Risk Management

I Financial Risk

This section describes the main financial risks to which Banco de Chile is exposed as well as the mechanisms used to measure and control them. As stated before, the purpose of financial risk management is to improve decision-making by enabling identification of the strategies that optimize the risk-return relation, thus creating value for our shareholders.

1.1 Philosophy

Banco de Chile's financial risk management is based on the concept that risk generates business opportunities and must be limited; thus, it must be managed. We know that risk is the force that generates the returns required by our shareholders, but we also know that our shareholders have a limited capacity to suffer losses.

1.2 Structure

Financial risk management is mainly carried out by setting a series of limits, which are approved by the Board of Directors' Finance Committee based on business strategy, market volatility, the liquidity of the products involved, and tolerance to risk. The Committee is comprised of four Directors, including the Chairman of the Board. The Committee's sessions are also attended by the Chief Executive Officer and the Managers of the Research and Planning, Treasury, and Large Corporations and International banking Divisions.

Financial risk is managed by the Financial Division within the limits and in accordance with the policies set by the Finance Committee. The Financial Division manages all the bank's financial positions as well as its liquidity. At the same time, the Financial Division manages the Bank's financial investment portfolio with the purpose of maintaining liquidity reserves, generating revenue from securities trading, and maintaining long term positions in order to obtain spreads. To meet its objectives, this Division sets the fund transfer prices that are to be applied to the Bank's commercial areas.

Banco de Chile also relies on a Financial Risk Control Area, whose main activities are as follows:

- Monitoring of financial positions.
- Daily update of databases against market prices.
- Review of financial investment market valuations.
- Financial risk quantification under normal and stress events.
- Risk model development.
- Monitoring of different risk levels.
- Risk report generation and distribution.
- Verification of compliance with the limits set by the Finance Committee.

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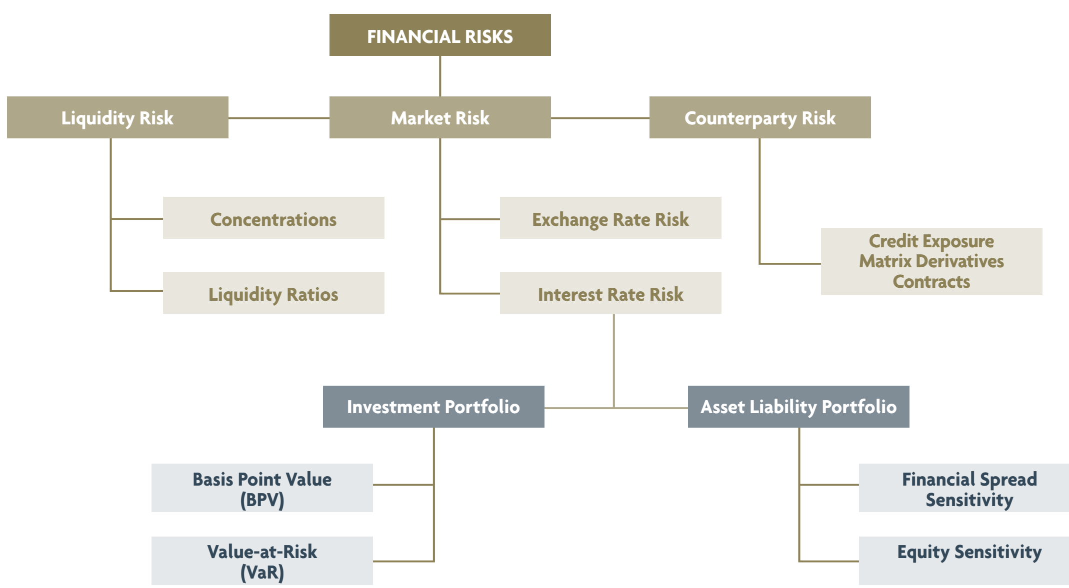
1.3 Financial Risk Measurement

Financial risk management is mainly based on the measurement of Liquidity, Market, and Counterparty risks.



Following is a brief description of the above mentioned risks and its management.

