

Venezuela
Special Report

Venezuelan Banks: Review and Outlook 2011

Analysts

New York
Franklin Santarelli
+1 212 908 0739
franklin.santarelli@fitchratings.com

Caracas
Pedro El Khaoui,
+58 212 286 3844
pedro.elkhaoui@fitchratings.com

Related Research

Applicable Criteria

- *Global Financial Institutions Rating Criteria, Aug. 16, 2010*

Other Research

- *Venezuelan Banks: Review and Outlook, April 1, 2009*

Summary

After more than 18 months of sluggish economic activity and recent history of government intervention, Venezuelan bank performance has proven again to be resilient against an adverse operating environment, though not immune. Not directly affected by the international financial crisis in 2008 and 2009, Venezuelan banks have faced different and serious internal challenges including not only a very complex set of controls and regulations limiting their operations, but lower economic activity, high inflation, and rampant intervention in most economic sectors, resulting in changes in the risk profile of many large creditors. Despite the environment, advances in funding costs, benefits from the nonrecurring devaluation of the local currency, and ongoing control of credit costs have aided the industry in preserving and in some cases recovering profitability, at least for the short term. This short breathing spell for profits may not last.

Loan demand remains very weak and is negative when accounting for inflation. Although interest rate controls limit the possibility of Venezuelan banks properly charging customers based on risk profile, the systematic change in funding base toward mostly low-cost demand deposits and the augmented participation of consumer loans in 2008, have been key to preserving net interest margin, and hence profitability. Given that loan demand will remain sluggish in the short term and government intervention does not seem to be decreasing, Venezuelan banks should post similar results in the near future, absent further or disproportionate government intervention. Such performance will be based mostly on the preservation of current net interest revenue and appropriate credit costs, being that improvements in income diversification and/or efficiency gains will remain challenged.

The liquidity shortages and bank failures observed during 2009 and 2010 reveal some structural deficiencies in the Venezuelan banking industry. Even though the root of the intervention into 13 financial institutions lay mostly in the termination of a period of tacit regulatory forbearance that started some years ago, the problems noticed during the intervention suggest the need of a more in-depth and close regulatory monitoring of all market participants. At the moment, liquidity issues have not affected the group of troubled banks, although there are still significant divergences in the financial profile of Venezuelan banks, being that further seizures or remedial actions cannot be ruled out.

Rating Prospects

The Rating Outlook for most Fitch-rated Venezuelan banks is Stable. The current set of issuer default ratings (IDRs) and individual and national ratings for a number of years already have incorporated the effects of the complicated and volatile operating environment and regulatory framework. As this report notes throughout, further government intervention into the banking industry cannot be ruled out; however, the possible effects of such measures cannot be anticipated in the current ratings. Nonetheless, greater than expected deterioration of their asset quality ratios and/or profitability also challenges the ratings of Venezuelan banks, while the upside potential of these ratings is quite limited given the sluggish economy as well as the fact that most of the ratings are at the country ceiling.

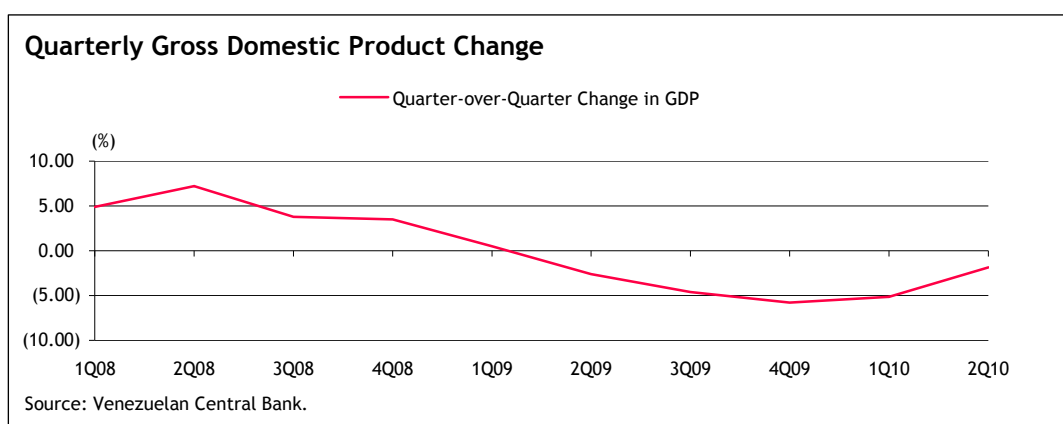
Amendment

This report was originally published Nov. 1, 2010. The table on page 8 was revised.

