

risk management



The object of risk management at Banco de Chile is to identify, measure and control the various business risks in order to integrate these into the Corporation's value creation process. This purpose includes the management of credit, financial and operating risks under individual and consolidated perspective.

Risk management also has the objective of ensuring full compliance with the different regulations that affect financial institutions in these matters, which entails the development of evermore sophisticated and complex standard measurement models and tools.

On the other hand, risk management is related to the optimization of the use of the Bank's equity, as the principal business risks affect the capital assigned to them.

The following are the objectives of risk management in Banco de Chile:

- To ensure compliance with the various rules and regulations relating to risk management.
- To determine the level of risk desired for each line of business.
- To align business strategies to the established risk level.
- To communicate the desired risk levels for the organization to the commercial areas.
- To inform the Board of the characteristics and evolution of risk in the different business areas.
- To develop models, processes and tools for evaluating, measuring, controlling and correcting risk in the different business lines and areas.

The new requirements contained in the international accord known as the Basle II Agreement, have led Banco de Chile to gradually introduce various initiatives, both in the technological area and in the formation of human capital, oriented to incorporating the new requirement and capital assignment concepts to its whole management, both commercial and operational.

The timetable for implementing the Basle II Agreement in Chile, including the route-map issued in January 2005 by the Chilean Superintendency of Banks and Financial Institutions (SBIF), states that by 2007 banks must define their minimum regulatory capital in line with a standardized system. Banco de Chile has therefore carried out quantitative impact studies, known as QIS 3 and QIS 5, which have concluded that the Bank then had sufficient capital as compared to the minimum requirement in the new regulations.

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It is important to note that implementation of the Basle II Agreement is a long-term project to which the Bank has assigned significant resources since 2003 in order to develop and improve its risk models and choose internal capital assignment systems in the medium term. The new technology platform developed under the Neos Plan therefore constitutes a strategic base of great value, placing Banco de Chile in a privileged position in the face of the increasingly more demanding requirements.

The Bank is currently at the stage of developing standardized systems in the areas of market, credit and operating risks. At a later stage, it will progress toward internal models and systems for assigning capital to each of these areas.

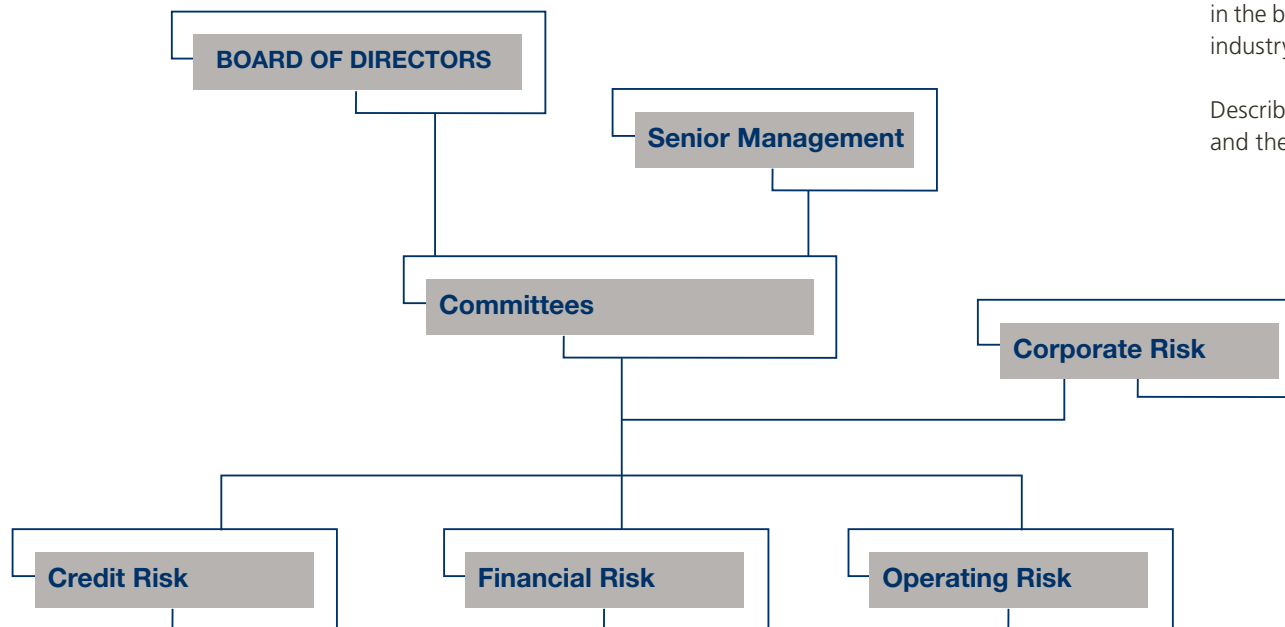
In addition to the initiatives so far carried out, in particular relating to regulatory requirements concerning corporate governance and internal control, the Corporate Risk Management was formed whose principal functions are:

