Our Operational Environment

Knowing our environment allows us to successfully advance in our strategy

Chapter 2

We **Know**

2. Our Operational Environment

International Context

The second half of 2014 saw marked differences in the growth rates and the monetary policies of developed nations. On the one hand, rapid growth within the United States meant that the Federal Reserve would be the first of the major central banks to raise its interest rates.

On the other hand, Japan fell into recession while Eurozone growth continued to be weak and fragile. This coupled with low inflation (which is a negative factor for the Eurozone) also contributed to an expansive monetary policy.

In the second half of the year, GDP growth in the United States was 3.8%, much higher than the rate recorded in the first half of the year (1.2%). As will be discussed below, lower oil prices helped drive up consumer spending. Not only was consumption positive, but also the labor market performed very strongly. Job creation continued a positive trend, with the unemployment rate in December dropping to 5.6%, the lowest figure since 2008.

Multilateral institutions such as the World Bank and the International Monetary Fund (IMF) revised their growth outlooks for 2015 upward. The IMF, for example, is expecting an increase of 3.6% in 2015, up from 3.1%.

In Japan, a higher sales tax that was implemented in April 2014 exposed the fragility of the country's growth. Initially, the hike was expected to have a temporary effect that would not extend into the second quarter. The effect continued, though, and led to two consecutive quarters of economic contraction. As a result, in November, Prime Minister Abe called early elections to ratify his proposal to postpone the second planned stage of sales tax increases.

Meanwhile, inflation (especially in the fourth quarter) was determined by a drop in oil prices. After peaking at the end of June, the price of this commodity fell 54% by the end of 2014. With these lower prices, the energy sector caused inflation levels to drop in most countries. The impact was greatest in the Eurozone, where deflation occurred for the first time since 2009.

Low inflation rates triggered various measures by the European Central Bank (ECB). With interest rates reaching as low as 0.05%, unconventional monetary policy measures became prominent. As the purchase of asset-backed securities, corporate bonds and the targeted long-term refinancing operations program (TLTRO) were unable to slow the falling inflation rate, the ECB announced the purchase of public debt.

The contrast with the United States could not be more pronounced. While the Eurozone announced measures to increase liquidity, the Federal Reserve confirmed in October that it would end its programs to buy back government bonds and mortgage-backed securities. This is the first step toward normalizing monetary policy, which, according to most analysts, will lead to the first increase in interest rates in the middle of 2015.

Divergence in growth trends and management of monetary policies characterize the economy of leading developed countries.

A brief overview of monetary policy in Latin America is merited. Chile, Peru and Mexico cut their interest rates to stimulate economic activity that was performing below expectations. The cycle of rate-lowering took place during a period in which inflation rates remained near the upper limit targeted by central banks, which underscores the relevance of the low growth rates achieved in these economies. Brazil departed from this trend by increasing interest rates despite being in a recession, instead paying attention to inflation risks.

Colombia

In the fourth quarter of 2014, the Colombian economy grew at an annual rate of 3.5%, continuing the deceleration that had been observed over the year. The construction sector continued to lead the economy at a growth rate of 5.9%; mining and industry saw annual contractions of -3.3% and -0.3%, respectively. The commerce sector, social services and the financial sector continued growing at above-average rates.

Overall, the growth rate for 2014 was 4.6%, slightly below the 2013 result of 4.9%. More recent information confirms that economic activity growth continued to slow down at the beginning of 2015.

Colombia is dealing with serious challenges after the price of oil, its main export product, decreased by more than 50%, as this is having an impact on external and fiscal accounts. A marked devaluation in exchange rates at the end of 2014 and the implementation of a new tax reform are results of lower oil prices.