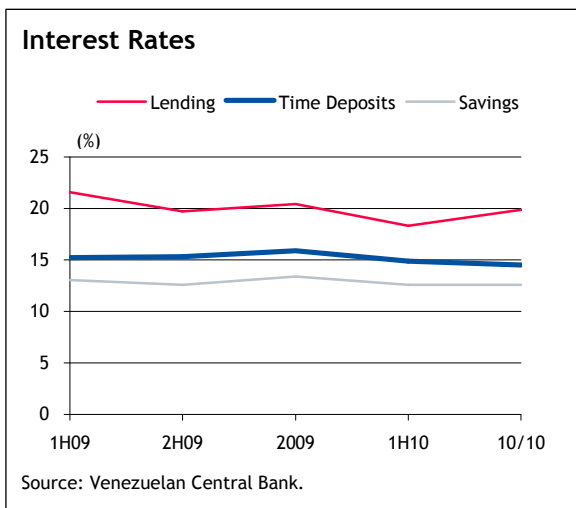
- Economic activity remains sluggish.
- Slight expansive monetary policy, but well below trends seen in the region.
- State-owned banks expand their share.
- Banks seizures continue in 2010.

Economic Environment

Since 2006, Venezuelan economic activity has recorded a sustained decrease due the volatility in the oil market, central government spending, and the negative effects of higher imports and capital flights. In early 2009, economic growth became negative, dropping 3.3% for the year and 3.5% in 1H10, with loan demand significantly plunging since then. In contrast to the trends observed in other countries, Venezuela has not undertaken a significant countercyclical economic program, as have many countries in Latin America, where governments engaged in significant expense projects (investment and current expenses) to boost economic activity in an environment of global recession. Nonetheless, government spending has tended more to mirroring political cycles, and also, monetary policy has resulted in some adjustments in interest rates; but quite shyly when compared to trends observed in other countries.



As such, the Venezuelan Central Bank (BCV) decided to lower the ceiling imposed on lending rates twice during 2009 (from 28% to 26% in March 2009 and to 24% in May 2009); while the floor imposed on deposit rates has decreased in a less than proportional manner. Also, the stringent monetary policy observed in previous years (using short-term securities and deposits issued by the BCV) was significantly reduced in a way to compensate the reduction of the monetary base due to lower foreign exchange reserves at BCV. As a consequence, interest lending rates decreased slightly, starting late 2008 and well into 1H10, although the average lending rate seems to be again recovering to YE09 levels. The ratio for the average yield of the loan portfolio has also steadily decreased since 2008, hitting 21.9%, 19.6%, and 18.40% for 2008, 2009, and 1H10, respectively. This not only reflects the trend on the average lending rate, but also the increased share of loans with controlled and below market interest rates (mostly related to the compulsory lending rule). Deposit rates have remained fairly stable since 2008 with some volatility, reflecting the changes in system liquidity. Average funding cost has definitively declined in the past 18 months, mostly aided by the shift in the funding base to demand deposits, while term deposits are today a rare



product within the Venezuelan financial system (12% of total funding as of June 2010). Currently, there are no clear signs about possible changes in the current monetary policy, while ongoing inflation levels result in negative interest rates (both for deposits and loans). The recent reduction of the cash reserve requirement to 20% from 23% announced in early October 2010 may result in further, but slight, reduction on interest rates, although, this measure was more driven by the volatility on the money market rather than by an explicitly expansionary monetary policy framework.

Nonetheless, the contraction of economic activity and, hence, loan demand, jointly with the decision of several banks to curb their credit risk exposure in times of economic recession, resulted in a sharp decrease in new loan origination, even to levels well below inflation. Even assuming the economy has reached bottom and economic activity will rebound in the short and medium term, it seems that the most likely scenario will be one of meager economic growth and, therefore, limited loan growth for the next 18 months.

Industry Trends

One of the most evident changes registered in the Venezuelan financial system in recent years relates to the sustained increase of the share of government owned/controlled banks within the sector. After having been a very limited direct participant in the banking industry (less than 10%, except in the period after the 1994–1995 financial crisis), the Venezuelan government has more than doubled its share to almost 30% of the assets of the Venezuelan financial system. This increase has been propelled by organic growth (Banco del Tesoro), acquisitions (Banco de Venezuela), and the intervention in troubled midsized banks in 2009 (merged into Banco Bicentenario). This expansion will allow the government to participate as a strong competitor that not only can count on stable funding from state-owned entities and capital support from the government, but also on a battery of well-designed and structured commercial and risk tools inherited from the previously acquired banks. As is the case in many countries and was announced by the Venezuelan government, these banks will contribute to the economic program and development policies of the government, suggesting that their current size can be augmented.

