset quality metrics. We expect projected NPAs to total loans to be below 3% and gross charge-offs at about 1% over the next two years, with a still moderate RAC ratio. We believe BBogota's funding and liquidity profiles will keep benefiting from a well-established deposit franchise, although wholesale funding dependence is fairly high, much like its large Colombian peers.

At this point, we don't incorporate notches of government support to the ICRs on BBogota because of its 'bbb-' SACP and the 'BBB+' local-currency long-term rating on Colombia. However, if its SACP deteriorates by one notch to 'bb+', due to a drop in the RAC ratio to below 5.0%, or if its risk position deteriorates, the ICR would remain at 'BBB-' given that it would then reflect one notch of government support. In this sense, we don't expect a downgrade in the short-term.

We could upgrade the bank if we raise our local currency rating on Colombia. We don't expect the bank to improve its SACP in the next 12-18 months.

## Rating Score Snapshot

|                       |                          |
|-----------------------|--------------------------|
| Issuer Credit Rating  | BBB-/Stable/A-3          |
| SACP                  | bbb-                     |
| Anchor                | bbb-                     |
| Business Position     | Strong (+1)              |
| Capital and Earnings  | Moderate (-1)            |
| Risk Position         | Adequate (0)             |
| Funding and liquidity | Average and Adequate (0) |
| Support               | 0                        |
| GRE Support           | 0                        |
| Group Support         | 0                        |
| Government Support    | 0                        |
| Additional Factors    | 0                        |

## Related Criteria And Research

### Related Criteria

- Banking Industry Country Risk Assessment: Colombia, Aug. 6, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

### **Related Research**

- Sluggish Economic Activity Is Weighing On Latin American Banks' Performance, June 5, 2014

## **Ratings List**

### Ratings Affirmed

|                                     |                 |
|-------------------------------------|-----------------|
| Banco de Bogota S.A. y Subsidiarias |                 |
| Counterparty Credit Rating          | BBB-/Stable/A-3 |
| Senior Unsecured                    | BBB-            |

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