

## VENEZUELAN BANKS – JUNE 2001 RESULTS

- *Credit expansion continued to be sluggish.*
- *The merger trend continued, and will be further spurred by new capital requirements and competition.*
- *The instability of deposits from the public and the need to diversify the sources of financing has stimulated participation in the fixed-income market by some financial institutions.*
- *Foreign exchange market pressure has forced monetary policy to become tighter.*

### Economic environment

- *The economic recovery that began in 2000 is running out of steam*

The decline of oil prices and the OPEC production cuts have depressed the pace of public spending, hence, affecting negatively expectations for short and medium-term economic performance. Gross Domestic Product grew 3.4% in the first half of 2001, nearly a percentage point less than in the second half of 2000. Anticipation of a drastic plunge of oil prices has fueled capital flight, putting pressure on the exchange rate and monetary liquidity. As a strategy to spur demand for credit and increase the rate of economic growth, the government has adopted a number of measures to drive down interest rates and narrow the financial spread. However, credit demand has not yet responded to those incentives to any significant degree. As the average price of Venezuela's oil export basket continues its downward trend or if the OPEC orders further production cuts, the slowdown in the pace of economic activity may intensify, which would further stimulate capital flight. These trends could potentially have a negative impact on the financial sector.

### Recent events

- *Pressure on the foreign exchange market has forced monetary policy to become tighter*

The intensification of capital flight in 2001, and especially since the beginning of the second half, led the Central Bank of Venezuela (BCV) to further tighten monetary policy in an attempt to relieve the foreign exchange market. On August 10, 2001 the BCV adopted a set of resolutions designed to reduce the volume of money in circulation: a) an increase in the bank reserve requirement for government deposits from 17% to 30%; b) a reduction in the maximum net foreign exchange position financial institutions can hold from 15% to 12% of equity; c) a reduction of the

maximum daily change in their foreign exchange position from 15% to 12%, and d) a prohibition on foreign exchange sales to companies not domiciled in the country. These measures' duration has yet to be specified, but they are not expected to be lifted in the near future. The bank reserve increase on government deposits caused a VEB 300 billion (approximately 2.2%) contraction of monetary liquidity and drastically reduced the financial institutions' surplus reserve position. The contraction of monetary liquidity will probably reverse the downward trend of interest rates and put stronger pressure on the banking system's management of the structural liquidity gap.

- *Three mergers announced in 2000 were completed*

Continuing to support the trend toward a reduction in the number of institutions in the Venezuelan financial system, the authorities approved three bank mergers in 2001: Unibanca Banco Universal (Banco Unión and Caja Familia E.A.P.), Fondo Común Banco Universal (Banco República and Fondo Común E.A.P.), and Norvalbank Banco Universal (Banco Noroco and Valencia E.A.P.). In addition, the operating mergers between Banco Mercantil and Interbank, and between Banco Provincial and Banco de Lara, were completed. Seventy seven financial institutions (38 universal and commercial banks) operated in Venezuela at the end of June 2001, compared to 87 institutions in operation at the end of June 2000.

- *Increased cost of bank deposit insurance*

In the second half of 2001 the Deposit Guarantee Fund (FOGADE) updated its basis for calculating the deposit insurance premium. Whereas before the calculation was based on deposits from the public minus deposits at the central bank used to comply with liquidity reserve requirements, it now includes the latter amount. This measure could cause a nearly 20% increase of bank contributions, which would represent 3% of total operating cost. That would further drive up the financial system's already high overheads.

- *Internet banking has substantially expanded its penetration, a trend which is expected to continue in the future*

Eighteen financial institutions had transactional websites at end-June 2001; these institutions account for 92% of the commercial and universal banking system's deposits. The need to reduce operating costs and offer high value-added services to cope with

competition will spur further development of this channel of distribution.

**The financial system's performance through June 2001<sup>1</sup>**

- *The growth of credit demand slows down*

Excluding the effects of certain accounting changes for loans granted under the Housing Policy Act Program<sup>2</sup>, net lending grew by a bare 1.3%<sup>3</sup> (falling slightly more than 4% in real terms) vs. end-2000. The economy's faltering strength was also reflected in the behavior of asset quality; the ratio of impaired loans to total loans rose to 5.4%, nearly a percentage point higher than at end-2000. However, an appropriate pattern of loan loss provisioning kept the coverage of impaired lending at 133%. It is important to note that a long period of economic instability has provoked a substantial growth of repossessed assets, which represented 1% of total assets in June 2001 compared with just 0.1% at end-1997.

- *Competition in an environment of meager credit demand continues to pressure margins*

The sluggish growth in lending, in combination with government pressure to narrow the financial spread, led to a new reduction of net interest margins (NIM) to 10.9%. In the first half of 2001, the BCV began direct placement of REPOS (sales of national public bonds with a short-term repurchase commitment) as a tool to drive up deposit rates in the banking system; the rate for 90-day time deposits has risen by more than 4 percentage points (to 18%) since these securities first went on sale in May 2001. The banks have intensified their income diversification and operating cost reduction efforts to offset the lower profitability of intermediation, but these actions have not advanced as quickly as the spread has narrowed. This trend is expected to continue in the second half of 2001, due both to competition and government pressure.

