Our Operational Environment

Knowing Our Environment Allows Us to Successfully Advance Our Strategy

Chapter 2

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We **know**

Our Operational Environment

International Context

Compared to the second semester of 2013, economic activity at the close of June 2014 was characterized by a slower rate of growth. The United States was the most influential aspect. It experienced a particularly cold winter which negatively impacted variables such as job creation, retail sales and industrial production. Consequently, first quarter GDP contracted by -2.1%, which had not occurred since 2009. As expected, following a temporary negative impact, the economy rebounded in the second semester with GDP growth of 4.2%. In any case, the evolution of the US economy has thus far been below that expected at the end of 2013. Entities such as the Federal Reserve (Fed), the Organization for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) have repeated lowered their growth projections. The IMF expects growth of 1.7% for 2014.

The words of European Central Bank President M. Draghi serve as an accurate description of the economic recovery process: growth is fragile, weak and uneven. Industry slowdown was a recurring theme in the second quarter, especially in Germany. The downturn in growth predictions from the aforementioned situation is being compensated by a greater-than-expected upturn in economic activity in Spain and England. Furthermore, China's economic growth has stayed on track with its government's goal of 7.5%, dispelling uncertainties raised at the beginning of the year regarding the possibility of a sudden slowdown.

Isolated factors limited *global economic* growth in the first semester.

As regards inflation, adverse climate effects in various parts of the world and military conflicts (particularly in Ukraine) gave rise to the upturn seen in the first semester. In the Eurozone, however, low inflation continued to be the determining factor in monetary policy. Contrary to global trends, inflation is at its lowest levels since 2009, and August showed an annual variation of 0.3%. In Latin America's principal economies, with the exception of Colombia, inflation is close to the upper end of the target range, and in the cases of Brazil, Chile and Peru the range has been exceeded. For 2014, the IMF expects global inflation of 3.7%.

In terms of monetary policy, the European Central Bank concluded an extended series of pronouncements with a cutback of 10 basis points, to 0.15%, in the primary interest rate. Together with the negative deposits rate and the announcement of aggressive liquidity measures, market expectations were exceeded. According to the entity's communiqué, additional measures are not out of the question if inflation outlooks continue to worsen. This expansion of liquidity, which will be felt more strongly in the second half of the year, is of particular interest because it compensates for the Fed's cutbacks in the asset purchase program. According to discussions within the entity, the program will end in October. The monetary policy normalization strategy plays a central role in the discussions, even more so when the labor market continues to progress but at an insufficient pace. For the time being, the consensus forecasts a rise in rates in the second half of 2015.

Latin America shows a downward trend in terms of monetary policy. As with inflation, Colombia emerged as the exception to this trend. A greater-than-expected slowdown in economic activity in Mexico, Peru and Chile was the principal driver behind the surprise interest rate cuts made by these countries, even in the midst of high inflation rates. For its part, Brazil halted interest rate increases in April, and does not rule out a rate cut before the year's end.

Colombia

Economic activity in the first semester of 2014 showed a positive trend, with a first quarter annual growth of 6.4%. The exceptional result was driven by internal demand, with 8.7% growth, which was in turn propelled by notable rises of 14.6% in investment and 5.6% in total consumption. By sectors, the construction sector stood out, jointly bolstered by infrastructure (24.8%) and private buildings (7.9%), followed by social services, (6.3%), agriculture (6.1%) and financial establishments (6.0%). It should also be highlighted that industry, which in recent quarters has lagged behind the rest of the economy, grew by 3.3%.

The most recent data confirms that good economic growth continues, although perhaps at a slightly slower pace. The Indicator of Economic Activity of Colombia (IAECO, in Spanish), calculated by Banco de Bogotá, recorded growth of 4.7%, 5.2% and 4.6% in April, May and June, respectively. Likewise, progress in the labor market has slowed in the past year, with the creation of around 200,000 jobs through July 2014 and a national unemployment rate of 9.3%.

