Research Update:
Bancolombia 'BBB-/A-3' Ratings Affirmed On High Systemic Importance; Outlook Still Negative

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Overview

- Colombia-based universal lender, Bancolombia, remains a systemically important bank in the Colombian financial system, and has maintained robust business diversification, a strong franchise, and sound business stability.
- Bancolombia's capital remains weak, primarily based on our projected risk-adjusted capital (RAC) ratio of 3.4% on average for next 18-24 months.
- We're affirming our 'BBB-/A-3' issuer credit ratings on the bank and on its core subsidiary, Bancolombia Panama.
- The negative outlook on Bancolombia continues to reflect that on the sovereign ratings. The bank's rating incorporates one notch of government support, given Bancolombia's high systemic importance and our view of the Colombian government as supportive towards domestic financial system.

Rating Action

On Aug. 26, 2016, S&P Global Ratings affirmed its 'BBB-' long-term and 'A-3' short-term issuer credit ratings (ICRs) on Bancolombia S.A. y Companías Subordinadas. At the same time, we affirmed our 'BBB-/A-3' ratings on its core entity, Bancolombia Panama S.A. The outlook on both entities remains negative.

Rationale

The ratings on Bancolombia continue to reflect its strong business position thanks to its leading market position in Colombia's banking system and sound business stability, weak capital and earnings underpinned by our forecasted RAC ratio of 3.4% for the next two years, adequate risk position due to manageable asset quality metrics and adequate risk diversification. The ratings also reflect the bank's average funding compared with the industry norm and adequate liquidity. The stand-alone credit profile (SACP) remains at 'bb+'.

The bank's SACP receives one notch of uplift, given our view of Bancolombia as having high systemic importance in Colombia's financial system--due to its prominent market share and its importance to the country's payment system--coupled with our view of the Colombian government as supportive towards domestic financial system, which results in a moderately high likelihood of extraordinary government support to Bancolombia. The combination of its 'bb+' SACP and the 'BBB+' sovereign local currency rating on Colombia
result in a 'BBB-' ICR on the bank.

Our bank criteria use our Banking Industry Country Risk Assessment's (BICRA) economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an ICR. Our anchor for Bancolombia is 'bb+', reflecting the weighted average economic risk of '7' given the countries in which the bank has loan portfolio exposures as of June 2016: Colombia (65.9%), Panama (21.3%), El Salvador (6.2%), and Guatemala (5.6%).

Colombia's economic risk assessment reflects its slowing economy and deterioration in the country's trade balance, which is mainly due to the low prices of oil and coal. We believe that the country's external debt and liability position will weaken further because of reliance on higher debt financing during the next two years to partly finance the widening current account deficit. As a result, higher economic imbalance risks, in our view, would pressure Colombian financial institutions. On the other hand, low-income household levels (GDP per capita is projected to remain below $6,500 in 2016 and 2017) and modest growth in real wages could raise credit risk in the economy. The peso's depreciation, high inflation, the impact of low oil prices on the domestic economy, and increasing lending rates could further pressure household income capacity. Given lower global commodity prices, Colombia's GDP slowed to 3.1% in 2015 and will likely be 2.3% in 2016 and 3.0% in 2017, down from 4.5% in 2014. We believe that the slowing economy could be a drag on domestic credit expansion. Overall, we expect total loans to grow 10%-11% in 2016 and 12%-13% by the end of 2017, compared with a compound annual growth rate of 20% for the past six years.

Colombian banks' moderate risk appetite and the absence of market distortions support our industry risk assessment. Core deposits have proven stable even during periods of market turmoil; however, credit keeps expanding at a faster pace than total deposits, and the share of retail deposits remains low (estimated below 30% of total deposits). The latter could increase risks because of greater dependence on wholesale funding, which we consider less stable during times of economic and market distress. The central bank has been centralizing all government entities' surpluses this year, and commercial banks had to find alternative funding sources to compensate for the exit of those cheap resources. In addition, corporations related to the oil sector and entities whose primary raw materials are denominated in foreign currency have been exposed to low oil prices and to the peso's sharp depreciation. These entities have had lower cash flows and financial resources to channel into the financial system in the form of deposits. In response, domestic banks have been tapping the local debt capital market, which has proven to be moderately broad and deep, allowing investment- and speculative-grade entities to access funds with medium- to long-term maturities. Moreover, despite recent regulatory changes to strengthen the financial system's capitalization, we still believe there is room for improvement in Colombia's regulatory framework and track record. However, transparency in domestic financial system is overall greater than those of its regional peers.