The Venezuelan government not only participates in the banking business using their own branch network, since the early 2000s, it heavily regulates banking activities and imposes a complex set of rules to complement its own economic planning. As such, interest rate controls, compulsory lending, and limits to fees and commissions have been in place in Venezuela for a number of years; and it is not expected those controls to be trimmed down and may even be increased in the future. With this, the government not only control's 20% of total lending (through its own network of public banks) but also, rules the uses of around 50% of the total loan portfolio of private sector banks, with prefixed and sometimes increasing percentages to be allocated into agribusiness, microfinance, mortgages, manufacturing, and tourism activity.

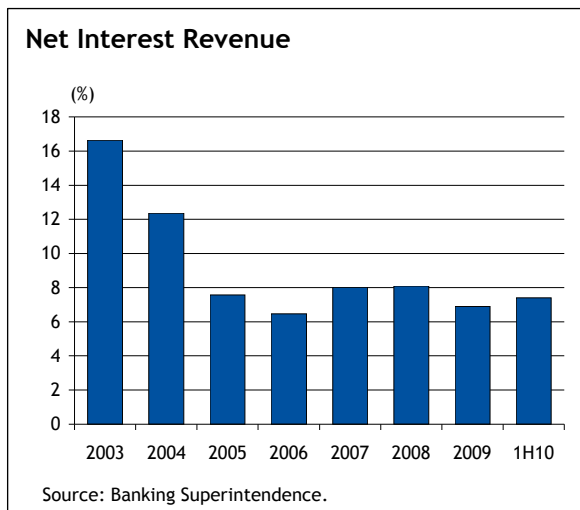
Given this complex set of control and compulsory lending rules, Venezuelan banks have not only dramatically changed their funding source profile, increasing the share of demand deposits (not affected by interest rate floors) to levels likely not seen in the region (65% of total deposits), but did so with significant limitations on the introduction of new lending products. As noted above, around 50% of the total loan portfolio is already controlled by the government, while around 22% is in consumer lending (mostly auto loans and credit cards), with an additional 3% is explained by other non compulsory mortgages. That leaves 25% of the loan portfolio available to finance other economic activities.

During 2009 and 2010, 13 banks (13% of total deposits) have been seized by the regulator for diverse reasons: capital insufficiency; liquidity problems; asset quality problems; violations to the current regulatory framework; among others. As in the past, the government used different approaches regarding these interventions — six institutions were closed (with funds paid to depositors up to the legal limit covered by the deposit insurance fund of less than USD7,000) while the rest were migrated into government owned banks. Despite some deposit losses (some depositors are still waiting on deposit insurance fund payments), the majority of retail deposits have been honored, and the system has not been significantly affected by the volatility of the market. It is worth noting that these kinds of government seizures were also observed in the insurance and brokerage house industries, with the final outcome varied as well. However, in the case of brokerage houses, most of the creditors have not been paid back and there is no explicit insurance fund to cover possible losses.

The last intervention occurred in October 2010, where a small regional bank (Bancoro, managing 0.5% of total system deposits) was seized by the government due to liquidity problems. According to preliminary figures, 98% of Bancoro’s depositors (by number of accounts, not aggregated deposits) will be covered by the national deposit guarantee fund, although it is not clear if the bank will be reopened in the future. Worth noting, several of the institutions that have undergone intervention showed a significant concentration of funding from government entities, which has been steadily transferred to state owned banks since 2008. This has exacerbated their liquidity issues while their asset quality metrics were below the system’s average and with very low profitability levels. As of June 2010 and excluding state-owned banks, there were still a number of small banks with asset quality ratios significantly worse than the sector median as well as a significant number (some of them regional) that registered government deposit concentrations well above the median, suggesting that the more interventions should not be ruled out.

Government intervention has not been limited to the banking industry. A long list of companies from diverse sectors has been nationalized over the past eight years. Some of the largest corporate clients of the banking industry have become state-owned entities, as have some midsized companies as well. This trend is affecting the loan demand dynamic and possibly changing risk profiles of those creditors. So far, it’s not easy to judge the final effect of those changes on the system; however, it could result in a significant deterioration of the collateral of current loan exposures due the legal uncertainty of such a process. These actions also affect a wide array of service and raw material providers for these industries, who may be affected by changes in the ownership of large customers. This process has been particularly evident in the oil, agribusiness, and food processing industries.