Although economic growth is slowing down, gains in the employment market picked up steam in the second half of the year: the average unemployment rate for the 13 largest cities was 9.2%, while the national rate was 8.5%. In both cases, the results improved over the previous year (9.6% and 8.8%, respectively). Although the oil sector is not labor-intensive, it is possible that the decrease in oil prices may indirectly reduce

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hiring in other economic areas, such as professional services. On the contrary, the government's second free housing program could stimulate hiring and construction activity.

In the second half of the year, inflation continued to rebound as a result of normalizing food and regulated goods prices and, to a lesser extent, the devaluation of the exchange rate, which marginally affected inflation for tradable goods. Overall, the inflation rate for 2014 ended at 3.66%, i.e., higher than the 2013 rate (1.94%). Despite rising prices, basic inflation measurements that exclude the most volatile components were within the range of the Colombian Central Bank's goal. If food is not considered, the inflation rate ended the year at 3.3%; if regulated goods are not included, the inflation rate was 2.8%. These figures confirm that inflationary pressure from internal demand remains in check. At the beginning of 2015, inflation was trending up. In February, a variation in the annual rate of 4.4% was recorded, while the core rate (which does not include food or regulated goods) hit 3.4%. Recent inflation expectations have been in the upper segment of the target range.

Relatively high inflation at the end of the year has consequences for 2015 prices through indexation. In contrast to 2014 trends, rents and other indexed prices will have a greater price variation as a baseline. Devaluation would also still have an effect on tradable goods. In contrast, any change in local or international economic activity will be associated with price pressures on the demand side. Lower fuel prices should also be passed on to various modes of transportation. Finally, although climate factors remain a risk, the impact of El Niño should be minimal on food inflation.

In terms of monetary policy, the Central Bank of Colombia completed a cycle of interest rate increases that put the rate at 4.50%, slightly below the neutral rate estimated by Banco de Bogotá for the current economic cycle (4.75%). The economic slowdown and the deterioration of external conditions, in part due to oil prices but also to the slower global growth rate, led the Central Bank to maintain the interest rate steady for five consecutive months. The stable inflation rate and expectations exceeding the target limit the engagement of monetary policy. In the first two months of 2015, the Central Bank of Colombia decided to keep its rate unchanged at 4.50%.

On the exchange front, the dollar exchange rate was influenced by the higher Colombian sovereign debt weighting in some benchmark indexes for international investors. As such, foreign portfolio investment continued to enter Colombia, recording a historical USD 12,436 million according to exchange balance information.

On the other hand, lower oil prices affected oil income and caused concern about the government's dependence on this sector. Foreign accounts weakened with a cumulative trade deficit of USD 6,152 million in 2014 due to lower export volumes tied to lower prices, whereas imports continued with a positive trend. In the medium term, this divergence should diminish as the devaluation drives exports and makes imports more expensive. In the second half of the semester, the exchange rate underwent a major adjustment, closing the year at COP 2,392, a devaluation of 24%. This made the Colombian peso the emerging-markets' most devalued currency relative to the dollar, after the Russian ruble. In the first two months of 2015, the value of the Colombian peso continued to decline, finishing February at COP 2,497. As at March 17, the representative exchange rate was COP 2,675.

Lower oil prices and the economic slowdown are *creating major challenges for 2015*