1.3.1 Liquidity Risk

Appropriate liquidity management enables adequate financing of asset growth as well as compliance with the financial commitments undertaken under originally agreed upon conditions. To this purpose, Banco de Chile seeks to diversify its funding sources, setting limits to counterparty concentration. The graphs below show that the Bank maintains an atomized depositor base in both domestic and foreign currencies.

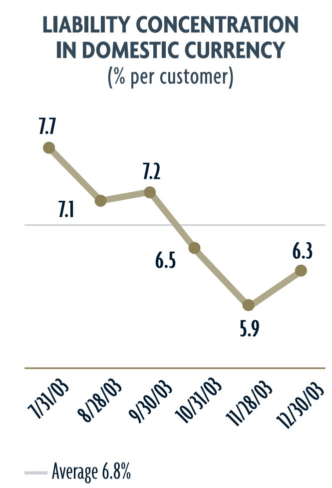
Additionally, 30-day liquidity ratios by currency type have been set, which limit current liabilities to a percentage of liquid assets. To determine the availability degree of a certain liability, Banco de Chile performs behavioral studies aimed at quantifying its liabilities' renewal rate.

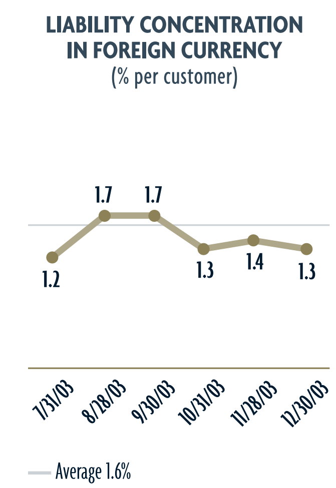
In order to cope with liabilities due, the bank maintains a short term financial investment portfolio comprised of instruments issued by the Chilean Central Bank. These instruments have a high degree of liquidity due to their market depth and low bid-offer spread.

Finally, Banco de Chile has also established a contingency plan that sets the strategy to be followed in case of an event

that might provoke a "financial shock". Some examples of such situations are:

- A significant liquidity contraction in the financial system as a result of the monetary policy.
- A world crisis caused by a lack of liquidity (for example, the Mexican, Asian or Russian, crisis).
- A run on banks.

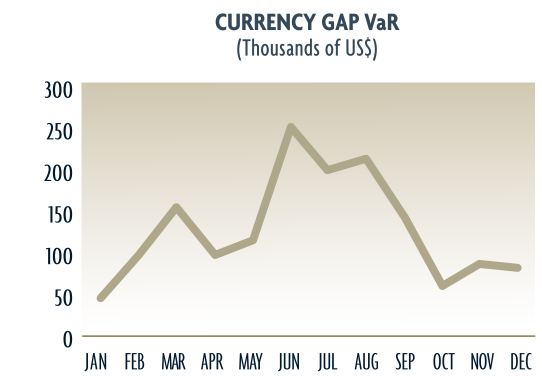




1.3.2 Market Risk

a) Exchange Rate Risk

Banco de Chile manages its exchange rate risk exposure by means of an absolute maximum gap limit as well as by means of a Value-at-Risk (VaR) methodology. This methodology is a statistical estimation of potential losses given a confidence level and a time horizon. Banco de Chile applies a 95% confidence level and a one-day horizon.



During 2003, average monthly VaR associated with the foreign exchange position was US$ 134,000 reaching a maximum of US$ 259,000 in June.

b) Interest Rate Risk

Asset Liability Portfolio: Banco de Chile's asset liability portfolio is comprised of assets and liabilities with different maturity dates. Depending on whether the bank has an asset or liability position, the changes in the interest rate structure may negatively impact the Bank's gross margin as well as its economic value. In order to manage these risks, the bank controls the sensitivity of the financial margin and the equity value to interest rate variations through the analysis of asset and liability gaps.

