

Venezuelan Banks – First Half 2004 Results

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■ Economic Environment

The operating environment in Venezuela has improved since late 2003 as a result of diminished political uncertainty and good local currency debt management by the sovereign, which has been facilitated by high oil prices, the country's main export. An estimated 20% increase in public spending and the rebound in aggregate demand from its very low levels of 2003 have resulted in 23% GDP growth in the first half of 2004. After the 20% devaluation of February 2004 the official exchange rate has remained fixed at 1,920 Venezuelan Bolivares (VEB) per USD, while the parallel market rate has eased as a result of higher foreign exchange (FX) disbursements from the government and foreign currency debt issuances sold in the local market. During 2004 the premium paid in the USD black market decreased to 35% of the official exchange rate, while at end-2003 this was around 60%, which has boosted consumption of imported goods. Despite the Central Bank's efforts to control excess liquidity, the sustained increase in foreign reserves puts significant pressure over monetary liquidity, resulting in lower interest rates compared with 2003. Average lending rates for the first half of 2004 declined to 18% (31% in 1H2003), while deposit rates reached 13% (1H03: 21%). This has resulted in higher loan demand while deposits remain within the banking system due to the FX control.

Sustained by high oil prices, the FX control and the resolution of the uncertainty related to the August 2004 presidential recall referendum, Venezuela's operating environment and creditworthiness should remain sound. In view of this, loan demand is expected to pick up in the remainder of 2004, which should be sustained well into 2005. Although an unlikely event, the possible lifting of the foreign exchange controls could wipe away excess liquidity in the banking system, which would cause interest rates to increase.

■ Recent Events

Following President Chavez's success in the August 2004 recall referendum and the October 2004 regional elections the political arena has become less volatile. High oil prices and contained social and political struggle will benefit economic activity in the short to medium term. However, the situation remains fragile given the polarization of the population that could result in more confrontation.

In place since February 2003, the FX control should remain in place in the foreseeable future. In turn, controlled devaluations could occur in order to sustain public finances and adjust the overvaluation of the VEB. The flow of USD within the regulated market has significantly increased during 2004, resulting in less pressure over the parallel market and a significant reduction in the gap between the official and parallel market rates. The FX control has had a limited impact on banks as their FX exposures are limited to letters of credit and correspondent bank obligations, which have been paid using pre-existing foreign currency assets.

After a decline of 15% in the loan portfolio during the 1H03, lower interest rates, higher economic activity and some financing needs within the private sector to acquire local issuances of foreign currency debt have resulted in a 36% increase in lending in 1H04. In turn, the year on year increase was of the order of 77%, well above average inflation (24%). During 2004 the government completed issuances of foreign currency debt within the local market, which were acquired by private companies and individuals, in some cases leveraged with short term loans from the financial sector.

The upturn in private consumption has resulted in higher working capital needs and significant inventory replacement, sustained by faster foreign currency allocations made by the authorities. Part of the growth in the loan portfolio could disappear in the short term due to the maturities of most of the loans provided to acquire the aforementioned government debt issuances. However, private consumption could increase further in a low interest rate environment coupled with high public spending. Many banks have increased their commercial efforts to tap the consumer market, taking advantage of the interest rate environment and the incentive created by the FX control to increase consumption, as a hedge against future devaluations. Despite the sizable financing needs of the government, excess liquidity in the market should fund the expected loan demand without a significant increase in interest rates.

The Financial System's Performance in the First Half of 2004

- *Asset quality ratios improve sustained by sizable charge-offs*

At end-June 2004 past-due loans declined 15% compared to end-2003, which brought down the past-due to total loans ratio to 2.8%, the lowest level since 1998. If restructured loans are included, the "adjusted" impaired to total loans ratio declined to 5.1%, compared with 8.0% at end-2003. A significant proportion of this improvement was derived from charge-offs, which represented 2.7% of average loans. Loan loss reserves grew in 1H04 aided by the channeling of higher FX profits obtained following the February 2004 devaluation into loan loss provisions. At end-June 2004 loan loss reserve coverage was 206% (113% including restructured loans), which is adequate given the level of risks undertaken by the banking system.

- *Bank's post significant profits despite narrowing net interest margins*

After an upturn in net interest margins in 2003, lower interest rates and fierce competition have resulted in narrowing spreads within the system. In 1H04, net interest revenue as a percentage of average assets (net interest margin) went down to 11%, almost 3,000 bps lower than in the same period of 2003. If ceded investments (investment funds involving the sale to the public of rights over a portfolio of bonds issued by the government or

other banks; the funds so managed are exempt from bank reserve requirements and are recorded net of the investment portfolio) are included, this ratio reached 9.2%, the lowest in the past five years. In view of this trend, banks have been proactive managing fee income, while FX gains are difficult to forecast due to the FX control. On the other hand, banks have been somewhat successful controlling operating costs, although these are still high by international standards (cost to average: 7.5% in 1H04, adjusted for ceded investments). The system's ROA (including ceded investments) and ROE in 1H04 were 5.9% and 49%, respectively.

- *High equity to assets ratios are justified by the volatile environment*

The upturn in profitability and lower cash dividends have more than compensated for the banking system's asset growth, preserving the historic ample capitalization ratios of Venezuelan banks. At end-June 2004 the equity to assets ratio stood at 14.4%, similar to the end-2003 level. In turn, the Basle-type risk-weighted total capital ratio (as per local guidelines) was 24% for the banking system. These ratios have to be viewed in the context of a moderate concentration in fixed and foreclosed assets (21% at end-June 2004). The minimum regulatory requirements for the equity to assets and risk-weighted capital ratios are 10% and 12%, respectively.