- Centralization and coordination of corporate risk management activities.
- Implementation of an integrated risk management system throughout the organization.
- Provide information to the board for managing the optimal use of capital.
- Maintain the Chief Executive Officer and the Board, through the Directors' and Audit Committee, Finance Committee and Loan Portfolio Committee, informed on risk matters.
- Interrelation and coordination with regulatory entities.

This new management area reports directly to the Directors' and Audit Committee and the Chief Executive Officer, and is responsible functionally for the credit, financial and operating risk areas.

This new organization, together with the Corporation's several advances in the risk management area, is a further reflection of Banco de Chile's commitment to its shareholders in the building up of a leading bank in the Chilean financial industry.

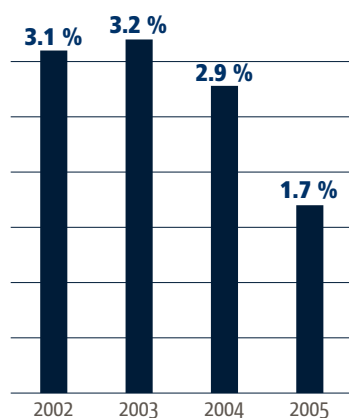
Described below are each of the Bank's risk control areas, and their principal functions and results during 2005.



credit risk

Risk Index

(at December of each year)



Source: Superintendency of Banks & Financial Institutions

Credit Risk

For its credit risk management, Banco de Chile has an organization very similar to the commercial structure, taking part in each of the credit process stages (methodology definitions, admission and analysis, approval, follow-up and recovery).

Every credit decision therefore has an effective counterpart of the commercial area in the Credit Risk Division. This structure is similarly extended to the Bank and to its subsidiaries and foreign branches, which facilitates risk management throughout the corporation.

The principal functions of the Credit Risk Division are:

- To propose Bank credit-risk policies to the Board.
- To establish for every business segment the rules and regulations governing the process of admission, approval, follow-up and recovery.
- To apply the rules established by the Board concerning credit discretionary limits delegated to Bank executives.
- To resolve transactions that are exceptions to mass market credit policies.

- To collaborate with the targets of each business area, in terms of selecting commercially feasible debtors or limiting their operations if necessary.
- To identify, quantify and control the risks arising from credit operations, at the levels of the individual debtor and of conglomerates, economic sectors and geographic areas.
- To maintain a constant supervision of the debt-collection subsidiary and its relationship with the Bank.
- To ensure the correct valuation of assets granted as security.

Credit Risk Approval and Control Models

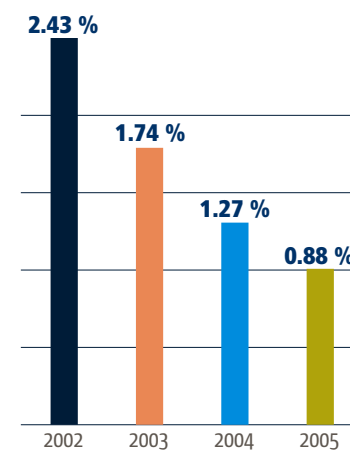
The Bank's credit analysis and approval operates under a differentiated focus according to each market segment. Three risk models are used for credit approval: automated, semi-automated and case-by-case. The automated model is directed to mass retail banking markets of a non-business nature and is based on the integral automation of the processes (admission, approval, follow-up and recovery) and scoring and behavior approval systems. The semi-automated model is applied to small businesses and individual business people. In these segments, the level of automation is lower and the individual case-by-case evaluation carries greater weight, the automated evaluation acting as a support for the decision. Lastly, the case-by-case model is used for the middle and large companies and corporations and is noted for the expert individual evaluation, whether by risk level, the amount of the operation or the complexity of the business, among other variables.