Our view of Bancolombia's business position as strong reflects its status as
the biggest bank in Colombia's financial system, adequate business
diversification, a strong franchise value, and sound business stability. The
bank has maintained its prominent market share in Colombia with a market share
of about 23% and 19% in terms of loans and total deposits, respectively, as of
June 30, 2016. The second- and third-largest banks in the country have
slightly less than 15% of total loans and deposits. Therefore, we consider it
unlikely that Bancolombia would lose its leading position in the coming years.
Its business diversification also provides revenue stability. The bank
continues to participate in practically all business lines, even though
commercial loans have historically represented the highest share in its loan
portfolio. As of June 30, 2016, these loans, including Financial Leases,
accounted for 72% of the bank's loan book, followed by consumer loans (15%),
and residential real estate loans (12.5%). Moreover, interest income accounts
for 71% of Bancolombia's revenue as of June 2016 with a three-year average of
66%, which we believe provide certain stability to the bank's profitability
ratios.

Thanks to the bank's fully-owned subsidiaries Banistmo S.A.
(BBB-/Negative/A-3) in Panama and Banco Agricola (B+/Stable/B) in El Salvador,
as well as its 60% stake in Grupo Agromercantil (BB/Stable/B) in Guatemala,
Bancolombia is one of the largest financial groups in Central America with a
wide geographic diversification. For the next 18-24 months, we expect the
bank's lending to grow about 10% on a consolidated basis, which will enable
Bancolombia to maintain its important market position all the regions.

Our assessment of Bancolombia's capital remains weak, primarily based on our
projected RAC ratio of 3.4%, on average, for next 18-24 months. Also, the
assessment incorporates a low quality of capital due to the preferred shares
and a large goodwill in the bank's capital base. Finally, the assessment
reflects an adequate quality of earnings and earnings capacity. We expect
solid earnings generation and around 10% loan growth help continue increasing
our RAC level for 2017. Our financial forecasts reflect the following
base-case assumptions:
• Colombia's likely GDP growth of 2.3% for 2016 and 3.0% for 2017 (please
  see "Brazil's Weak Economy And Global Volatility Are Clouding Latin
  America's Credit Outlook," published on July 8, 2016).
• Lower foreign exchange volatility in the next two years—COP3,250 per $1
  for 2016 and COP3,200 per $1 for 2017;
• A 2.4% goodwill increase for 2016 and a 1.5% drop for 2017, mainly due to
  the peso's moderating depreciation and no additional acquisitions;
• A consolidated loan portfolio growth of 10.5% in 2016 and 9.5% 2017;
• An average net interest margin (NIM) of 5.15% for the next two years;
• Adequate profitability with core earnings to adjusted assets and
  efficiency levels around 1.3% and 52%, respectively, for the next two
  years;
• Similar payout ratio as in previous years--30% average for the next 18-24
  months;
• Nonperforming assets (NPAs) and credit losses at about 2% and 0.87%,
  respectively, with a fully reserved coverage; and
• The latest 20% increase stake in Grupo Agromercantil Holding S.A. (not
Bancolombia's profitability metrics and earnings capacity have remained fairly stable, and we expect to remain so in our base-case scenario. The bank's core earnings to adjusted assets was 1.29% at the end of the first half of 2016, slightly lower than in the same period of last year, but better than the 1.22% average of the past three fiscal years. Over the next 18-24 months, we don't expect core earnings to adjusted assets to change as a result of the bank's focus on maintaining its balance sheet profitable, without major increases in its securities portfolio, and sustained cost-controls efforts. Moreover, fee income should keep rising, given the bank's efforts to promote the use of credit cards and the distribution of insurance policies.

Our assessment of Bancolombia's risk position remains adequate due to diversified risk exposures and credit losses in line with those of the Colombian banking system and other banks operating with same economic risk scores. The bank's risk dispersion among several asset classes remains satisfactory. Its top 20 exposures represented only 8% of its consolidated total loan portfolio and a large share of its total consolidated reported equity as of June 30, 2016. These metrics are in line with those of Bancolombia's closest peers. Furthermore, the bank doesn't have concentration in economic sector exposure. Construction and oil and gas segments, which we currently view as riskier amid low oil prices, represented around 14% and 1.5% of total loans, respectively, at the first half of 2016.

Despite a cooling economy in 2015, Bancolombia's asset quality has remained adequate and similar to that of its domestic and regional rated peers. NPAs (nonperforming loans of more than 90 days) and credit losses (measured as net charge-offs) have remained in line with those of domestic and regional banking systems. As of June 2016, Bancolombia's both ratios were 1.9% and 0.7%, respectively. Nevertheless, the bank's NPAs are slightly higher than in previous years mainly due to weaker quality of the consumer and petroleum industry loans. Reserve coverage remains strong, at 131% as of June 2016, with a similar average ratio for the past three years.