Politically driven decisions are difficult to forecast, but calculating the final outcome of such decisions in an industry that has shown for a number of years great flexibility in dealing with these challenges is even more complicated. Fitch understands that Venezuelan banks have learned to navigate these turbulent waters; nonetheless, the magnitude of the



unknowns makes it very difficult to assess the capacity of the system to deal with new challenges. In general, assuming a scenario of moderate government intervention, the Venezuelan financial system should be able to adapt itself to new situations, although, as is noted throughout this report, not all the banks are created equal and the long period of controls and economic volatility has resulted in significant asymmetries in the performance of individual banks. To sum up, some of those with weaker financial profiles may not survive, at least under their current configurations.

Performance

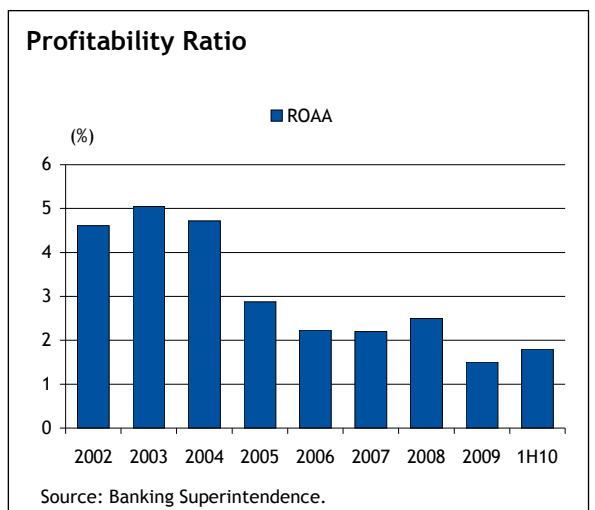
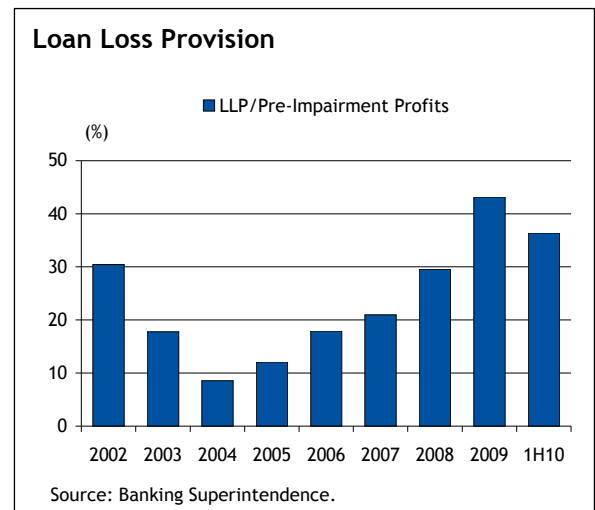
Earnings and Profits

The significant contraction of spreads observed in 2009, jointly with higher loan loss provisions and still high overheads, resulted in a significant contraction of the operating profits to a record minimum level since the last financial crisis of 1994–1995. In 2009, operating profits were 1.6% of average assets, well below the average of above 4% observed in the past 10 years. Although the improvement in funding cost, foreign exchange gains, and relatively lower loan loss provisions resulted in a recovery of the ratio to 2% for 1H10, a trend that may be difficult to sustain during 2H10 and 2011, despite the expected but meager economic rebound and excluding changes in the regulatory framework.

In addition, as has often been the case, the current year's figures were aided by foreign exchange gains following the January 2010 currency devaluation, which benefited banks with large open foreign exchange positions. Although such nonrecurring income is not easy to isolate (it is stated as other operating income under Venezuelan accounting rules for banks), the major portion of the 47% increase on this item in 2010 should be explained by this accounting gain, given the current set of controls over fees, controlled trading gains on security portfolios, and overall stagnation of business volume.

Overall, for 2010 and 2011, operating profits will likely return to the 2% mark (with an expected return on average equity approximating 20%). This is considered inadequate to compensate for the country's high inflation (average accumulated inflation to September 2010 was 28.5%).

