
VENEZUELAN BANKS – FIRST HALF 2002 RESULTS

- *Growing political uncertainty intensifies capital flight and puts pressure on system liquidity.*
- *Rising interest rates and the recession have already affected asset quality.*
- *The banking industry's nominal earnings benefited from the drastic currency devaluation.*
- *The merger trend will continue and intensify.*

The Economic Climate

Despite the oil price recovery in 2002, economic activity continued the decline that has been under way since the second half of 2001, chiefly as a result of falling government spending and intensified political and social instability. The mass protests and attempted coup d'etat in April 2002 exacerbated the country's economic problems as interest rates rose dramatically and the currency devaluated by over 70% in the first half of the year following its floatation. During this period, Venezuela's GDP contracted by 7% from its level in the same period of the previous year, and the same downward trend is expected to continue through the remainder of the year. Capital flight, exceeding USD 3.4 bln, provoked a 10% contraction of monetary liquidity, with bank deposits dropping by around the same proportion, pushing the financial system into a state of severe illiquidity. This illiquidity induced the Central Bank to actively pursue open market operations to provide the system with needed liquidity. This was done through automatic repos of national public bonds to the institutions most in need of funds, and placement of certificates of deposit and borrowing of public securities with repurchase agreements from institutions having surplus funds. To illustrate, the Central Bank had VEB 1.9 trillion (over USD 1.7 bln) of outstanding advances at the end of February 2002; nearly all of that assistance has since been repaid.

The drastic plunge of liquidity and the Central Bank's policy of discouraging foreign exchange purchases resulted in a drastic surge of interest rates, to more than double the 2001 average, as well as more volatility in the interest rate spread. The average lending rate for the first half of 2002 came to 44%, compared to just 20% for the same period of last year, while the average deposit rate climbed to 35%. Note that lending rates peaked at

over 100% in some cases in April. Most of the rate adjustment came in the corporate segment; consumer loan rates increased but to a lesser extent.

As part of a package of policy measures designed to relieve the pressure on foreign reserves and trim the deficit for the current year, in February 2002 the Central Bank discontinued its exchange rate band arrangement in favor of a floating exchange rate system. Thus, the Central Bank participates in the market through daily auctions of fixed amounts of foreign currency. Following the new system's inauguration in February 2002 and in a context of high volatility, the exchange rate depreciated by 73% by the end of June.

Legal and Regulatory Environment

Debate on a reform of the "Banks and Other Financial Institutions Act of 2001" commenced in April. Still under discussion in the National Assembly, the bill calls for the following changes, among others: greater autonomy for the Banking Superintendency (SUDEBAN); placement of the State-owned banks under the SUDEBAN's authority; liberalization or elimination of the obligation to provide loans to microbusinesses; and elimination of the current restrictions on trusts. The reform is expected to be enacted in the course of the second half of 2002.

Among the measures taken by the national government to reduce the 2002 budget deficit is the application of a Bank Debit Tax for a year. Initially, the rate was 0.75% of the value of each transaction; it was raised to 1% as of August 23, 2002. The tax is applicable to debits or withdrawals from checking and savings accounts, custody deposits, or any other kind of demand deposit, investment fund, trust, and other financial market fund, or any other financial instrument, at any bank or financial institution. The following are exempt from the tax: the Republic of Venezuela, the state and municipal governments, the autonomous institutes, the Central Bank of Venezuela, the State schools and national higher educational institutions, transfers of funds by a single holder among accounts at the same financial institution, overnight transactions, acquisition of securities issued or guaranteed by the Nation, and accounts belonging to individuals from which no

more than VEB 460,000 (approximately USD 300) are withdrawn monthly.

