

Venezuela
Special Report

Venezuelan Banks' Year-End 2003 Results

Analysts

Franklin Santarelli
+58 212 286-3356
franklin.santarelli@fitchvenezuela.com

Carlos Fiorillo
+58 212 286-3356
carlos.fiorillo@fitchvenezuela.com

Gustavo López
1 212 908-0853
gustavo.lopezcortes@fitchratings.com

■ The Economic Climate

Despite the rising oil prices since 2001, the deep political crisis in Venezuela has resulted in the worst recession in the country's history (real gross domestic product [GDP] has declined 10% for the past two years) and increasing social unrest. In an attempt to contain the economic deterioration, the government has resorted to measures such as price and foreign-exchange controls, changes in the import regime for some products, the imposition of a bank debit tax since 2002 and a program to refinance its short-term debt maturities for 2003 and 2004. The foreign-exchange controls that have been in place since early February 2003 became the main drivers for key macroeconomic variables. Monetary liquidity expanded rapidly, and interest rates declined as a consequence of the halt in capital flight and scarce loan demand (the average lending rate was 56% for 2002 and 37% for 2003). In addition, inflation remains high (the average was 13% for 2001, 22% for 2002 and 31% for 2003), because prices are highly correlated with expected devaluation and less affected by the actual fixed foreign-exchange rate. Also, the constant increase in the price of the U.S. dollar in the black market continues to pressure local prices in the short term. Given the lower capital flight, international reserves at the central bank increased rapidly (totaling US\$12.3 billion at year-end 2002 and US\$20.6 billion at year-end 2003).

■ Recent Events

The Political Arena

After an attempted coup d'état in 2002 and a general strike that lasted from December 2002 to February 2003, Venezuela's political situation remains fragile. While regional elections must take place in the summer of 2004, opposition parties in Venezuela have called for a referendum that could potentially recall President Chávez from office. This environment has not only resulted in social unrest and constant protests, but it also precludes any real rebound in private investment and consumption. While Venezuelan banks have managed to continue performing adequately in these difficult conditions, the logical connection to the economic instability of the country will always be a threat to a bank's performance.

Foreign-Exchange Controls and Price Ceilings

Following the implementation of foreign-exchange controls, the authorities set up the Comisión de Administración de Divisas (CADIVI), which is in charge of the administration of foreign currency. Despite a difficult start in February 2003, when the normal flow of foreign currency was virtually stopped, CADIVI has increased the pace of approvals and disbursements of foreign currency to several economic sectors, particularly in 2004. During February 2004, the government decided to devalue the official exchange rate to VEB1,920

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per US\$1.00 from VEB1,600 per US\$1.00, while the black market rate has reached more than VEB3,000 per US\$1.00, although this has been very volatile. In regard to price controls, during the first year of application, the government has eased its schemes and allowed significant changes in prices. It has also excluded some goods and services from the list of controlled items. Nevertheless, there still exists a significant number of basic goods and services whose prices are fairly rigid.

Government Exposure vis à vis Loan Demand

Despite some external financing achieved in 2003 and the first half of 2004, local currency debt remains one of the most important sources of funds for the Venezuelan government, just behind oil exports. The increase in bank liquidity, as a consequence of the foreign-exchange control and low loan demand, has prompted banks to invest funds in either government debt (Deuda Pública Nacional bonds and treasury bills) or CDs issued by the central bank. At year-end 2003, public debt (including central bank CDs) reached almost US\$14 billion, accounting for slightly more than 50% of the banking system's invested funds (total assets plus ceded investments, which are similar to off-balance-sheet mutual funds but are, in practical terms, viewed as liabilities of the banking system) and 4.3 times (x) equity. The central bank CDs represented almost 56% of total government securities on banks' balance sheets. These securities are a heavy burden to the central bank's income statement, which has, until now, been mitigated by the sizable foreign-exchange gains recorded as a consequence of the devaluation.