Financial margin sensitivity is a short term measure of the change in expected interest accrual over a 12-month horizon in face of a given change in interest rates. In turn, the

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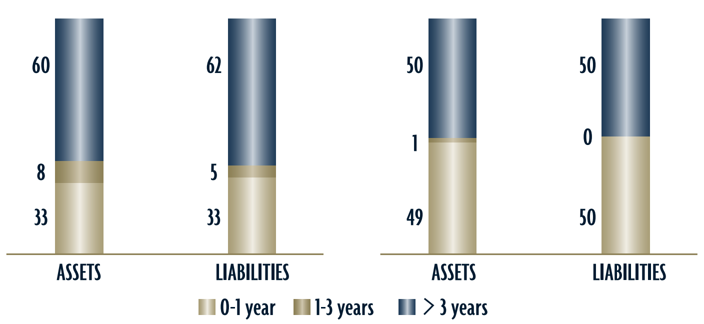
sensitivity of the equity value is a long term measure of the economic risk of equity, i.e., the change in the present value in face of variations in the interest rate structure.

The Finance Committee has set limits to financial margin and economic value sensitivity for both domestic and foreign currencies. The following graphs show that, at the closing of 2003, Banco de Chile had a low interest rate risk exposure; the differences between assets and liabilities for time bands: 0-1 year, 1-3 years, and more than 3 years, for both domestic and foreign currencies, are minimal.

INTEREST RATE SENSITIVITY IN DOMESTIC CURRENCY (%)

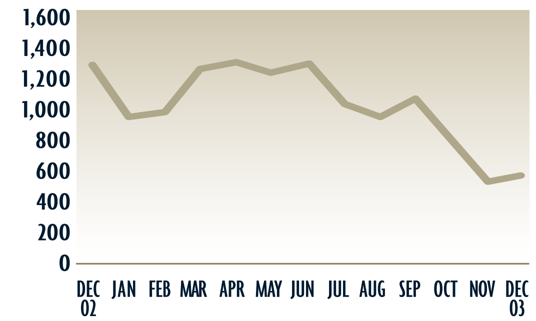
INTEREST RATE SENSITIVITY IN FOREIGN CURRENCY (%)



Investment Portfolio: Banco de Chile quantifies the interest rate risk of its investment portfolio by means of the Value-at-Risk (VaR) and the basis point value, which measures the variation in the present value of future cash flows in face of a 0.01 percent interest rate variation.

During 2003, maximum daily VaR reached Ch $1.7 billion, with a minimum value of Ch$ 358 million and a decreasing trend resulting from a drop in interest rate volatilities.

AVERAGE VaR (millions of Ch$)

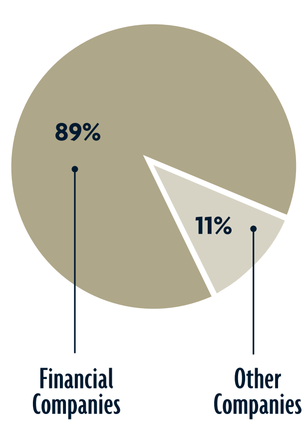


1.3.3 Counterparty Risk

Counterparty risk measurement is the mechanism used to define credit lines granted to our customers when they perform financial transactions, particularly derivatives transactions.

As of November 2003, 89 percent of the credit risk of our derivative contracts came from companies in the financial sector, including, among others, banks, pension funds (AFPs), insurance companies, stock brokerage firms, and mutual funds.

DERIVATIVES RISK EXPOSURE



II Credit Risk

2.1 Structure and Functions

In order to guarantee long term value generation, credit risk management is based on an organization that reflects the business line in each of the stages of the credit process (acceptance, approval, follow-up, and collection) and for each of the segments in which the Bank operates.

Under the scheme stated, for every credit decision, there is an effective counterpart in the Credit Risk Division. This organization is homogeneously extended throughout the Bank, its Subsidiaries, and Foreign Branches, facilitating risk management throughout the Corporation.