The control and follow-up of the credit risk is managed in two large segments: the companies market and the retail market. In the first, the control and follow-up is based on a vigilance system that detects in time those customers who present potential risks, through a constant monitoring of bad debts and the quality of the portfolio. In the retail market segment, control and follow-up is carried out through an analysis of batches or vintage through which feed-back is provided to the automated approval and follow-up models. As for the companies market, there is a constant monitoring of bad debts and different risk indicators so that these remain within the margins approved by the management.

On the other hand, recognition of the expected losses on the portfolio is also managed through a differentiated focus by segment. For the retail segment, a model is employed that estimates expected losses by batches at the time loans are granted, as a function of behavioral and demographic indicators. Through later retrospective analyses, actual losses are monitored in comparison with expected ones, information that is fed back to and used to perfect the predictive model.

In the small and middle business segment, the risk rating is implicit in the approval process, taking into account aspects of commercial behavior and payment, as well as financial, sector and business management factors.

Past Due Loans/Total Loans



Foreign branches not included.

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For the large company and corporations segment, a rating system is used that is an integral part of the approval model and in which both the company risk and that of the credit transaction are evaluated. This rating system takes into account financial, sector, partners and company management information, as well as their capacity to obtain internal and/or external financing.

In order to check the risk evaluation and the portfolio expected-losses estimation processes, a test is made annually of the adequacy of allowances, independently from the commercial and recovery lines, which is presented to the Bank's Board.

The Board of the Bank actively takes part in credit risk management. The Directors' Credit Committee, comprising all the directors, participates in the approval of large credit facilities and also approves the general credit policies for the different business areas. The Director's Loan Portfolio Committee analyzes the global evolution of the loan portfolio and the adequacy of allowances.

Credit Risk Performance 2005

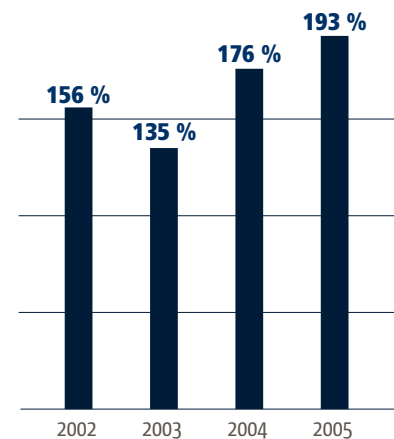
Continuing with the process of improvement and coordination between the different Bank business units and the Credit Risk Division, risk management concentrated its efforts in 2005 on the subsidiaries and foreign branches in order to optimize commercial efforts and control.

Approval levels were also established nearer to the business centres which permitted a closer knowledge of customers and faster approval processing times. Important improvements and technological development were carried out in the retail segments which permitted the improvement of the admission and approval processes, together with strengthening the follow-up and recovery processes.

The performance of Credit Risk in 2005 was outstanding, in line with the progress and developments carried out so far and the country's favorable economic performance. The improvements to the control and follow-up processes again meant an improvement in the bad debt indicators in each of the segments, a trend noted since 2002. In particular, there was a significant reduction in the past due loan indicator, from 1.27% at December 2004 to 0.88% at December 2005.