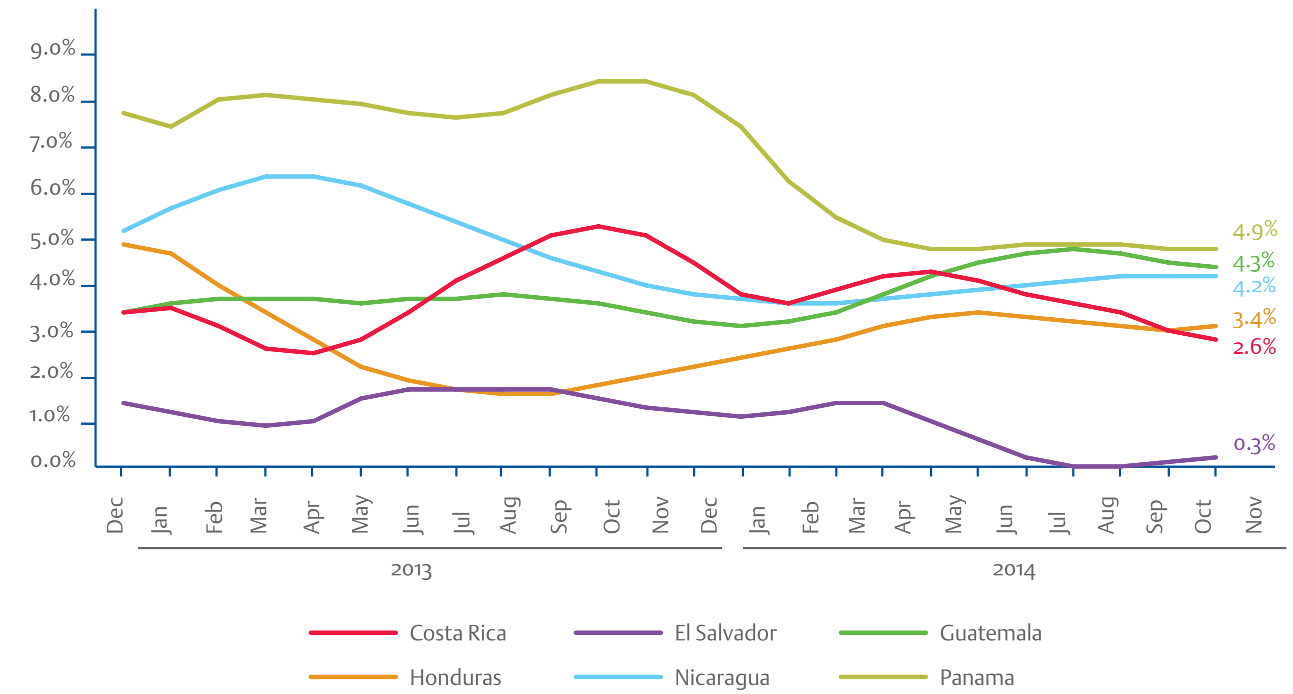
In this context, the Colombian Central Bank suspended its exchange intervention program early, limiting its purchase of dollars to USD 2,458 million during second half, and accumulating USD 4,058 million of foreign currency over the course of the year.

Economic Environment in Central America

In contrast with the first half of 2014, Central America saw its growth rate slow down in the second half of the year. As at November 2014 (latest information), four of the six economies in the region achieved growth rates below the economic activity indices. After weighting the economies by size, the average growth rate in Central America over the last six months was 3.5%, while for the year it was 4.4%.

Panama continues to have the highest growth rate at 4.9%. Even so, the economy's strength is losing steam as the canal expansion program wraps up. On the other end of the spectrum is El Salvador, where the average growth rate is 0.3% as a result of the weak internal demand. For 2015, the Economic Commission for Latin America and the Caribbean (Cepal) expects economic growth in Central America to increase by 4.1%, compared to 3.7% in 2014.

Monthly Economic Activity Index (IMAE)



It should be noted that earlier forecasts did not fully consider the favorable effect that lower oil prices would have. This situation has a positive net effect on growth as the region is an importer of this commodity. Lower fuel prices mean higher household spending and lower government subsidies.

Another effect of lower oil prices can be seen on inflation. This was evident in all of the region's countries in December. The greatest change took place in Nicaragua: -120 basis points between November and December. The weighted average for the region was 3.3% in December, 60 basis points lower than the previous month. Nicaragua ended the year with the highest inflation rate in Central America (6.4%); while El Salvador had the lowest rate (0.5%). As oil prices have remained low in 2015, the effects have endured.