The Financial System's Performance in the First Half of 2002¹

- *The recession is putting pressure on banking system asset quality*

The system's total loan portfolio decreased by 14% in the period January-June 2002 as a result of flagging demand for loans and the financial institutions' liquidity enhancement policy which led them to demand some loan prepayments. Moreover, the recession and the drastic interest rate rise provoked a 26% growth in impaired loans, which, in conjunction with the decline in total lending, drove up the system's impaired to gross loans ratio by more than 200 bps, to 7.3% at end-June 2002. This is the highest level for this indicator since 1995. Taking advantage of the foreign exchange gains posted during 1H02, financial institutions drastically increased loan loss reserves, which allowed them to raise loan loss reserve coverage to almost 140%. If restructured loans are considered (a further 3% of gross loans), loan loss reserve coverage declines to 97% at end-June 2002.

- *Volatile rates and currency devaluation benefited first-half earnings*

The system's net interest revenue grew by 29% when compared with the same period for the previous year, aided by the higher level of interest rates, which more than offset the decline of productive assets. In turn, net interest margin increased to 11%, 100 bps higher than the first half of 2001. Anticipating a likely growth of arrears in loan payments, the financial institutions increased loan loss provisions to 7% of average gross loans (vs. 2% in the comparable period of last year). The growth in other net operating income, largely as a result of the currency devaluation, reinforced the positive effect of the higher margin and produced a 150% expansion of net earnings, while ROA and ROE improved to 4.8% and 54%, respectively. The expected increase of impaired loans, and operating cost pressure, are the most serious challenges financial institutions will face in their

attempt to maintain current profitability levels at a time of smaller foreign exchange gains.

- *Government measures and inflation may neutralize the progress made in controlling operating costs*

Since 1998 the Venezuelan financial system has been emphasizing cost control, which has yielded an improvement in the cost to average assets ratio from 12% that year to 9% in the first half of 2002. However, the recent minimum wage adjustment, the imposition of a firing freeze expiring in October 2002 (following an additional 90-day extension), and the revival of inflation provoked by the currency devaluation could potentially reverse this trend. Operating costs rose by 14.5% in the first half of 2002, which, although roughly in line with inflation, compared unfavorably to a 10% increase in 1H01.

- *Steady capital flight continues to put pressure on deposits and liquidity*

After having stagnated throughout 2001, deposits (including ceded investments) fell by 11% in nominal terms during the first half of 2001. This was mainly a consequence of the 17% reduction in demand deposits and the 21% drop in savings accounts (both of them transactional funds). This contraction of deposits, concentrated mainly in the first quarter of the year, provoked a general system illiquidity which required the Central Bank to activate the new liquidity assistance tools mentioned above. At end-June 2002, the ratio of liquid investments to total deposits (including ceded investments) came to 62%, slightly higher than in December 2001 but varying widely across the financial system. System liquidity pressure may persist if the prevailing climate of political uncertainty continues into the future.

Performance of the Leading Venezuelan Banks

Banco de Venezuela (BdV, majority owned by Spain's Banco Santander Central Hispano): Thanks to its June 2002 merger with Banco Caracas (BCS), BdV recorded a 20% growth of assets under management vis-à-vis end-2001. The merger with BCS not only increased the institution's size but also changed its profile. BdV had previously been concentrated in the corporate market, but has now come to manage a large portfolio of middle-market clients and consumer loans. These loans increased in relative terms from

¹ The tax increases and the devaluation propelled average inflation to 16% in the first half of 2002 (1H01:13%) while year on year inflation came up to 20% in June 2002. It must be noted that Venezuelan accounting standards do not call for inflation adjustments, which results in growth trends and profitability ratios, among others, being distorted.

40% of total loans to around 60%. On the liability side, BCS had a large number of new middle and upper-income customers, who had been a minority of the former BdV's customer base. Loan arrears were affected by the recession and high interest rates, as well as by the merger with BCS, which was subject to higher risk because of its substantial middle-market exposure. By June 2002, the impaired to total loans ratio had risen to 3.8%, a level still far below the market average, and loan loss reserve coverage stood above 180%. Profitability continued to be buoyed by a strict spending control policy and the effect of foreign exchange earnings, which raised the ROA and ROE to 6% and 41%, respectively. The merger with BCS brought about an expansion of market share to 14.4% of the system's managed investments, making BdV the country's largest financial institution (for operations in Venezuela).