Control Measures

Since 2000, the banking sector has confronted a number of measures imposed by the authorities that may potentially affect its longer term performance. These measures include the following:

Compulsory Lending

In the past three years, the government has increased the proportion of loans that have to be granted to the agribusiness sector to 16% as a proportion of total loans for 2004. A new measure also requires banks to lend to the microbusiness sector up to a minimum of 3% of total loans. Both these measures have, so far, had a limited negative effect on banks, because these institutions are historically accustomed to lending to the agricultural sector and the microbusiness lending requirement is small as a proportion of total lending.

Notably, some minor penalties have been imposed by the regulator on banks that did not comply with the aforementioned compulsory lending limits. However, more pressure could arise from the current discussion of another reform to the Banking Law that would force banks to lend to the mortgage sector as a fixed proportion of the loan portfolio and potentially increase the exposure to the microbusiness sector to 10% of total loans.

Control Over Fees and Commissions

The financial regulator in Venezuela has the right to monitor and control fees and tariff charges for services provided by the banks to their customers. Since mid-2003, a ceiling has been placed on fees relating to services such as maintenance of accounts and penalties derived from returned checks, among others. The effect of these controls has been small so far.

Foreign-Exchange Controls

Foreign-exchange controls took away an important source of income for Venezuelan banks, which benefited from constant currency devaluations due to their historically long positions in U.S. dollars. However, a scenario in which the government needs to resort to future devaluations of the controlled exchange rate to boost its income (as happened in February 2004) is easy to envision, and this will benefit the banking system's bottom line. Finally, it is noteworthy that the regulatory maximum open foreign currency position for banks was raised to 15% in 2003 from 12%.

■ The Financial System's Performance in 2003

With the substantial growth in government securities, the lending book for the banking system has come to account for only 23% of invested funds. For this reason, loan-loss provisions have declined in importance in the income statement, representing only 5% of total revenue and 10% of net interest revenue (NIR). This is also because Venezuelan banks, in general, have ample loan-loss reserves, which allow them to charge off bad loans aggressively. At year-end 2003, impaired loans declined to 4.5% of gross loans from 7.3% at year-end 2002. This is partially explained by the 17% total loan growth in the year but is largely due to charge offs, which averaged approximately 4% of total loans in 2003. If restructured loans are considered in the measure of asset quality, total doubtful loans represented 7.7% of total lending at year-end 2003 and 10.1% at year-end 2002. Despite the banks' aggressive charge-off policies at 180% at year-end 2003 (104% including

restructured loans) loan-loss reserve coverage remained ample. The February 2004 Venezuelan bolivar devaluation and the ample interest margins prevailing in the market will contribute to enhanced loan-loss reserve coverage, as Venezuelan banks continue to create loan-loss provisions.

Profitability

The 14% devaluation of the official exchange rate in 2003 resulted in foreign-exchange gains for banks. In addition, the decline of deposit rates and the high yield of government bonds more than offset the lower lending rate, resulting in an ample net interest margin (NIM) of more than 13% (11.4% including ceded investments). Also, banks placed a tight grip on costs, which reflected in a cost/income ratio of 56.7%, although the cost/average assets ratio continues to be high at 10.2% (8.6% including ceded investments). The latter is explained by the banking system's low asset base and the heavy burden of the payments system in Venezuela.

Market Consolidation

Since 1998, several mergers and acquisitions have taken place in the Venezuelan banking system, resulting in a significant decrease in the number of banks (51 institutions in 2003 versus 98 in 1998). Nevertheless, this trend has been mostly concentrated in large and mid-sized banks, creating a significant gap between those banks and the rest of the system. Even though these banks have increased market share, a significant number of participants have very low penetration levels (36 institutions managing less than 1% of the system's invested funds), while 64% of total invested funds are concentrated within the top five banks. The imposition of foreign-exchange controls in early 2003 and the subsequent increase in monetary liquidity has resulted in a significant increase in the size of the banks.

