Background Note – Bancolombia

BanRep-IADB-IMF Seminar
November 29-30, 2017
Bogotá, Colombia

The International Expansion of Financial Conglomerates
2.00 *Session 2:* ***Main drivers for international expansion of FCs***

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Session 2 will present industry reasons for international expansion, challenges, particularly to establish risk management policy and procedures to the whole FC. Ideally a FC with a concrete example should lead.]

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Presenters would be ask to prepared a short and concise background note, between 1,500 and 2,500 words' long

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Our experience

In each country where we arrive, we have the option to replicate what we are in Colombia, an important and systemically important commercial bank, and that is why Bancolombia and/or its subsidiaries are the # 1 or # 2. We do not choose to carry out an expansion strategy to be in many countries at the same time and thus impose a single brand as other entities have done in the past, but rather to preserve the 'Local Flavor'.

Bancolombia has undertaken few acquisitions, but truly disruptive and important, which certainly changed the balance sheet structure of the bank. For example, first, the purchase of BancoAgrícola in El Salvador for USD 1.0 bln at 2.2x book value, and then 9 years later we executed another important acquisition for USD 2.1 blns at 3.0x book value. These are transactions that definitely changed the Assets, Liabilities and Equity structure of the Bank because we want to be important in the geographies and markets in which we have presence.

The acquisition models in Latin America make sense if large and important operations are purchased, otherwise the contribution will be quite marginal, and potentially could destroy value. The main investment driver of Bancolombia is the potential up-side in acquisitions, therefore, the price factor, although it is important, for us it is accessory, because if we manage to replicate in these countries the model of banking of the Bancolombia Group we fully trust that the banking industry in these countries will promote critical changes for the benefit of all agents.

For the Bancolombia Group, the regulatory environment plays a fundamental role in our acquisitions matrix. It is important to mention that our acquisition model does not focus on creating a single platform, on the contrary, each bank has its own systems, its capital structure, etc., and very important, each entity funds its own operation. The best example is that we are the only Colombian group that all its subsidiaries have already taped the

international capital markets to raise money with the aim to self-manage their funding needs.

In our acquisitions, only 3 or 4 management positions are part of the top management of the banks in order to replicate the Bancolombia's corporate model: Finance, Risks, Internal Audit and Human Talent, and the other positions are covered by locals, so we keep the 'local flavor' and the market knowledge. The President or CEO of the operation is local, and obviously we seek to manage the Bank with autonomy, and for this it is key that the CEO can develop his work with local talent in topics such as Product Portfolio, Clients, Legal, etc. It is key that the CEO connect the Bank very well with the corporate model.

About 9 years ago we were 100% Colombia, yet now we are 67%, the great transformation process took place in Colombia. In all this way we made some mistakes, such as creating an international area to manage overseas investments, and we had to adjust the model because it did not work out. We are a team of corporate people that accompanies the international operation, but that also serves the Colombia banking operation. In fact, our variable compensation is based on the results and strategic goals of each book and not on the consolidated results.

We promote and leverage in the colleges of supervisors, in order to adopt the best practices. These spaces are a valuable opportunity for the Supervisors of different countries to share their impressions about the companies, have a comprehensive understanding of the strategy and risk management and articulate initiatives.

From our point of view, one of the most important challenges of the regional Conglomerates like ours, has to do with the effective coordination and decisive cooperation among the supervisors in order to unify standards and methodologies and even promoting regulatory changes that facilitate the consolidated management. A concrete example is the rules that each country has in terms of sharing information of its customers. Nowadays, these restrictions limit the scope of the matrix management of a conglomerate, to the extent that neither the parent company nor its supervisor can access the information of the clients.

Big Challenge of Banking: Bring regulators to the distribution models we have implemented so far in our channels, where, for instance, more than 77% of our banking operations are carried out between the Internet and the App, and 4% through the offices. Clearly the tendency to support the banking operation is to have less paper, and there the regulator must accompany this dynamic. There are cases such as Guatemala, where the point of sale by excellence are the offices, so the challenge is huge in order to bring society and the various agents to interact with us making use of more efficient and safe channels.

It is essential in our internationalization process to replicate the bank's control panel: same practices such as ALCO and Risk Management Committees. For us, this bank has 3 basic pillars: (i) Liquidity, (ii) Risks and (iii) Capital: Very stable policy of Dividends→1/3 of the profits, and the remaining 2/3s are recomposed and enter into the bank's pipeline to support businesses, initiatives and core projects. These are our 3 main obsessions when we talk about a process of this magnitude and scope.