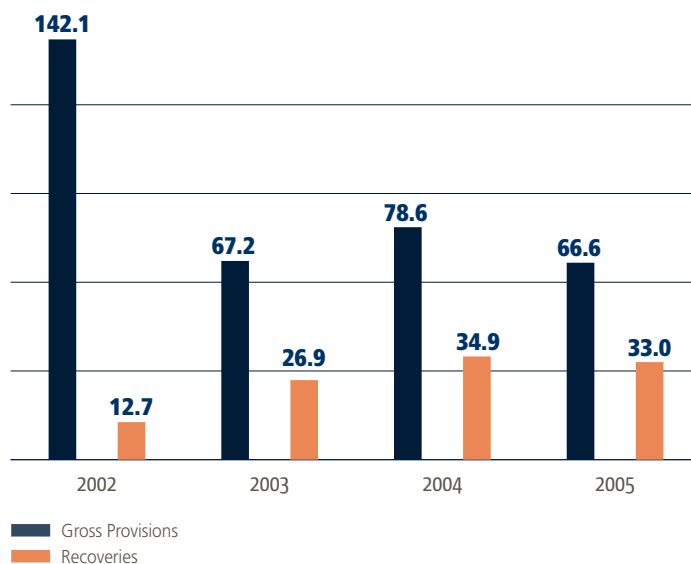
Allowances over Past-Due Loans

(at December of each year)



Gross Provisions and Recoveries ⁽¹⁾

(billions of Ch\$ of December 2005)



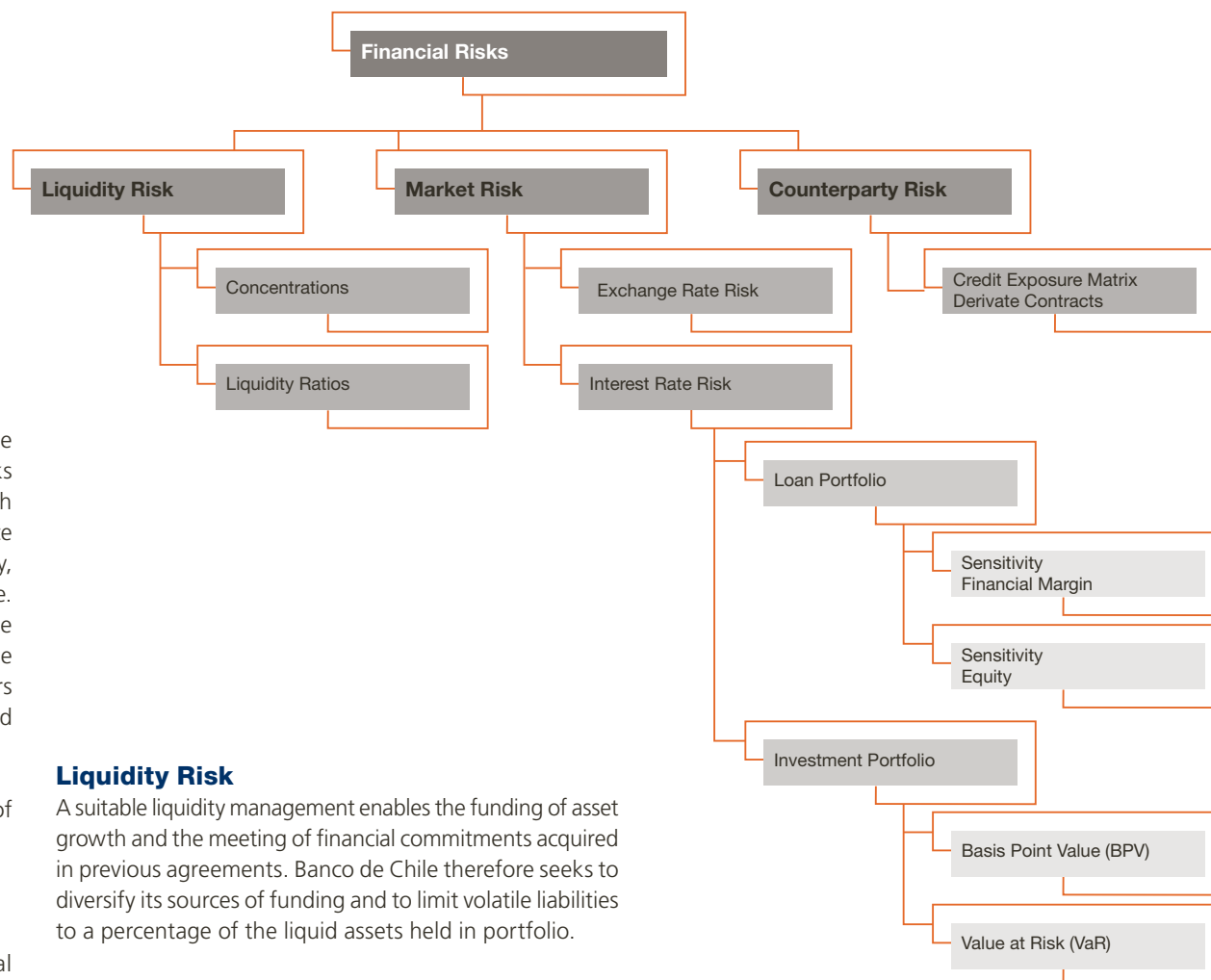
(1) Includes provisions for write-offs of assets received in lieu of payment