Among the region's countries with an active monetary policy, Guatemala was the only country that lowered its interest rate in the second half of the year. Costa Rica and Honduras, the other two countries with monetary policies, held steady. In June and November, the Central Bank of Guatemala implemented an expansive monetary policy as the inflation rate remained within the target range. At the beginning of 2015, all countries with monetary policies lowered their reference interest rates.

Country	IMAE Annual Variation	Inflation	Central Bank Interest Rate*	Exchange Rate		International Monetary Reserves (Millions of USD)
	Nov-14	Dec-14		Dec-14		Dec-14
Colombia	4.6%	3.6%	4.50%	2,392.4	Peso	47,323
Costa Rica	2.6%	5.1%	4.75%	533.3	Colon	7,211
El Salvador	0.3%	0.5%	N.A	1	Dollar	2,661
Guatemala	4.3%	2.9%	3.50%	7.6	Quetzal	7,333
Honduras	3.4%	5.8%	6.75%	21.5	Lempira	3,516
Nicaragua	4.2%	6.4%	N.A	26.6	Cordoba	2,153
Panama	4.9%	2.6%	N.A	1	Dollar	N.D

* Current Interest rates at the close of February 2015.
Source: Central Bank of Colombia; DANE; central banks and the Panamanian National Statistics and Census Institute.
IMAE: Monthly Economic Activity Index.

Colombian Banking System

The remarkable growth of the financial sector was backed by the results of the banking system, which saw the value of assets increase by 13.8%, reaching COP 442.1 trillion by December 2014, primarily driven by the gross loan portfolio, which grew by 15.6% and finished 2014 at COP 304 trillion. In particular, the housing and commercial loans portfolios saw the highest growth at 18.1% and 16.7%, respectively. The quality and coverage indicators were at adequate levels as well: 2.9% and 150.5%, respectively.

CDs were the deposit products that saw the greatest growth in 2014 (19.0%), ending the year with a value of COP 88.3 trillion. Savings accounts, though, continue to hold the highest share of the deposits category, closing the year at COP 136.8 trillion (47.9% of the total).

The system's profits totaled COP 7.9 trillion, representing an annual growth of 22.1% backed by a capital adequacy ratio of 15.1%, which exceeds the legally mandated minimum of 9.0%.

The efficiency indicator improved 51.4%, 174 basis points less than the previous year. Profitability ratios also improved relative to the previous year: the ROA and ROE ended at 1.8% and 13.3%, respectively.

In this sense, the banking system continues to be committed to maintaining its strength and growth, ensuring that entities within the sector are the most important source of formal credit through a wide range of products and financial education. This is still one of the challenges that the Colombian banking system faces.

The banking system's greatest accomplishments include its presence in nearly all municipalities in Colombia, the growing use of alternative channels such as internet and mobile phones, and the system's high level of innovation and development.

Our Share in the Colombian Banking System

As at December 2014, the Bank held a 15.1% share of assets, 20.8% of investments, 13.7% of the gross loan portfolio, 17.5% of the commercial loans portfolio, 9.5% of the consumer loans portfolio, 4.3% of the mortgage portfolio, 19.8% of checking account deposits, 11.7% of savings accounts, 17.0% of CDs, 14.7% of net commissions, 22.5% of the equity and 19.0% of the net profitability.

Central American Banking System

In 2014, the Central American banking system performed well, with annual growth rates at the end of December of 10.4% in assets, 10.1% in portfolio, and 10.1% in deposits[6].