Recent Rating Actions

In September 2004 Fitch Ratings upgraded the long-term foreign currency, local currency, and national ratings of a number of Venezuelan banks. The rating action followed Fitch's upgrade of the Bolivarian Republic of Venezuela's long-term foreign and local currency ratings from "B-" to "B+" (Stable Outlook). The rating action for banks reflected the improvement in the sovereign creditworthiness as well as a relative improvement in the operating environment, supported by low interest rates and a rebound in economic activity. In addition, other concerns relating to possible politically motivated interference of the banking system, including but not limited to a distressed debt exchange by the government, directed lending, fees control, and interest rates ceilings, diminished as these actions have either not taken place or done so in a watered-down form. Table 1 shows the ratings currently assigned by Fitch Ratings to Venezuelan banks.

Table 1 – Ratings for Venezuelan banks

Bank	Individual	Support	Foreign Currency		Local Currency		Outlook	National
			L/Term	S/Term	L/Term	S/Term		L/Term
Banco Provincial	D	5	B+	B	B+	B	Stable	AA(ven)
Banco Mercantil	D	5	B+	B	B+	B	Stable	AA(ven)
Banco de Venezuela	D	5	B+	B	B+	B	Stable	AA(ven)
Banesco Banco Universal	D/E	5	B-	B	-	-	Stable	A-(ven)
Banco Occidental de Descuento	D/E	5	B-	B	B-	B	Stable	BBB(ven)
Banco del Caribe	D	5	B+	B	B+	B	Stable	A+(ven)
Banco Exterior	D	5	B+	B	B+	B	Stable	A+(ven)
Banco Venezolano de Crédito	D	5	B+	B	B+	B	Stable	A+(ven)
Corp Banca	-	-	-	-	-	-	-	BBB(ven)

	Assets (VEB mln)*		Assets (USD bln.)*		Equity (VEB mln.)		Equity/Assets (%)		NPL/Total Loans (%)		LLR Coverage (%)	
	Dec-03	Jun-04	Dec-03	Jun-04	Dec-03	Jun-04	Dec-03	Jun-04	Dec-03	Jun-04	Dec-03	Jun-04
Banco Mercantil	6,252,081	6,950,846	3,908	3,620	774,035	948,737	13.33	14.66	3.05	2.15	256.45	308.23
Banco de Venezuela	5,922,291	7,020,576	3,701	3,657	722,613	869,012	13.93	13.77	2.57	1.34	168.04	186.17
BBV Banco Provincial	5,875,009	7,090,906	3,672	3,693	713,332	813,927	12.68	12.08	3.20	2.65	253.79	242.02
Banesco	5,463,856	7,409,325	3,415	3,859	644,551	820,518	14.47	14.62	3.73	3.43	302.42	277.89
Occidental	4,093,351	4,936,858	2,558	2,571	358,535	397,909	17.27	13.88	4.94	2.95	130.69	160.37
Corp Banca	1,719,776	1,951,232	1,075	1,016	161,018	185,982	11.53	10.88	3.46	1.79	114.32	181.73
Venezolano de Crédito	1,296,368	1,298,412	810	676	161,464	167,282	12.46	13.88	2.21	1.20	202.37	195.16
Caribe	1,494,744	1,760,767	934	917	148,363	193,663	15.60	14.72	1.50	0.42	437.48	1,083.86
Exterior	1,297,983	1,597,935	811	832	141,260	192,711	13.93	16.41	2.32	1.79	793.60	997.39
Commercial and Universal Banks	43,942,813	52,145,881	27,464	27,159	5,159,162	6,298,307	14.33	14.35	4.47	2.81	179.50	206.39

	Net Income (VEB mln)		Net Int. Rev./Assets* (%)		ROA* (%)		ROE (%)		Cost-Income (%)		Cost/avg. Assets* (%)	
	Dec-03	Jun-04	Dec-03	Jun-04	Dec-03	Jun-04	Dec-03	Jun-04	Dec-03	Dec-02	Dec-03	Jun-04
Banco Mercantil	236,779	198,446	12.35	10.10	4.53	10.10	37.16	46.08	52.78	48.62	8.44	7.47
Banco de Venezuela	259,513	204,075	11.34	9.49	5.32	6.31	41.05	51.29	55.11	45.35	7.85	6.95
BBV Banco Provincial	291,513	181,288	13.76	9.61	6.12	5.59	46.49	76.35	55.51	58.53	8.98	7.45
Banesco	241,639	234,794	9.10	7.52	5.31	7.30	40.74	64.10	60.46	42.66	8.76	7.12
Occidental	85,010	62,441	7.66	8.18	2.65	2.77	26.27	44.95	66.37	58.45	5.82	5.28
Corp Banca	52,810	45,389	9.96	7.95	3.31	4.95	36.01	52.32	63.32	57.11	8.02	6.38
Venezolano de Crédito	83,797	41,986	10.25	10.24	7.16	6.47	52.53	101.96	47.09	49.24	6.55	6.52
Caribe	61,759	58,242	12.21	9.82	4.72	7.16	44.95	68.11	62.69	51.60	9.13	8.60
Exterior	100,049	54,296	15.30	12.61	9.06	7.50	74.91	65.03	39.11	40.62	6.66	5.94
Commercial and Universal Banks	1,054,670	1,404,890	10.77	9.21	5.44	5.85	44.39	49.05	55.66	52.35	7.90	7.53

Consolidated Figures.

Inflation: 2003:22.43%; 1H04: 23.67%

Exchange Rate: Dec-03: 1,600.0; Jun-04: 1,920.0

* Adjusted by investment funds (ceded investments)

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