Among the main functions of the Credit Risk Division are the following:

- To propose Risk Policies for the Bank to the Board of Directors.
- To establish, for each business segment, the standards and procedures governing the process of acceptance, approval, follow-up, and collection.
- To set the credit authority levels that are delegated to the Bank's Executive Officers.
- To resolve which transactions with individual debtors or conglomerates are to be ratified because of their amount and/or risk level and which transactions are to be submitted to senior levels for approval due to their amount.
- To resolve which transactions are exceptions to Credit Policies on massive markets.
- Based on individual and market information, and maintaining the business line effective counterpart nature, to collaborate with the goals of business areas in terms of selecting those debtors with whom a business relationship is feasible or should rather be limited.
- To generate joint training opportunities with the business line.
- In relation to approvals, to identify and quantify existing risks at the level of both individual debtors and conglomerates, economic sectors, and geographic areas with the aim of ensuring exposure recoveries under stated conditions and terms.
- To perform periodical follow-up of the credit risk levels assumed with individual debtors, conglomerates, economic sectors, and geographic areas.
- To maintain permanent supervision over the Collection subsidiary and its relationship to the Bank in order to optimize recoveries and reduce possible losses.
- To provide relevant information on economic sectors, as regards their current condition and the technical-financial perspectives and parameters under which the Bank-Debtor relationship is advisable.
- To supervise compliance with risk objectives as approved by the Board of Directors through periodical management reports, implementing the corrective measures approved or proposed.
- To ensure correct valuation of assets granted as collateral, through the approval of qualified external professionals and in accordance with internal definitions.

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2.2 Differentiated Risk Approach

The Bank's risk management is characterized by a differentiated approach by segment. Thus, it is possible to distinguish three risk models:

Automated Model: This model services massive markets of individuals without a commercial line of business which, in turn, are also sub-segmented.

The basis of this model is the integral process automation (acceptance, approval, follow-up, and collection), relying on approval models based on Scoring and Behavior. These tools are supplemented with portfolio behavior analysis, enabling feedback to approval models, to the credit process, to the credit policy, and to the maximum exposure levels by debtor.

Semi-Automated Model: This model basically corresponds to a debtor income and rating profile through which service is provided to small companies and individuals with a commercial line of business. In these segments, there is a lower level of automation, and the individual case-by-case evaluation is more relevant than in the Automated Model.

The transactions approved under this model consider the assessment of quantitative and qualitative variables within which emphasis is given to debtor cash flows, commercial and payment behavior, and adequate guarantee coverage (all of which are evaluated as to liquidity and value stability).

Case-by-Case Model: This is a personalized management model with expert individual evaluation (by risk level, transaction amount, and business complexity, among others) under which service is provided to the middle market and the corporate market.

The transactions approved under this model consider the analysis of quantitative and qualitative variables maintaining an adequate risk-return relationship.

2.3. Portfolio Management Control

Debtor follow-up is based in Commercial Areas due to their closeness and direct contact with customers. The Credit Risk Division controls Portfolio Management based on two large groups:

Corporate Market: Control and follow-up over this group is based on a "Surveillance System," under which action plans for those customers in respect of which potential risks are detected are established and controlled.

Likewise, there is ongoing monitoring of default cases (including past due portfolio) and portfolio quality through automatic evaluations and the establishment of risk committees.

The transfer of debtors with above-normal risk to units specializing in collections and recoveries is made through formal credit committees where executives of the Credit Risk Division participate.

Massive Markets: There are tools available for this markets that enable batch or vintage analysis through which feedback is provided to automatic approval and follow-up models.

As in the Corporate Market, default and several risk ratios are permanently monitored so as to keep them within the margins approved by Management.

Risk rating, for its part, is automatically determined, the same as early collection management and the transfer to collection subsidiary.

2.4 Risk Management in 2003

The actions and strategies undertaken during 2003 in relation to credit risk management were focused on transactions with above-normal risk as well as on the implementation of increasingly more expedient risk preventive measures. This has enabled the Bank to maximize recovery.