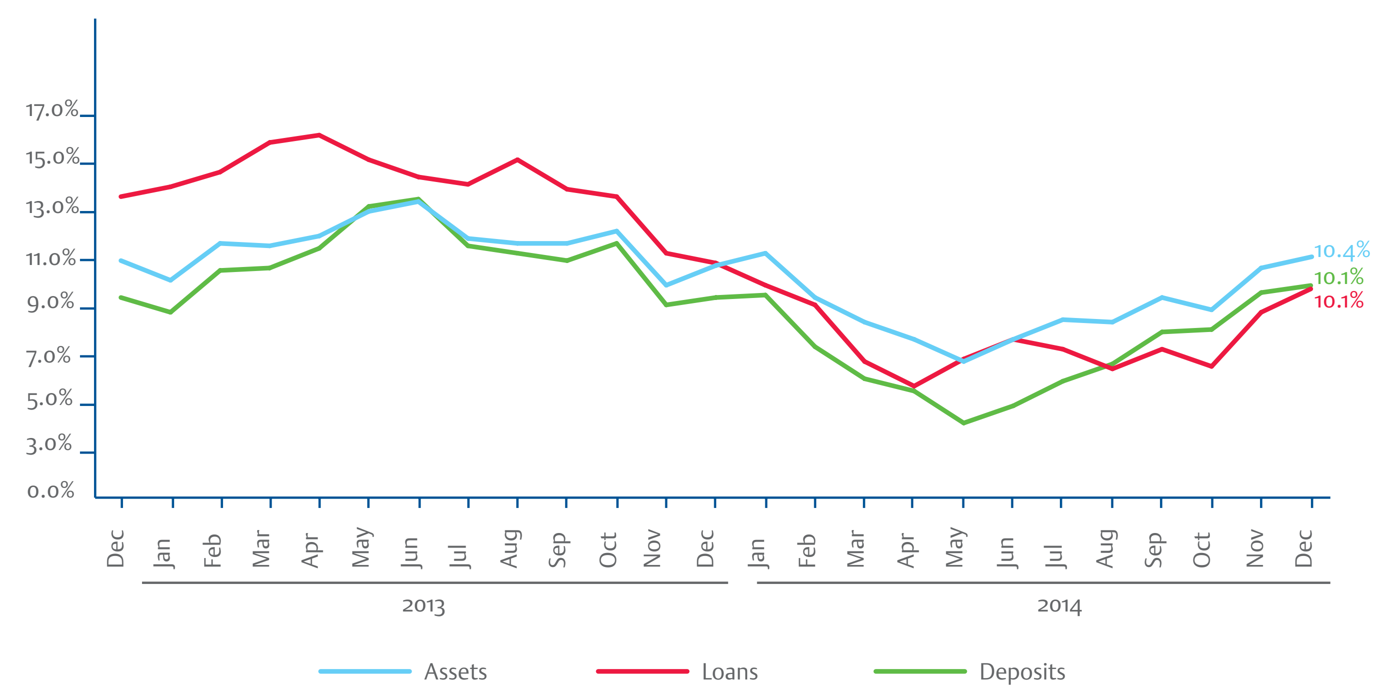
At the country level, Honduras had the greatest annual growth by the end of the year with 14.2% in assets, followed by Nicaragua with 12.9% growth, Panama with 12.4% growth and Guatemala with 11.8% growth. El Salvador and Costa Rica were the countries with the lowest levels of asset growth, with annual rates of 2.5% and 5.7%, respectively.

Loan portfolio performance was more uniform across the countries, with annual growth rates above 8.0%. As for deposits, Nicaragua (+13.4%), Panama (+12.6%), Honduras (+12.5%) and Guatemala (+10.5%) were the countries that enjoyed double-digit growth rates.

Ernesto Castegnaro Odio, President of BAC Credomatic

Central American Banking System

Annual Growth Rates



[6] Source: Data obtained from the superintendencies of each country. All financial groups in Guatemala are included, as well as those banks that do not belong to a financial group. Banks with a general license are included for Panama.

The strong performance of the Central American banking system creates growth opportunities for banks in the region. BAC Credomatic took advantage and established itself as the leading bank in the region with a 12.4% market share in terms of profits as at the end of December 2014.