Banco Mercantil (Mercantil): Mercantil did well despite the industry's generally negative performance and thanks to the operations of its overseas branches; operations in Venezuela grew only by 4%. The completion of Mercantil's 2001 integration with Interbank and the application of a range of cost control measures kept the growth of operating costs in the half of 2002 to 12% (vs. 32% in the first half of 2001). Together with the institution's higher net interest revenue and foreign exchange earnings, which more than offset the rise in loan loss provisions, net income grew by 340%. This brought the ROA and ROE to 5.9% and 45%, respectively. Unlike the industry as a whole, Mercantil succeeded in containing the growth of impaired loans through effective collection efforts and some write-offs. At end-June 2002, the bank's impaired to total loans ratio stood at 3.4%, with loan loss reserve coverage of 248%. However, Mercantil has pursued an active restructuring policy, as a result of which restructured loans increased in relative terms to 6% of total loans. That would bring the adjusted arrears ratio to 9%, a level still below the market average.

Banesco Banco Universal (Banesco): The merger of Banesco and Unibanca Banco Universal (Unibanca) was completed in June 2002, producing an expansion of the former institution's assets by almost 200%. Unibanca, which had been partially controlled by Banesco's majority shareholder, was a universal bank that concentrated on the retail market and consumer loans, created by the merger of Banco Unión and

Caja Familia in 2001. The addition of Unibanca's loan portfolio (with a high proportion of credit cards), the higher interest rates, and the recession, combined to drive the impaired loans to total loans ratio up to 8.1%. Anticipating further deterioration of the economy and taking advantage of the growth in earnings, Banesco increased its loan loss provisions to 16% of average loans, which allowed it to expand its reserve coverage to nearly 200%. When restructured loans are factored in, the modified loan arrears ratio rises to slightly over 13%, higher than the market average. Hence, control of asset quality is the greatest challenge facing the institution. Most back office operations had already been centralized, along with the risk control area, prior to the merger; this reduces the risk accompanying the two institutions' integration. The joint management of the two institutions has yielded major cost savings, which have in turn substantially improved the profitability ratios. Note that the institution participates actively in the ceded investments market; when these funds are taken into account, investments managed by the bank (assets + ceded investments) totals VEB 3.3 bln at the end of June 2002, representing a 13.3% market share and making this the country's third largest financial institution.

Banco Provincial (Provincial, majority owned by Banco Bilbao Vizcaya Argentaria): The bank's assets contracted by slightly more than 7% in the first half of 2002, putting it in fourth place in the ranking for managed investments (assets + ceded investments) with a 13.1% market share. This reduction stemmed from continuing capital flight, which reduced the institution's deposit base. While total loans fell by 11%, impaired loans grew by a similar proportion, reaching 4.8% of total lending. However, if restructured loans are added, this ratio rises to 8%, 200 bps below the market average. Earnings in the first half benefited chiefly from a 58% increase in net interest revenue and operating cost control. Also, loan loss provisions increased by over 400% (6% of average loans) to anticipate the additional deterioration of the loan portfolio due to the country's economic problems. Note that while net income increased by over 70% in 1H02 when compared with 1H01, foreign exchange gains did not contribute significantly to this result, which implies more medium-term earnings recurrence for Provincial than for its peers.

Corp Banca: Along with the rest of the industry, Corpbanca benefited from higher interest rates and

foreign exchange profits. The higher income allowed it to raise its loan loss provisions to 3.3% of average loans and offset the 17% growth of operating costs. Net earnings were 78% higher as of June 2002, while the institution's ROA and ROE reached 5% and 45%, respectively. In spite of the recession and high interest rates, Corp Banca succeeded in reducing loan arrears to 5% (-100 bps) and raising coverage of impaired loans to 118% thanks to effective collections and some write-offs. In response to the money market's volatility, the bank increased its liquidity reserves while modifying its funding mix in favor of traditional deposits from the public to the detriment of ceded investments. At end-June 2002 total funds under management (deposits + ceded investments) were up by 13%, with ceded investments' share of the total falling from 56% to 34%.