Following the unusually low results at the close of 2013 (1.9%), inflation had spiked as of July of this year due to an adjustment in the prices of regulated foods and goods. It rose to 2.9%, quite close to the midpoint of the 2.0% - 4.0% goal set by the Central Bank of Colombia. Likewise, measurements of basic inflation showed a lower uptick. Inflation without food products rose to 2.8%. The measurement that also excludes regulated goods fell to 2.5%. In this context, inflation expectations are locked, and projections for the year's end rose only slightly.

The Central Bank of Colombia was motivated to begin a cycle of monetary policy normalization due to acceleration in activity to the point at which the economy was in danger of growing beyond its potential, even with controlled inflation. This cycle began with an increase in the interest rate in March, followed by additional increases in subsequent months until a level of 4.50% was reached in August. In the meantime, debate continues within the Central Bank of Colombia regarding potential GDP and the ideal interest rate level. Recent intervention rate increases (averaging 4.04% for August) have not been applied to FTDs.

On the exchange front, Foreign Portfolio Investment flows were noteworthy after the weight of Colombia's sovereign debt was increased in certain international benchmark indexes. This adjustment caused the arrival of many investors to the country, with flows of more than USD 8,700 million through mid-August. The large currency inflows led to an appreciation of 0.43% in the exchange rate as of August, passing from COP 1,927 to COP 1,919. It also compensated the moderation in Foreign Direct Investment flows and the reduction in exports due to the lower volumes of petroleum produced. In order to counter the excess of dollars, the Central Bank of Colombia maintained its exchange intervention, and even doubled its purchase amount to USD 2,000 million in the third quarter.

With the Fed's moderation of economic stimulus, the probable end of the interest rate adjustment cycle in Colombia, and the stabilization of currency flows in the coming months, the exchange rate will likely depreciate for the remainder of the year.

The Central Bank of Colombia began a cycle of *interest rate* increases that may soon end.

Central American Economic Environment

Central America showed favorable economic performance during the first semester of the year, with four out of six countries recording an average growth in first semester of 2014 higher than that of the previous year. Particularly notable were the cases of Costa Rica, with an average growth of 4.2% in the Monthly Economic Activity Index (IMAE, in Spanish), Guatemala with 4.0%, and Honduras, with 3.6%. Although El Salvador was less dynamic (1.3%) it also improved compared to the previous year. Although growth in Panama and Nicaragua slowed, these countries maintained a favorable trend, with 4.3% and 3.7%, respectively.

As regards prices, in the majority of countries annual inflation through June 2014 is below that seen in June 2013. Honduras and Nicaragua recorded the region's highest inflation rates (6.2% and 6.1%, respectively). These countries were followed by Panama with 3.4% and Guatemala with 3.1%. In the case of Costa Rica, inflation ended at 4.6%, outside of the Central Bank's target range and 0.6 percentage points below that from the same period in 2013. On the contrary, the low levels of inflation in El Salvador are understandable in light of the dollarization of the Salvadorian economy, with a low annual variation level of 1.1%, the highest since July 2013.

In contrast to events in the second half of 2013, interest rate movements had greater reach in Costa Rica and Guatemala. In Costa Rica, the Central Bank resumed interest rate increases, and between January and June increased the rate 150 basis points to 5.25%, to control inflation following an expansive monetary policy in the wake of the financial crisis. In contrast, Guatemala continued with its expansive monetary policy, this time with two cutbacks of 25 basis points to 4.50%. Stability prevailed in the remaining cases.

Central American countries with their own currencies showed a depreciation trend. Such is the case of Costa Rica, where the dollar as of June 2014 was quoted at 537.6 Costa Rican colons. This represents an 8.6% increase in the currency compared to its December 2013 value. Currency depreciation in Nicaragua and Honduras has been lower. These countries have experienced exchange rate increase of 2.4% and 1.8%, respectively. For its part, Guatemala's currency has not shown significant fluctuations.