The Bank's loan portfolio risk rate, measured according to the methodology of the Superintendency of Banks and Financial Institutions, also shows a substantial improvement from 3.1% at December 2002 to 1.7% at December 2005.

The consistent reduction in the volume of overdue loans again meant an increase in the Allowances for Past Due Loans coverage indicator which amounted to 193% at December 2005. This provides an important margin to cover unexpected or unpredictable risks.

On the other hand, the control and follow-up of the management of the recovery and judicial recovery units, together with the favorable economic activity, permitted the Bank to maintain a large volume of recoveries of debts written off which, combined with the timely follow-up of potential cases of deterioration, meant gross provisions of Ch\$ 66.6 billion, less than in the previous year. Provisions net of recoveries of previously changed-off loans, fell to Ch\$ 34 billion, the equivalent of 0.5% of the Bank's total average loans.

financial risk



Financial risk management is carried out through the identification of a series of different expressions of risks related to market variables and the setting of limits for each of these. Such limits are approved by the Directors' Finance Committee based on the business strategy, market volatility, the liquidity of the products involved and risk tolerance. This Committee comprises four Directors including the Chairman of the Board. Also participating in committee meetings are the Chief Executive Officer and the managers of the Planning and Management Control, Finance and Corporate and International Divisions.

The following are the principal activities and functions of the Financial Risk Area:

- Monitoring of financial positions.
- Daily updating of data bases with market prices.
- Revision of the market valuations of the financial investments.
- Quantification of the financial risk under normal and stress events.
- Development of risk models.
- Monitoring of the different levels of risk.
- Preparation and distribution of risk reports.
- Checking compliance with the limits set by the Finance Committee.

Financial risk management includes the measurement of liquidity, market and counterparty risks. Models and methodologies have been developed for each one, which are constantly improved and updated as a function of changes in the financial and regulatory environment. The model shows graphically Banco de Chile's general financial risk management.

Liquidity Risk

A suitable liquidity management enables the funding of asset growth and the meeting of financial commitments acquired in previous agreements. Banco de Chile therefore seeks to diversify its sources of funding and to limit volatile liabilities to a percentage of the liquid assets held in portfolio.

In order to diversify its sources of funds, the Bank has established two kinds of limits: first, that the total deposits and repurchase agreements taken from any one institutional investor do not exceed a certain percentage of current liabilities; and second, that the sum of deposits and repurchase agreements taken from all institutional investors do not exceed a certain percentage of current liabilities.

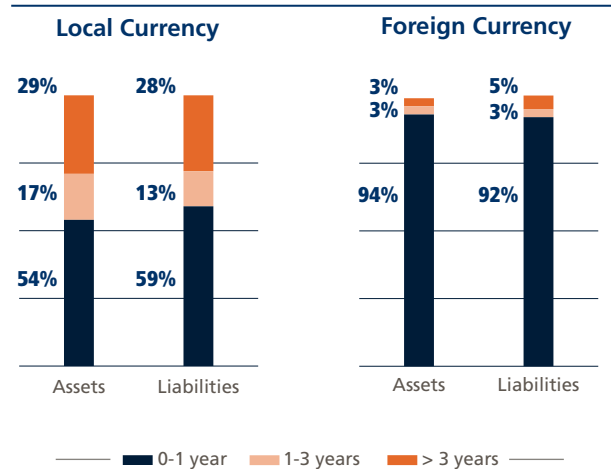
30-day liquidity ratios allow the Bank to limit volatile liabilities to a percentage of liquid assets. In order to determine the degree of volatility of a liability, behavioral studies are made in order to quantify the velocity of renewal of its obligations in order to face its current liabilities. The Bank maintains a short-term financial investment portfolio composed of investments with a high degree of liquidity due to the depth of the market and the low "bid-offer" spreads.