■ Performance of the Leading Banks

Banco Mercantil

During 2003, Banco Mercantil (Mercantil) kept its conservative approach to lending, which resulted in a 220-bps reduction in its share of invested funds (14.2% at year-end 2003). Nevertheless, Mercantil remains the largest bank in the country by total invested funds and equity. An aggressive loan-loss provision and charge-off policy resulted in an improvement in the bank's asset-quality ratios. The past-due to total loans ratio declined to 3.1%, while loan-loss reserves covered more than 256% of the

past-due portfolio. Also, the positive effects of past operating cost reduction initiatives and a proactive approach to increasing fees and commissions allowed the bank to cope with mounting inflation and relatively lower spreads. Mercantil experienced a significant reduction in foreign-exchange gains in 2003, reflecting a slight increase in its return on average assets (ROA) to 4.54%. Higher earnings and a prudent cash dividend pay out resulted in an increase of the equity-to-assets ratio to 13.3%.

Banco de Venezuela

Banco de Venezuela (BdV, a wholly owned subsidiary of Banco Santander of Spain) continues to have the best cost efficiency ratios of the large banks in Venezuela. Coupled with a healthy NIM, the bank obtained ROA and return on equity (ROE) ratios of 5.3% and 41.0%, respectively, in 2003. At year-end 2003, the past-due to total loans ratio declined to 2.6%, the lowest of the five largest banks, while loan-loss reserve coverage remained ample at 168%. The bank's equity-to-total assets ratio stood at almost 14% at year-end 2003, which is slightly less than the average for commercial and universal banks in Venezuela.

Banco Provincial

Banco Provincial (Provincial, a subsidiary of Banco Bilbao Vizcaya Argentaria of Spain) continued to implement a tight grip on costs in 2003, which resulted in a 20% decline in overheads in real terms during the year. After an increase in loan-loss provisions in 2002 (partially in anticipation of possible problems derived from the difficult economic situation in the country), Provincial was able to lower provisioning due to the favorable performance of its loan portfolio in 2003; loan-loss provisions declined to 2.4% of average loans during 2003, compared with 4.5% in 2002. At year-end 2003, Provincial's ROA increased to 6.1%, one of the highest among the top nine banks. This result is also explained by the positive effect of the devaluation over the long foreign-exchange position of the bank. Also, during 2003, asset-quality ratios experienced another improvement compared with previous years, with past-due loans representing just 3.2% of gross loans, and loan-loss reserve coverage increasing to 254%. The bank's equity-to-assets ratio is less than the average for the system but still adequate.

Banesco Banco Universal

Banesco Banco Universal (Banesco) was the second-largest bank by total assets and the fourth largest by equity at year-end 2003. Also at year-end 2003, Banesco's NIM decreased to 8.2%, the second lowest

among the nine largest banks. This was, in part, explained by the bank's strategy to increase its market share and by a higher than proportional portfolio of lower yielding foreign currency sovereign debt. Operating costs increased at a rate higher than inflation but lower than the increase in average assets, resulting in an improvement of the cost-to-average assets ratio to 8.2%. The lower NIM was also partially compensated for by the significant reduction in loan-loss provisions to less than 1% of average loans, compared with a much higher 9.6% of average loans in 2002. This stems from the better performance of the loan portfolio, which is partially explained by sizable charge offs in 2002. The bank had ROA and ROE of 5.0% and 40.7%, respectively, in 2003. At year-end 2003, the past-due to total loans ratio declined to 3.7%, while loan-loss coverage increased to 302%. The growth in assets, as well as a VEB140 billion cash dividend paid in 2003 (equivalent to 99% of 2002 net income), resulted in a decline in the equity-to-assets ratio to 14.5% (11% excluding goodwill).

Banco Occidental de Descuento

After its merger with another midsized bank at year-end 2002, Banco Occidental de Descuento (BOD) significantly increased its market share, becoming the fifth-largest bank in Venezuela, with a special leadership in the Zulia Region (the main oil producing area in the country). During 2003, lower NIM and higher overheads were compensated for by the significant reduction in loan-loss provisions (less than 1% of average gross loans). Meanwhile, noninterest revenues were positively affected by the devaluation. However, BOD's ROA and ROE of 2.65% and 26.3%, respectively, in 2003, remain significantly less than the average for its peers. Contrary to the market behavior, the bank's past-due loan portfolio grew by 30% in 2003. However, total lending grew by 41%, reducing the past-due to total loans ratio to 4.9%. Nevertheless, some charge offs and the reduction in loan-loss provisions were reflected in a lower loan-loss reserve coverage ratio of 131%. At 17.3%, the bank's equity-to-assets ratio appears high, but significant goodwill has been generated in the past few years, which hinders the quality of BOD's capital.