Banco del Caribe (Caribe): Following the initiatives taken since 2001, Caribe continued to aggressively build up its loan loss reserves, raising loan loss reserve coverage to slightly over 200% at end-June 2002. This was accomplished despite a growth of the impaired to total loans ratio to 6.0%, a level still below the market average. Caribe did not experience any major change of funds under management (+0.4%), but weak credit demand and the management's intention of limiting credit risk led to a 14% contraction in total lending. In spite of the decline in average productive assets, higher interest rates and wider spreads yielded a growth in net interest revenue of over 60%, more than enough to cover the growth of operating costs, loan loss provisions, and tax costs. As a result, net earnings rose by 137% to reach VEB 13.0 bln.

Banco Exterior (Exterior): The economic slump was reflected in a growth of impaired to total loans to 1.8%, while the loan loss coverage dropped to 216%; even so, both figures continue to be among the best in the Venezuelan financial system. Unlike the market's overall performance, Exterior's total loan portfolio expanded by almost 2%, while investments under management (assets + ceded investments) grew by 8.3%. The larger volume of productive assets and the higher interest rates brought about a 38% improvement in the bank's net interest revenue, while other operating revenue surged by 285%, partly as a result of the currency devaluation. Net earnings were 110% higher as of

June 2002, while ROA and ROE stood at 10% and 62%, respectively.

Venezolano de Crédito Banco Universal (Venezolano): Venezolano's conversion to universal banking status was completed during the first half of 2002, following its merger with other member companies of the Vencred group: Soficrédito Banco de Inversión C.A. and Sogecrédito C.A. de Arrendamiento Financiero. The incorporation of these subsidiaries not only increased the institution's total assets by 27% but also changed the loan profile from that of the old commercial bank. Long-term financings, financial leases, and some mortgage loans, whose risk profile differs from that of the corporate loans in which the institution had formerly concentrated, were added to Venezolano's portfolio. At end-June 2002, the incorporation of the subsidiaries' portfolios and the recession drove the institution's impaired to total loans ratio to 5.41% (vs. 1.8% at end-2001), while loan loss reserve coverage declined to 102%. Though conversion to a universal bank impaired asset quality, it did not adversely affect Venezolano's traditionally high levels of profitability and capitalization; ROA and ROE rose to 15% and 72%, respectively at end-June 2002, while the equity to total assets ratio rose to 21%.

Banco Occidental de Descuento (BOD): Despite the large-scale capital outflow that affected the entire financial system, the aggressive expansion strategy pursued by the institution since 1999 brought about a 28% growth of total assets as of June 2002. This growth stemmed mainly from a larger investment portfolio, since loans increased by only 8%. In spite of the expansion of total loans and the application of write-offs amounting to almost 2% of average gross loans, the impaired to total loans ratio continued to rise, reaching 5.6%. When restructured loans are considered, the modified impaired loan ratio increases to 7.3%. Higher loan loss provisions, reaching 21% of average gross loans, yielded an improvement in loan loss reserve coverage to 224% (172% if restructured loans are included). The 95% increase of net interest revenue and the 38% reduction of operating costs more than offset the drastic rise of loan loss provisions and produced an improvement of the ROA and ROE to 7% and 66%, respectively.