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Exchange Rate Risk

Banco de Chile manages its exposure to exchange risk through an absolute limit on the maximum mismatch and also through the Value at Risk (VaR) methodology. The latter is a statistical estimate of the potential losses in the face of adverse changes in market variables, which takes into account a level of confidence of 95% and a time horizon of 1 day. During 2005, the average monthly VaR related to the exchange position was 172 thousand dollars, reaching a peak of 595 thousand dollars in February 2005.

Interest Rate Sensitivity



Interest Rate Risk

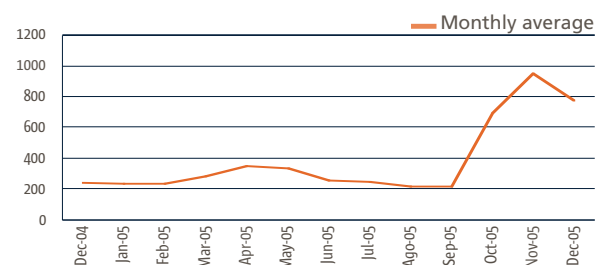
The management of the interest rate risk of the balance sheet portfolio is based on the sensitivity of the financial margin and of the economic value in the event of interest rate changes. The Finance Committee therefore sets limits of sensitivity of the financial margin and economic value, for both local and foreign currencies. During 2005, Banco de Chile showed a low exposure to the interest rate risk: the difference between assets and liabilities for the time bands: 0-1 year, 1-3 years and more than 3 years, both for local and foreign currency, were minimal.

Regarding the investment portfolio, the interest rate risk is measured by Value at Risk (VaR) and the base point value, which measures the change of the present value of future flows in the event of a 0.01% change in interest rates.

During 2005, the maximum daily VaR of the investment portfolio was Ch\$ 1,136 million, with a minimum of Ch\$ 156 million, and a tendency to rise during the last months of the year as a result of rate increases and their corresponding volatility.

Average Var

(millions of Ch\$)



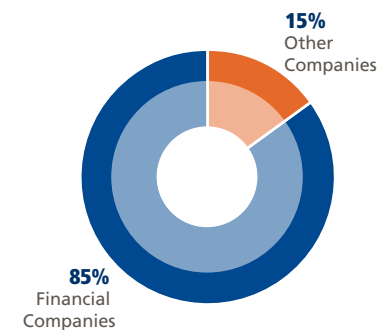
Counterparty Risk

The measurement of counterparty risk is the mechanism used to define the limits assigned to our customers when carrying out financial transactions, particularly in derivatives.

At December 2005, 84.6% of the derivative contract credit risk is with companies in the financial sector which includes banks, pension funds, insurance companies, stockbrokers and mutual funds.

This section has described the principal financial risks to which Banco de Chile is exposed and the mechanisms used to measure and control them. As already commented, the objective of the financial risk management is to improve decision taking by being able to identify the strategies that optimize the risk return ratio, creating value for our shareholders.

Derivatives Credit Exposure



New Regulations on Market Risks

In September 2005, the new regulations came into effect for measuring market risk under the standardized model methodology which determines, using regulatory criteria, the exposure to interest rate, currency and "optionality" risks faced by financial institutions.

In order to implement the standardized model, the Bank's balance sheet is divided into two "books": the banking book and the trading book. The latter comprises the positions in financial instruments that can be valued at market price, plus the foreign currency mismatch. The banking book is composed of all the asset and liability entries not forming part of the trading book.

The new rules state that the risk of the trading book, also called market risk exposure (MRE), plus 10% of the weighted assets by credit risk, may not be greater than the Bank's effective equity.