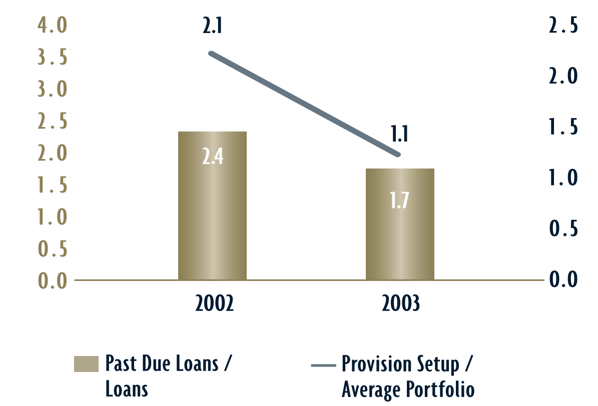
All of these actions, together with a more favorable global and regional environment, are reflected in the positive evolution of all the Bank's risk indicators.

The past due portfolio as a percentage of total loans decreased in all levels, with a remarkable reduction in past due loans from 2.4 percent at the closing of fiscal year 2002 to 1.7 percent in 2003 (according to unconsolidated figures).

This favorable evolution, that is evident in all economic sectors, is a consequence of an important collection management as well as a policy based on the write-off of assets associated with irrecoverable debtors.

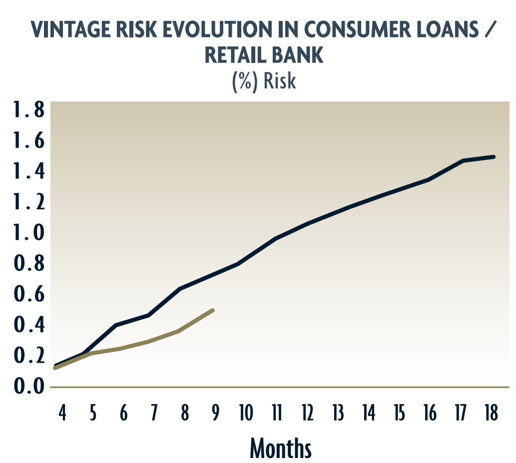
Collection management in connection with stock is coupled with a strict risk practice applied to approvals and timely referral and processing of loans implying higher risk at specialized units.

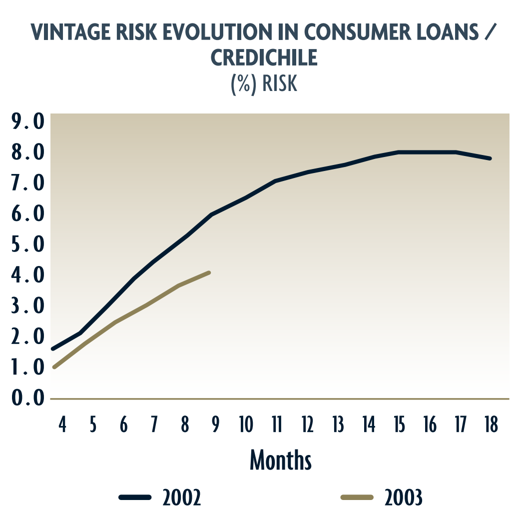
PAST DUE LOANS / TOTAL LOANS
PROVISION / AVERAGE PORTFOLIO
(%)



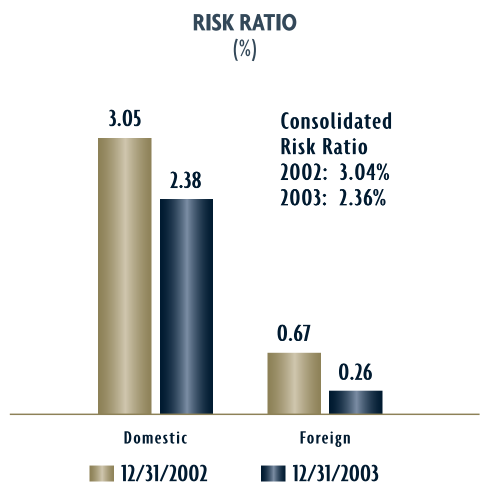
The rate of provision setup provides evidence of the above. In fact, while during 2002 provisions were established in the equivalent to 2.1 percent over average Bank loans, in 2003, this figure reached 1.1 percent and maintained a comfortable position since provisions reasonably reflected the expected portfolio risk.