Even though past-due levels have increased less than expected after five straight quarters of economic recession and the significant loan portfolio expansion observed during the 2004–2007 period, loan loss provisions (LLP) have increased as a share of pre-impairment profits,



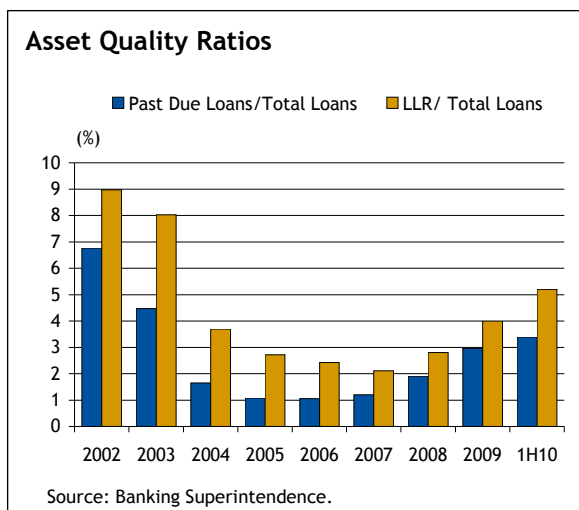
mostly due to the reduction of such recurring income. As such, LLP represented around 40% in 2009–1H10, compared to an average of approximately 19% during 2002–2008. This comparison is important in gaining an idea of the structural shift in Venezuelan banks balance sheets and recurring income. The balance sheets are characterized by a higher share of loans to total assets (approximately 47% of total assets for 2009–2010, compared to 32% for 2002–2004). By far, spreads are not as wide at 9% for 2009–2010 compared to 13% for 2002–2004. Also, recurring foreign exchange gains (almost recurrent during the years previous to 2003) and the expansion of business volume and advances on fee income are also currently significantly restricted. With all that, it is possible to forecast that LLP will keep pressuring Venezuelan bank results in the short- and medium-term; even when past due levels increase moderately.

High inflation levels, distortions of local relative prices due to the foreign exchange control regime (with three different legal exchange rates plus the volatile black market rate) as well as the structural deficiencies of a payment system still ruled by cash transactions, and the heavy use of the branch networks remain the Achilles' heel of the system. With one of the worst ratios for non-interest expenses to average assets in the region (approximately 7% over the past four years) and efficiency ratios much higher than 65%, the Venezuelan banking system stands as one of the most expensive in the region and, hence, is hindered in confronting the challenges of the limited expansion opportunities for its recurring income.

Even when the economic rebound and the advances on funding cost bode well for Venezuelan banks, the limited breadth of the economic recovery, the challenges to continued improvement in the funding base, and limitations regarding fee income and interest rates suggest that profitability ratios will remain well below historic averages. Certainly, they are not enough to compensate for inflation levels, resulting in few incentives for shareholders to preserve strongly capitalized banks while their return is negative when adjusted by inflation.

Asset Quality

Thanks to stringent charge-off policies, the below-average loan penetration rate, and the historic low participation of consumer loans before 2007, Venezuelan banks have been characterized by relatively low levels of past-due loans ratios (excluding years of sizable and sometimes double-digit recession levels). As such, past-due loans represented an average of 1.25% of total loans during 2004–2007, versus 5.6% in 2002–2003 when greater than a 20% accumulated economic contraction was recorded. Nevertheless, while consumer loans increased their share of loans to slightly more than 20% (mostly credit cards and auto loans but excluding mortgages) since 2007 and economic activity has remained well below the so called optimal economic output, past-due loans have risen three fold from a low 1.2% of total loans to 3.4% as of June 2010. This level may look controlled as compared to other countries, but is certainly well above historic levels in Venezuela. Even when consumer loans still perform better than on average in other countries with similar characteristics, its larger



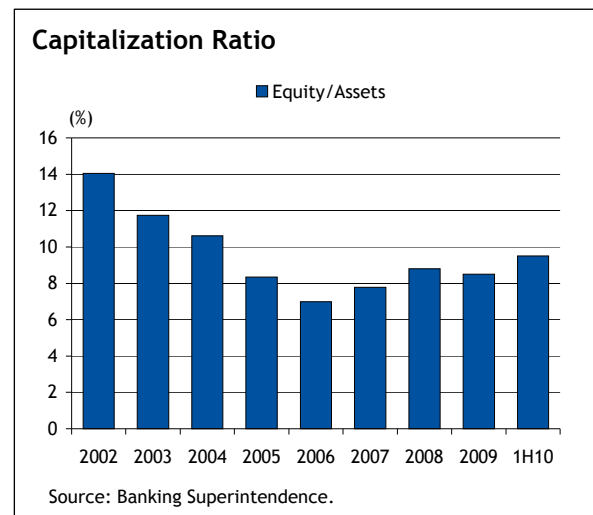
share influences the total impairment figure more, while economic contraction affects across the board to Venezuelan creditors. So far, compulsory loans performance is similar to the average (and sometimes better), aided by the significant incentive of below-market rates and overall negative interest rates, although some exposures could be affected by changes in the operating environment and rampant government intervention in economic activity. The increase on past due ratios has been also magnified by the almost stagnant gross loan portfolio since 2009, with absolute figures showing a lower growth rate, with 100% in 2008, 84% in 2009, and 35% in 1H10. This trend may suggest a less vigorous increase in the past due ratio for 2H10 and year 2011.