Selected Indicators:

Country	IMAE* (Annual Variation)	Inflation (Annual Variation)	International Monetary Reserves (millions of USD)	Exchange Rate**	
	jun-14	jun-14	jun-14	jun-14	
Costa Rica	4.2%	4.6%	7,494	537.6	Colon
El Salvador	1.4%	1.1%	2,660	1.0	Dollar
Guatemala	4.0%	3.1%	7,096	7.8	Quetzal
Honduras	3.6%	6.2%	3,173	21.0	Lempira
Nicaragua	3.7%	6.1%	1,944	26.0	Cordoba
Panama	4.3%	3.4%	N.D	1.0	Dollar

Source: Latest information available in Central Banks, the Central American Monetary Council and the National Statistics and Census Institute for Panama.
* IMAE: Monthly Economic Activity Index
** Local currency per dollar

Colombian Banking System

The current favorable situation of the Colombian economy has allowed for the solid, sustained growth of the Colombian Banking system thus far in 2014. With this momentum, Banking System Assets grew 11.5% annually, closing at COP 407.2 trillion as of June 2014.

At the close of June, the Gross Loan Portfolio recorded an annual increase of 14.3%, closing at COP 282.6 trillion. This was thanks to growth in Commercial (13.6%), Consumer (11.6%) and Home Loan Portfolios (28.5%). Banking System Investments reached COP 70.8 trillion, which represents an annual growth of 2.4%. In the first semester of the year, there was also valuation of TES investments, given the stability of local and external markets and the recomposition of Public Debt Securities on the J.P. Morgan Index.

Better management and a provisions level higher than the balance of past due loans kept Quality and Coverage indicators at appropriate levels: 3.1% and 144.2%, respectively. In June, total Provisions were COP 12.5 trillion, and continue to out pace the balance of Past Due Loans, at COP 8.7 trillion.

Banking System Deposits rose 13.2% annually and recorded a balance of COP 270.5 trillion, primarily due to Savings Account growth (14.8% annually) which closed the first semester at COP 136.9 trillion. For their part, Checking Accounts and Term Deposits closed at COP 45.4 and COP 79.7 trillion, respectively.

As of June 2014, the Banking System had a Solvency Ratio of 14.9%. Bank Assets grew by 20.3%, reaching COP 57 trillion. Profits for the first semester closed at COP 3.8 trillion, 10.4% more than the same period for the previous year. ROA and ROE for this period were 1.9% and 14.0%, respectively. The industry continues to face challenges in education and financial inclusion, penetration (as part of its social responsibility goals and to ensure the entire population has access to financial instruments), and in adoption of International Financial Reporting standards (IFRS) in response to the internationalization of the Colombian banking system.

The Colombian Banking System is competitive and dynamic. It is increasing the products it offers and expanding its service channels, complemented with broad, effective oversight.

Central American Banking System

The Central American Banking System continued to show satisfactory levels of growth, with an annual increase as of June 2014 of 8.3% in Total Assets. The Loan Portfolio shows the same tendency, undergoing a positive variation of 7.3% compared to the same period in 2013[6].

Deposits also performed positively, growing at an annual rate of 6.0% in June 2014, exceeding USD 134,000 million. In this category, the momentum shown by Nicaragua, Guatemala and Panama stands out, with annual variations of 13.7%, 10.4% and 5.8%, respectively. The positive performance of the Central American Banking System affirms it was a good decision to acquire the Grupo Financiero Reformador in Guatemala and BBVA in Panama (now called Panama BAC) in order to continue the consolidation of BAC Credomatic as one of Central America's leading financial groups.

The combination of the regional level consolidation policy and efficient resource management has improved BAC Credomatic's market position. For the second quarter of 2014, it holds first place for Assets, with 8.6% of the total percentage.

BAC Credomatic strengthens its regional positioning through the favorable industry climate and its *efficient management of resources.*

Our Market Share

At the close of the first semester of 2014, Banco de Bogotá increased its share in: Assets (15.3%), Investments (20.6%), Gross Loans (14.0%), Commercial Loans (18.2%), Consumer Loans (9.4%), Microcredit Loans (4.0%), Mortgages (3.6%), Deposits (15.3%), Checking Accounts (19.7%), Savings Accounts (14.3%), Net Commissions (14.3%) and Equity (20.8%).