A similar situation was observed in massive banking areas, where the efforts aimed at regularizing the portfolio with an above-normal risk were furthered and the systems for acceptance, approval, follow-up, and collection were refined. The latter was done through consolidation of scoring systems, customer segmentation, batch or vintage analysis, and the introduction of behavior analysis tools, which have made it possible to direct and orientate the sales efforts to previously selected costumer segments. Thus, for example, the evolution of the loss risk of loans granted and selected during 2003, both in the Retail Banking Area and CrediChile, showed a significant down word trend to that of 2002, reflecting the effectiveness of the measures taken.





For its part, the risk rating showed a significant improvement, particularly the one associated with the Chilean portfolio, which fell from 3.05 percent in 2002 to 2.38 percent in 2003.

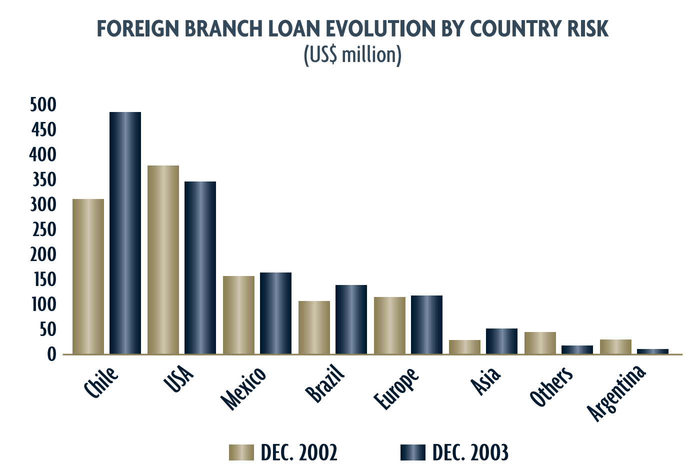


As stated before, the approach based on preventive risk measures resulted in an important increase in past due loan recovery. The above, together with a lower total expense on provisions and write-offs, implied a decrease in the Bank's net expense on loan losses by almost 70 percent in real terms as of 2002. Thus, the consolidated ratio of net expense on risk assets to average loans decreased from 1.98 percent in 2002 to 0.60 percent in 2003.

As regards portfolio concentrations, there are no risk situations regarding individual debtors nor conglomerates. Concerning sector exposures, these are related to the country's productive structure.

Additionally, during 2003 several changes were introduced into the loan portfolio of U.S. branches, reducing the exposure level in those countries recording higher instability and risk.

Thus, in 2003, the Bank decreased its exposure in Argentina and increased its participation in Chile, Mexico, and Brazil, which countries have recorded an important improvement in their respective risk levels. At the same time, the exposure in USA, characterized by a low risk-return relation, was transferred to emerging Asian countries, where attractive business opportunities with limited risk levels have emerged.



2.5 New Regulations for the Calculation of Loan Loss Allowances

In September 2002, the Superintendency of Banks and Financial Institutions (SBFI) amended the regulations governing loan loss allowance setup. These amendments will be effective as of January 1, 2004.

Essentially, these amendments are based on the principles of self-regulation for the banking sector and involve the transformation of a static portfolio analysis system to a dynamic one, relying on expected loss. This is a crucial aspect to be able to quantify latent risks within the loan portfolio, recognizing them and setting up the corresponding provisions before the default takes place.

These regulatory changes are aligned with Banco de Chile's traditional conservative policy for provision setup whereby the debtor is being evaluated at all times.

Thus, during 2003, we performed the necessary adjustments to our risk methodologies and models, which enables us to sustain that our general allowance volume responds to the expected loss principle for which several adequacy tests have been conducted.

Said situation is derived from the tailoring of the risk rating model to each of the specific segments, ranging from models enabling massive evaluation of the Retail Banking Area to integral evaluation of quantitative and qualitative variables in the corporate market.