What have worked for us…
A corporate business model that has a 'Supra' structure and then the operations of the banks: Colombia, El Salvador, Panama and Guatemala. Therefore, the creation of a corporate model that seeks a combination of 2 factors is mandatory: (i) strategic alignment, and (ii) keep the local flavor. This strategic alignment is basically achieved with the positions of Risk, Finance, Human Talent and Internal Audit, covered from the parent company; and the 'local flavor' with local talent. For example, in the case of Banistmo, we did not transform the bank as a Colombian bank, we simply carry the background of the 4 areas described above, but the execution of the business and the same operation lead by the CEO, that is, the President of the Bank in Panama has autonomy and develops the business model taking into account the drivers of the local market. That is precisely the big difference versus the models of international banks that sought to replicate their products, with very elaborate manuals, but that were unaware of the particularities of the products nor the market at the local level.

What have we done in risk management?
We have certified the market risk measurements of the treasury, liquidity, operational and compliance books. In credit, we have created regional models that avoid arbitrage and consolidate good customer service. In the same way, we have homogenized and centralized practices in construction and validation of models, mitigating the risk model.
We have a structure of control over shareholders' equity, which guarantees through the areas of Risk, Audit and Finance, a general framework and guidelines that are taught from these corporate areas. The Audit and Risk Committees of the Boards of Directors support this task by making the connection between the parent company and the markets.

Reasons

(i) Market diversification: In the first place, the banking model wanted to diversify markets to find growth potentials, and the driver was Central America, which in the light of the banking business is several years back compared to the business in Colombia; and therefore, we clearly see an up-side potential in terms of products, segments and incremental growth.

Some examples, payrolls: the payroll loan was an opportunity for an up-side to implement in other geographies, as it was done in Colombia and in El Salvador. Another important success story is the Bancassurance business, which allows us to replicate it with significant market growth where it did not exist, so one of the reasons for our internationalization is that we saw in these geographies a tremendous up-side potential for delivering value-added products.

We are exporting our products, as well as the risk model. In the same way, we have also transferred knowledge from the acquired operations and we have promoted the transfer of good practices between the different countries.

This expansion has also accompanied the dynamics of the Colombian business and industrial base, which has also been present in Central America with very important investments in the region. A sample of them is the business fabric that exists today in Panama, where different agents of different sectors of the economy converge that

strengthen the economic growth of the country through greater flows of foreign direct investment. In this way we play a leading role in the structural change that is taking place in the region. Precisely in the period 2016-18 in which the growth of the Colombian economy is low compared to previous years, it is when the diversification effect bears its fruits

Challenges

(i) Cultural: Understand the geographies and their markets, and act as such. The best way for Bancolombia to do so was to keep the name of the banks and the management in its great majority local, just to be able to give that message. For example, BancoAgrícola is considered the most Salvadorian bank in El Salvador. In the case of Banistmo, we gave it back its name and sense of belonging, hence the cultural theme and not losing the local idiosyncrasy is the great challenge we have as Grupo Bancolombia, recognizing that there is a local work culture that is precisely explained by the alignment of local flavor and the business lines.

(ii) Capital allocation: determine that there are geographies such as Panama where it is necessary to have high solvency levels in order to replicate the corporate model.

(iii) Funding structure: each subsidiary has gone to the capital markets to fund itself, because there is no connection between the different books to carry out a 'cash pooling'. The biggest challenge is to be able to guarantee the financial sustainability and the funding structure of each of the institutions. Example: the competitive advantage of banks in Panama lies in their funding structure.

(iv) Alignment of the government structure: each one has its own model, and each bank depends on the regulatory model, the regulatory framework of the market where it is located, and the microstructure of the market it serves, among others.

(v) Regulatory environment: In terms of financial conglomerates, regulation becomes a key element, since a regulatory environment is required that favors the integral management of risks, the adoption of best practices among entities and effective coordination among supervisors.

In the case of Colombia, the recent issuance of the Financial Conglomerates Law is a very important step that allows the country to be in line with international best practices following the recommendations of the OECD - Organization for Economic Cooperation and Development, provide the government and the regulator with new monitoring and supervision capabilities.

In general, experience has shown us that groups have to adapt to some regulatory environment challenges, which range from the way of accounting to the demands of capital, each of them have their own particularities. For us, although we are a financial group that shows the consolidated figures of capital, IAS, of solvency, it must meet many challenges, and the regulatory challenge is to try to see that in these geographies the regulators are aligned to understand the business in a uniform manner, and thus avoid the replication of reports or, as we have indicated, the imposition of barriers that hinder comprehensive and consolidated supervision.