Corp Banca

As in previous years, Corp Banca prioritized its profitability and asset quality, resulting in a decline in market share in 2003. The bank preserved its NIM at 10%, while operating costs were strictly contained

(less than 2% growth in nominal terms), which compensated for the increase in loan-loss provisions to 4% of average gross loans. This resulted in an ROA of 3.31%, similar to that of 2002. The bank's past-due to total loans ratio of 3.5% in 2003 was lowered mostly by loan charge offs (5.9% of average gross loans) and is one of the lowest historical levels for the bank. Loan-loss reserve coverage was 114% at year-end 2003, which is less than the average for its peers. At 11.5%, the bank's equity-to-assets ratio is the lowest of the top nine banks.

Venezolano de Crédito

As in previous periods of crisis, Venezolano de Crédito preserved its financial strength by focusing on lending to its traditional client base while limiting its exposure to the government. As a consequence, the bank's market share declined somewhat. At year-end 2003, total lending declined by 6%, while past-due loans also declined. The bank's past-due to total loans ratio stood at 2.2%, which is similar to the bank's average over the past five years and less than the average for its peers. Loan-loss reserve coverage of 202% remains ample. The reduction of the bank's net interest margin to 10.3%, compared with 13.2% at year-end 2003, was mostly explained by the lower interest rates in the monetary market. Venezolano de Crédito's ROA fell to 7.2% (compared with 12.5% in 2002) but was still one of the highest in the system. Venezolano de Crédito's equity-to-assets ratio of 12.5% was less than the peer average, but the bank has proven to be sufficiently profitable to generate enough capital internally to strengthen its ratios.

Banco del Caribe

Banco del Caribe's aggressive charge-off policy resulted in a significant improvement in the bank's asset quality in 2003. During the year, the bank's charge-off to average loans ratio increased to 4.4%, which reduced its past-due to total loans ratio to 1.5%, the lowest level in five years and among the lowest of its peer group. In turn, loan-loss reserve coverage increased to 437%, as loan-loss provisions in 2003 accounted for 1.3% of average loans. The decreased need for provisioning compared with previous years, coupled with a higher NIM and well-controlled costs, resulted in an ROA of 4.7% in 2003, the highest level in five years for Banco del Caribe. Banco del Caribe's equity-to-assets ratio of 15.6% at year-end 2003 remained roughly similar to that of year-end 2002, despite the growth in its asset base during the year.

Banco Exterior

As has become customary, Banco Exterior was one of the most profitable banks in 2003, maintaining, at the same time, some of the best asset-quality ratios in the system. The past-due to total loans ratio declined significantly to 0.3%, while loan-loss reserve coverage increased to almost 800%. This is explained by Banco Exterior's excellent knowledge of its client base and conservative charge-off policy for consumer loans, an important part of its loan portfolio. The bank also implemented tight cost control measures, as its cost-to-average assets declined to 6.5%, which is one of the lowest ratios within its peer group. Coupled with relatively low loan-loss provisions, the bank was able to post the highest ROA and ROE, 8.9% and 74.9%, respectively, of its peer group at year-end 2003. Banco Exterior's equity-to-assets ratio was 13.9% at year-end 2003.

■ Outlook

The political situation in Venezuela is likely to remain uncertain for the rest of 2004. While real

GDP growth will surge as a mathematical certainty, considering the very low level of economic activity during 2003, the volatility of the unofficial foreign-exchange market vis-à-vis the controlled exchange rate will keep pressuring inflation. In addition, if the foreign-exchange control remains in place for some time (the most probable scenario), monetary liquidity will keep growing and pressuring interest rates. Nevertheless, increasing local financing needs from the government will set again a floor to the lending rate. Despite the substandard economic environment, banks will most likely be able to preserve their financial strength, not only due to the already comfortable loan-loss coverage position achieved in the past few years and the boost in net income derived from the 20% Venezuelan bolivar devaluation in February 2004, but also because of large capital bases and conservative lending policies. In regard to ratings, Fitch continues to be concerned about political interference with the banking sector, but the financial strength of most of the players would probably prevent any downgrade of the rated banks in the short term.