Our assessment of Bancolombia's funding as average reflects a stable and high share of customer deposits and adequate stable funding ratio (SFR). At the first quarter of 2016, customer deposits represented at about 70% of the bank's total funding base. Wholesale deposits represented around 50% of total deposits in the bank and this share has remained relatively stable in the past two years. The remainder of Bancolombia's funding consists of market debt, interbank loans, and repurchase agreements. The bank's SFR was 97.25% as of June 2016, slightly lower than the 104% average of the past three fiscal years. This reflects both the drop in Bancolombia's available stable funding sources, due to lower deposits, and no change in its stable funding needs. We don't expect significant changes in Bancolombia's funding structure in the near term, given that it will continue to leverage its nationwide branch network to expand its deposit base.

Bancolombia's adequate liquidity reflects its broad liquid assets that covered...
short-term wholesale funding by 1.4x as of June 2016, with a three-year average of 2.0x. This ratio has decreased because of a 17% drop in the bank's broad liquid assets due to a lesser volume of repurchase agreements and total liquid securities. Furthermore, Bancolombia's has a manageable refinancing risk with healthy maturity profile. The majority of its market debt starts maturing after 2017, which also provides adequate liquidity cushion. We expect similar liquidity levels for the next 18-24 months.

The ratings on Bancolombia Panama reflect its core status to the group. The subsidiary consolidates the group's operations in El Salvador and the 60% majority equity investment in Guatemala-based Grupo Financiero Agromercantil (GFA; not rated) which in our opinion, enhances Bancolombia's presence in Central America and its geographic and business diversification. Bancolombia Panama operates in lines of business integral to the parent's strategy and is fully integrated with the group. The subsidiary is closely linked to the group's reputation and risk management, and we believe it's highly unlikely that Bancolombia Panama could be sold in the near future.

**Outlook**

The negative outlook on Bancolombia over the next 18-24 months continues to reflect that on the sovereign ratings. Currently, the bank's rating incorporates one notch of government support, given Bancolombia's high systemic importance and our view of the Colombian government as supportive towards domestic financial system. Nonetheless, if we were to downgrade the sovereign, which has a negative outlook, we would also downgrade Bancolombia, given its 'bb+' SACP. We also expect the bank to maintain its leading business position in Colombia and its solid franchise in Central America. Given the core status of Bancolombia Panama and Banistmo, the ratings on both entities will continue to move in tandem with those on the parent. Therefore, these subsidiaries' negative outlooks reflect that on Bancolombia.

**Downside scenario**

We could downgrade the bank in the next 18-24 months if its RAC ratio falls consistently below 3% due to unexpected inorganic or organic growth beyond our current base-case scenario and/or a higher number of intangibles that are not offset by internal capital generation.

**Ratings Score Snapshot**

<table>
<thead>
<tr>
<th>Score Category</th>
<th>Rating Description</th>
</tr>
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<tbody>
<tr>
<td>Issuer Credit Rating:</td>
<td>BBB-/Negative/A-3</td>
</tr>
<tr>
<td>SACP</td>
<td>bb+</td>
</tr>
<tr>
<td>Anchor</td>
<td>bb+</td>
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<tr>
<td>Business Position</td>
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<tr>
<td>Capital and Earnings</td>
<td>Weak (-1)</td>
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<tr>
<td>Risk Position</td>
<td>Adequate (0)</td>
</tr>
<tr>
<td>Funding</td>
<td>Average (0)</td>
</tr>
</tbody>
</table>
Liquidity Adequate

Support 0
GRE Support 0
Group Support 0
Sovereign Support +1

Additional Factors 0

Related Criteria And Research

Related Criteria

• Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
• Group Rating Methodology, Nov. 19, 2013
• Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
• Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
• Banks: Rating Methodology And Assumptions, Nov. 9, 2011
• Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
• Bank Capital Methodology and Assumptions, Dec. 6, 2010
• Use Of CreditWatch And Outlooks, Sept. 14, 2009
• Commercial Paper I: Banks, March 23, 2004

Related Research

• Latin American Banking Sector Mid-2016 Outlook: Economic And External Volatility Will Test Lenders' Resilience, Aug. 16, 2016
• Brazil's Weak Economy And Global Volatility Are Clouding Latin America's Credit Outlook, July 8, 2016
• Will Pressure Increase On Latin American Banks In 2016?, Nov. 18, 2015
• External Factors And Weak Economies Continue To Pose Challenges For The Top 30 Latin American Banks, Sept. 29, 2015

Ratings List

Ratings Affirmed

Bancolombia, S. A. y Companias Subordinadas
Bancolombia Panama S.A.

Counterparty Credit Rating BBB-/Negative/A-3

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed...
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to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.
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