At December 31, 2005, the Bank's market risk level amounted to almost Ch\$ 15 billion.

operating risk

The Superintendency of Banks and Financial Institutions has currently established, in Chapter 1-13 of its Regulations, "Classification of Management and Solvency", the essential aspects of the management of operating risk that are included in the Basle II Agreement. This chapter contains the referential framework and provides the basic guidelines for a proper administration and management of operating risk. The degree of compliance conditions the results of the annual process of self-evaluation of the Bank's management and solvency and also permits advancing to the establishment of a global standard.

The Superintendency also requires for 2007, the assignment of the Bank's operating risk capital to be calculated using the alternative standard calculation method, and to become integrated, together with the credit and financial or market risks as a global risk exposure indicator.

Objectives of operating risk management

- To identify present and potential operating risks, set the form to measure them and establish the controls for permitting the monitoring of the exposure to them. Effective operating risk management will permit the elimination, reduction, transfer or acceptance of operating risks.
- To continuously improve operative processes and control mechanisms and monitoring to finally minimize the organization's operating risks and reduce the use of capital for this concept.
- To establish processes for assigning allowances (for expected losses) and capital (for unexpected losses) for achieving the requirements demanded by the Basle II Agreement.

Three lines of work have been defined in order to make the operating risk administration and management more efficient:

- Security of information
- Operating control
- Business continuity

These functions are organized in two distinct areas of the Operations and Technology Division, both reporting periodically to the Operating Risk Committee.

Operating Risk Management.

Operating risk administration and management is the responsibility of the Operating Risk Executive Committee, comprising the Chief Executive Officer and the divisional Managers. This Executive Committee reports to the Directors' and Audit Committee.

The Operating Risk Executive Committee relates to the internal committee structures with respect to risks (the Irregularities Prevention Committee, the Fraud Prevention Committee, Ethics Committee and the Security Committee) and also to representatives of the organization's transversal functions like Human Resources, Technology, Administration and Legal.

The Operating Risk Area of the Operations and Technology Division consolidates operating risk information and reports periodically to the Operating Risk Executive Committee.

The principal activities of the Operating Risk Area with respect to the administration and management of risk, are:

- To propose to the Operating Risk Executive Committee policies and strategies for the proper administration and management of operating risk.
- To ensure the correct implementation and compliance of operating risk policies and strategies.
- To implement the operating control model suitable for the Bank.
- To maintain data bases in the event of losses due to operating risks.
- Centralized coordination of the development, maintenance, training and testing of business continuity plans.
- Control and monitoring of operating risk in outsourcing companies for services critical to the Bank.
- To provide consolidated management information to the Operating Risk Executive Committee.
- To participate in the evaluation of new products and services, and of new processes, activities and systems.
- To analyze exposure to operating risk of the Bank's critical business processes, establishing suitable control and risk mitigation measures.
- To lead in the development of initiatives and/or projects of an operating nature to mitigate risks.

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The following is a summary of performance during 2005:

- Definition and Board approval of global policies on Operating Risk, Business Continuity Risk and risk related to the Outsourcing of Critical Processes.
- Establishment of typologies of loss due to operating risk for each line of business, adapted to meet the provisions of the Basle II Agreement.
- Expansion of the fraud prevention service and improvements in its detection mechanisms, avoiding economic losses in this respect.
- Introduction of improvements in the control of cash payments and exchanges for bankers' drafts and checks.
- Creation of a risky events and operating risk loss management module in order to gather historical data.
- Development of a program of information and training for the whole organization.
- Implementation of a control panel for some critical operating processes.
- Participation in the QIS 5, quantitative impact exercise, number five, coordinated by the Superintendency of Banks.
- Participation in the study of the state of operating risk management in Latin American banks.

Credit Rating at December 2005

chilean rating agencies		
Instruments	Feller Rate	Fitch-Chile
Time deposits up to 1 year	Level 1+	Level 1
Time deposits of over 1 year	AA+	AA+
Mortgage-Fundingnotes	AA+	AA+
Subordinated bonds	AA	AA
Shares	1st Class Level 2	1st Class Level 2
international rating agencies		
Instruments	Type of Rating	Current Rating
Standard & Poor's	Long-term Issuer	A-
Standard & Poor's	Short-term Issuer	A-2
Fitch	Long-term Foreign Currency	A
Fitch	Short-term Foreign Currency	F1