BAC Credomatic also leads in Net Loans, and Deposits, with a share of 8.9% and 8.1%, respectively. Its effective management

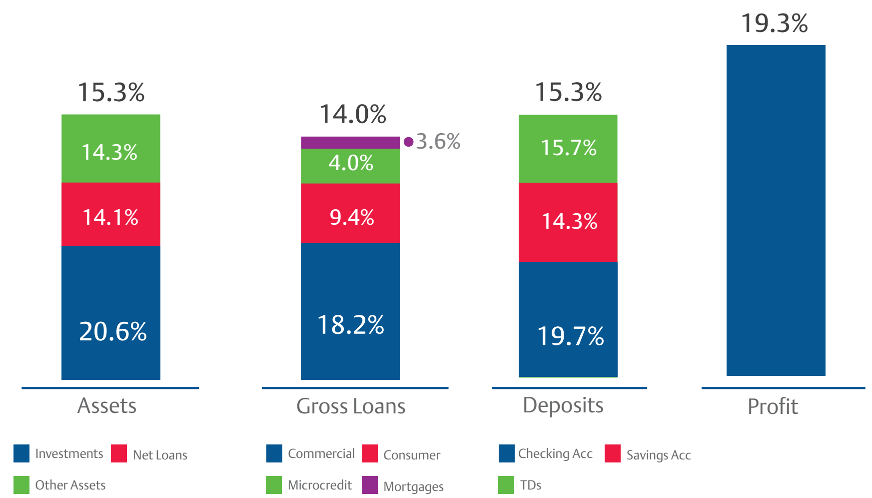
BAC Credomatic Nicaragua

[6] Source: Superintendencies in each country; for Panama, banks with a general license were taken into account. The published consolidated financial statements were used.

of resources should be highlighted; it is a product of wise Loan Portfolio placement and good Asset management, together with high quality customer service. This is reflected in Net Profit, where BAC Credomatic stands out as the best with a 12.9% market share.

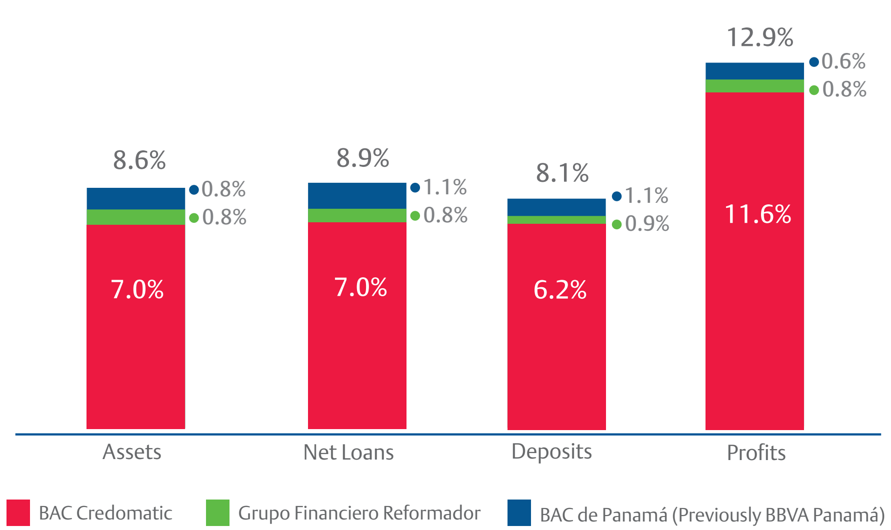
Market Share in Colombia

(figures % market share as of June 2014)



Market Share in Central America

(figures as of june 2014)



Note: As of June 2014, Assets include the local operation of BAC Credomatic Panama, which has not yet been integrated with BAC Credomatic.

We assist businesspeople in their expansion processes. Thereby, strengthening our coverage in Central America through BAC Credomatic, which is present in every country in the region. Thus, we become the financial bridge for promoting business in the region.

BAC Credomatic Network