As noted, Venezuelan banks have aimed at keeping LLPs in excess of its past-due levels (180% on average since 2002 but decreasing) that have helped to maintain conservative charge-off policies. Since 2007, over all provisioning has increased compared with gross loans (from a low 2.1% in 2007 to a more appropriate 5.3% as of June 2010) in an attempt at recognizing that the seasoning of the expanded loan portfolio may behave differently than the more plain vanilla corporate and commercial loan portfolios at the beginning of the decade, but also as a consequence of the lower value of the collateral in hand. Changes in the regulatory framework regarding mortgages, increasing nationalization of private industries, and the deficiencies of the judicial system have significantly decreased the expected recovery value of traditional collateral and deteriorated the foreclosure process, a trend that may not change in the short term.

Even when it is not expected a significant increase of past-due levels during 2H10 and maybe a recovery during 2011; the fact that Venezuelan banks recurring income is challenged; a proper management of the loan portfolio is required to control possible negative effects on profits due an unexpected increase of past due loans.

Capitalization

Double-digit capital ratios are gone for Venezuelan banks. Low profitability and the uncertainty regarding the prospects of the system have eroded their capital base. Despite the former, changes on the capital regulatory framework (mostly limits on cash dividends payout and the lower portion of government securities on the balance sheet of Venezuelan banks) have resulted in a sustained increase on the equity to capital ratios in Venezuela. After a record minimum equity-to-assets ratio of 7% in 2006, the capital base for the system increased faster than assets, resulting in a recovered equity-to-assets ratio of 9.5% as of June 2010. The ratio is still tight considering the volatile environment and, especially, the significant asymmetries observed between large- and medium-sized banks in comparison to their smaller competitors. In addition, several changes in the regulatory capital rule regarding the weighting of a portion of the banks assets (government securities weighting of 0% and, more recently, a lower weighting for a portion of the sizable compulsory loan portfolio) results in a ratio of regulatory capital to risk weighted assets that is not easily comparable with those of other countries (roughly 13% as of June 2010). Despite the aforementioned increase on



capital ratios, expected low profits, and the uncertainty of the operating environment suggest that capital ratios should not depart too much from this figure in the medium term, while a rebound in lending should result in some reversal to the ratio.

Outlook

The Rating Outlook for most Fitch-rated Venezuelan banks is Stable. The current set of IDR's, individual, and national ratings have already incorporated for a number of years the effects of the complicated and volatile operating environment and regulatory framework. However, as expressed throughout this report, further government intervention into the banking industry cannot be ruled out, and the possible effects of such measures cannot be anticipated in the current ratings. Nonetheless, the ratings of Venezuelan banks may be also challenged by higher than expected deterioration of their asset quality ratios and/or profitability, while the upside potential of such ratings is quite limited given the challenges of a sluggish economy and the fact that most of the ratings are capped by the country ceiling.

Current List of Ratings Assigned by Fitch

	Individual	Support	LT IDR	ST IDR	LT National	ST National
Banco de Venezuela	D	4	B+	B	AAA(ven)	F1+(ven)
Mercantil Banco	D	5	B+	B	AA+(ven)	F1+(ven)
Banco Provincial	D	5	B+	B	AA+(ven)	F1+(ven)
Banco Occidental de Descuento	D/E	5	B-	B	BB(ven)	B(ven)
Bancaribe	D	5	B	B	A-(ven)	F2(ven)
Banco Exterior	D	5	B+	B	AA-(ven)	F1(ven)
Venezolano de Crédito	D	5	B+	B	A+(ven)	F1(ven)
Banco Nacional de Crédito	—	—	—	—	BB(ven)	B(ven)

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTP://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](http://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE.

Copyright © 2010 by Fitch, Inc., Fitch Ratings Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings, Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion is based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at anytime for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of Great Britain, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.