Ratings for Venezuelan Banks

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

ven – Venezuelan national scale.

Summary of Reported Consolidated Results for the Banking Systems

(VEB Bil.)

	—Assets*		Assets (US\$ Bil.)		—Equity—		Equity/ —Assets (%)—		NPL/Total —Loans (%)—		LLR —Coverage (%)—	
	12/03	12/02	12/03	12/02	12/03	12/02	12/03	12/02	12/03	12/02	12/03	12/02
Banco Mercantil	6,252	4,176	3.91	2.98	774	500	13.33	12.78	3.05	4.72	256.45	149.38
Banesco	6,084	3,632	3.80	2.59	645	542	14.47	17.67	3.73	6.01	302.42	256.28
Banco de Venezuela	5,922	3,841	3.70	2.74	723	542	13.93	14.65	2.57	3.76	168.04	167.47
BBV Banco Provincial	5,875	3,650	3.67	2.61	713	541	12.68	15.61	3.20	4.07	253.79	219.85
Occidental	4,093	2,328	2.56	1.66	359	289	17.27	17.84	4.94	5.35	130.69	175.36
Corp Banca	1,720	1,474	1.08	1.05	161	132	11.53	10.89	3.46	5.64	114.32	118.67
Caribe	1,495	1,121	0.93	0.80	148	126	15.60	15.61	1.50	5.14	437.48	223.73
Exterior	1,350	911	0.84	0.65	141	126	13.93	18.03	0.29	0.92	793.60	346.47
Venezolano de Crédito	1,296	1,044	0.81	0.75	161	158	12.46	15.10	2.21	2.13	202.37	195.95
Commercial and Universal Banks	43,943	25,410	27.46	18.13	5,159	3,225	14.33	14.24	4.47	7.30	179.50	129.66
	—Net Income—		Net Interest Revenue/ —Assets* (%)—		—ROA* (%)—		—ROE (%)—		Cost-Income (%)		Cost/Average —Assets* (%)—	
	12/03	12/02	12/03	12/02	12/03	12/02	12/03	12/02	12/03	12/02	12/03	12/02
Banco Mercantil	237	173	12.38	13.02	4.54	4.49	37.16	38.84	52.78	55.97	8.46	10.24
Banesco	242	141	8.52	10.90	4.97	6.07	40.74	44.29	60.46	57.95	8.20	11.83
Banco de Venezuela	260	196	11.34	11.20	5.32	5.79	41.05	39.60	55.11	50.59	7.85	9.32
BBV Banco Provincial	292	176	13.76	15.90	6.12	4.97	46.49	35.71	55.51	59.29	8.98	10.93
Occidental	85	43	7.66	9.15	2.65	2.66	26.27	22.51	66.37	36.00	5.82	3.14
Corp Banca	53	47	9.96	10.41	3.31	3.38	36.01	39.87	63.32	64.24	8.02	9.00
Caribe	62	39	12.21	12.05	4.72	3.46	44.95	34.64	62.69	61.18	9.13	9.12
Exterior	100	72	12.52	13.53	8.85	8.40	74.91	66.79	39.11	43.09	6.50	7.52
Venezolano de Crédito	84	98	10.25	13.24	7.16	12.50	52.53	75.29	47.09	38.39	6.55	8.70
Commercial and Universal Banks	1,800	1,116	11.39	11.27	5.19	4.48	42.49	35.74	56.74	58.18	8.61	9.61

*Total assets plus ceded investments. VEB – Venezuelan Bolivar. Notes: 1. Inflation was 22.43% for 2002 and 31.08% for 2003. 2. The exchange rate was 1,401.25 for December 2002 and 1,600.00 for December 2003.

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