Central American Banking System by Country

December 2014	Assets		Loans		Deposits	
Millions of USD	USD	Annual Variation	USD	Annual Variation	USD	Annual Variation
Guatemala	36,569	11.8%	20,176	11.6%	25,574	10.5%
Honduras	18,304	14.2%	9,692	8.8%	10,160	12.5%
El Salvador	15,064	2.5%	10,412	8.1%	9,805	-1.0%
Nicaragua	5,865	12.9%	3,604	12.6%	4,412	13.4%
Costa Rica	37,561	5.7%	24,369	8.1%	25,265	6.4%
Panama	90,196	12.4%	55,923	10.9%	67,052	12.6%
Total	203,559	10.4%	124,176	10.1%	142,268	10.1%

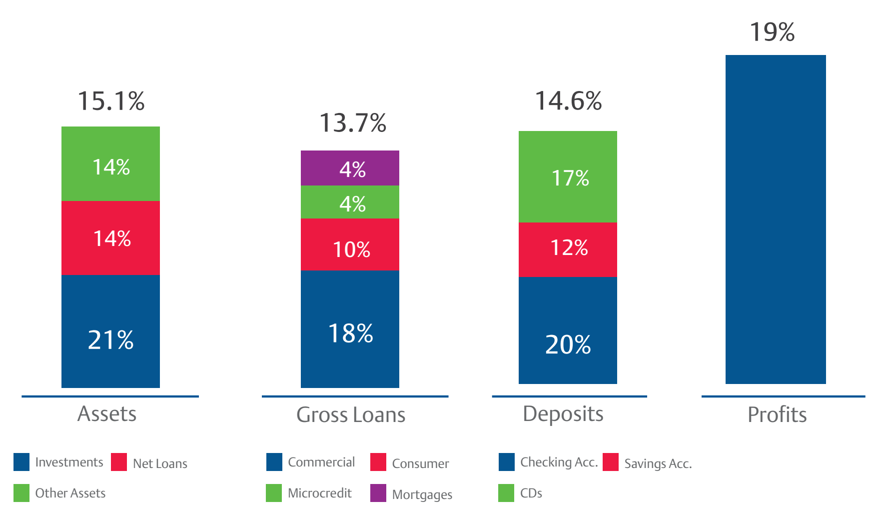
BAC Credomatic Collaborators - Costa Rica

BAC Credomatic leads in net loans and deposits, with shares of 9.3% and 8.1%, respectively[7].

Market Share

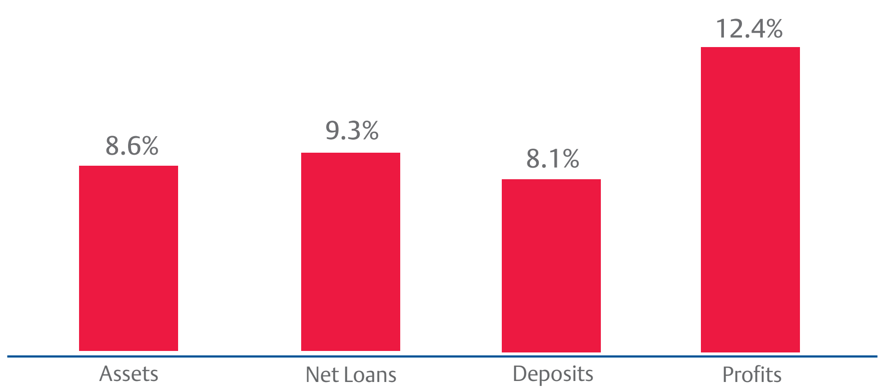
Market Share in Colombia

(Market share as of December 2014)



Market Share in Central America

(Market share as of December 2014)



[7] Source BAC Credomatic.

"BAC helped me launch my business. In the six years during which I have been a client of the financial group, I have received constant support through tools and specialized advisory services to help my business grow. In the beginning, we were five. We are now a team of thirty employees, and reached the break-even point within three years."

Marjori Fernández Vásquez, N&F Asociados. BAC Credomatic client and supplier. San José, Costa Rica.