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	C/D	4T	B	B	B-	B	Negative	AA(ven)
Banco Mercantil	C/D	4T	B	B	B-	B	Negative	AA(ven)
Banco de Venezuela	C/D	4T	B	B	B-	B	Negative	-
Banesco Banco Universal	D/E	4T	B-	B	-	-	Stable	-
Banco Occidental de Descuento	D	4T	B	B	B-	B	Negative	-
Banco del Caribe	D	4T	B	B	B-	B	Negative	A+(ven)
Banco Exterior	C/D	4T	B	B	B-	B	Negative	A+(ven)
Banco Venezolano de Crédito	C/D	4T	B	B	B-	B	Negative	-

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Summary of reported results for selected Venezuelan banks (end-2001)

	Assets (VEB bln)		Equity (VEB bln.)		Loan Portfolio (VEB bln)		Equity/Assets (%)		NPL/Total Loans (%)		LLR Coverage (%)	
	jun-02	jun-01	jun-02	jun-01	jun-02	jun-01	jun-02	jun-01	jun-02	jun-01	jun-02	jun-01
Banco de Venezuela	3,422,812	2,451,470	514,709	450,556	1,388,638	1,017,124	15.04	15.62	3.8	1.47	180.11	190.38
Banco Mercantil	3,579,881	3,016,180	478,082	391,348	1,734,152	1,534,517	13.35	12.32	3.39	4.05	248.32	158.88
BBV Banco Provincial	3,038,875	3,080,748	462,910	445,029	1,395,663	1,471,921	15.23	13.55	4.78	4.57	199.16	135.22
Banesco	2,460,257	748,446	472,728	96,256	737,890	234,296	19.21	11.71	8.09	4.41	198.36	254.89
Occidental	1,136,937	632,723	126,432	64,082	375,281	211,889	11.12	10.13	5.64	6.14	224.87	137.26
Caribe	638,028	644,310	106,624	96,182	343,887	343,559	16.71	13.15	5.97	5.56	202.64	158.94
Corp Banca	1,124,077	817,653	119,995	104,658	554,381	476,127	10.67	11.05	5.08	5.71	117.92	96.08
Exterior	611,359	525,062	111,581	89,303	362,207	321,549	18.25	15.19	1.76	0.85	215.78	479.87
Venezolano de Crédito	838,867	473,123	173,893	101,927	277,251	194,751	20.73	19.63	5.44	1.77	101.51	197.37
System Average	20,859,894	18,900,571	3,396,418	2,742,105	8,115,249	8,091,839	16.28	14.51	7.26	5.44	136.96	133.32

	Net Income (VEB bln)		Net Int. Rev./Assets (%)		ROA (%)		ROE (%)		Cost-Income (%)		Cost/avg. Assets (%)	
	jun-02	jun-01	jun-02	jun-01	jun-02	jun-01	jun-02	jun-01	jun-02	jun-01	jun-02	jun-01
Banco de Venezuela	99,315	38,352	11.00	8.22	6.30	3.11	41.16	16.63	43.59	63.36	8.03	7.28
Banco Mercantil	98,752	22,422	14.49	11.67	5.85	1.49	45.43	12.46	51.62	78.66	11.19	11.21
BBV Banco Provincial	72,193	41,828	17.48	10.83	4.57	2.59	31.81	20.76	58.56	75.56	11.45	10.23
Banesco	70,864	14,584	8.60	12.92	8.64	4.06	49.82	39.63	40.47	59.49	9.77	10.19
Occidental	35,706	9,965	21.20	10.10	7.05	1.83	65.79	19.78	24.39	71.29	5.22	7.79
Caribe	13,002	5,500	18.84	13.05	3.80	1.79	25.64	12.00	65.14	82.34	14.46	14.15
Corp Banca	25,477	14,320	13.51	13.43	4.92	3.25	45.36	30.75	62.58	73.81	12.00	12.1
Exterior	30,908	14,701	19.34	16.88	10.31	5.92	61.54	40.75	42.98	52.39	10.34	9.62
Venezolano de Crédito	49,771	11,167	16.38	8.85	14.66	4.96	72.18	25.68	36.30	57.95	9.26	7.89
System Average	571,543	228,178	14.32	10.72	6.18	2.38	42.73	17.80	53.62	73.30	10.48	10.06

Consolidated Figures.

Inflation: IH01:12.6%; IH02 16.1%

Exchange Rate: Jun-01: 718.75; Jun-02: 1,316.00

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