- *For the first time since 1996, deposits from the public contracted in nominal terms in the first half of the year*

The smaller volume of public spending and the rising tide of capital flight combined to depress deposits from the public, which dropped by 5% in the first half of 2001<sup>4</sup>, while the cumulative inflation rate was 6%. The more than proportional reduction of liquid investments was reflected in falling liquidity indicators. Liquidity on the interbank market was more volatile in the first half of 2001 than in 2000, and the downward trend of interest rates came to an end in April 2001, as a result of the liquidity squeeze in the market. This instability in conjunction with a very short-term structure of deposits has led some banks to move into the fixed-income market by placing commercial paper; they are trying to stretch out their average liability maturity and attract institutional funds, as well as those from savings unions. Four commercial paper issues for approximately USD 300 million have been approved to date, equivalent to 8% of total time deposits in the commercial and universal banking subsystems. The improvement of the secondary securities market and the BCV's rising volume of open market operations are needed to reduce the volatility of deposit flows.

- *The system's equity strength remains in being*

Maintenance of the Banking Superintendency's limitation on payment of cash dividends, the start of the timetable for increasing minimum capital stock required by the authorities and slow growth of assets combined to produce an improvement in capital ratios. The total equity to assets ratio rose to 14.7%, while the capital to risk-weighted assets ratio (local guidelines) came to 17.4%. Both of these figures were higher than the legal minimum levels (10% and 12%, respectively). It is important to note that capital ratios in foreign private institutions are higher than in their domestic counterparts and this gap has widened in the past 18 months as a result of the formers' higher profitability and capital injections into some institutions in the course of merging. Given the modest expected growth of assets and the timetable for increases of financial institutions' minimum capital stock (concluding in June 2002), no significant change in the Venezuelan banking system's equity levels is anticipated in the short-term.

<sup>1</sup> The figures reflect the commercial and universal banking system, which concentrates 93% of the Venezuelan financial system's total assets.

<sup>2</sup> A governmental program funded by workers and companies in order to provide mortgages to medium to lower income people.

<sup>3</sup> The figures were adjusted to exclude the effect of financial institutions which recently converted to universal banks: Unibanca, Fondo Común, and Norvalbank.

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## The leading banks' performance

**Banco Provincial** (Provincial, majority owned by Banco Bilbao Vizcaya Argentaria (BBVA)): The country's largest bank in terms of deposits (for local operations), Provincial has also been hit by the capital flight prevailing in the first half of 2001; during that period its total funds under management (deposits + liquid asset funds<sup>5</sup>) contracted by nearly 5%. The economy's slowdown has also had a negative impact on Provincial's broad consumer loan portfolio, leading to a deterioration in asset quality indicators; the ratio of impaired loans to total loans rose slightly to 4.6%. The institution's profitability kept its downward trend, affected by higher loan loss provisioning, lower margins and the 9% growth in overheads that offset an 8% increase of other operating income. The intensification of competition in the banking industry and the meager opportunities to place loans have negatively affected Provincial's NIM, which is at a level similar to the market average, while it was at least 10% higher than the market in 1996 and 1997. Progress in mergers by other financial institutions will stiffen competition for Provincial, and may continue threatening its market share and profitability.

**Banco Mercantil** (Mercantil): The second largest Venezuelan bank completed its operating merger with Interbank in the first half of 2001. Its efforts concentrated on integration of the two institutions' platforms and cultures. Mercantil now has not only an advantageous position in the middle market segment, but also the country's largest mortgage and trust portfolios. However, in spite of its strength in highly profitable business segments, Mercantil's high overheads and the costs associated with the merger will continue constraining its profitability. Despite the low growth in lending (+1%) and investments in a period of lower interest rates, Mercantil was able to keep its NIM at levels similar to those of 2000 (12%) and slightly higher than the market average. This was achieved as a result of a smaller relative share in corporate banking and higher profitability of the investment portfolio. However, the 32% growth of operating costs, (partially affected by the incorporation of Interbank's operations during 2001) and the 25% increase in loan loss provisions resulted in a decline in profitability ratios. Control of

operating costs is the institution's greatest challenge and success will enable it to benefit from its competitive advantages in the segments with the highest margins, thereby raising profitability and strengthening its equity base.

**Banco de Venezuela** (BdV, majority owned by Banco Santander Central Hispano (BSCH)): In view of BdV's highly corporate-oriented loan portfolio, it has not suffered any major portfolio contraction, as have most of its competitors. It has even improved its impaired to total loans ratio to 1.5%. Growing competition in the corporate lending market and for deposits continues to depress the institution's NIM, but this trend might be reversed as a result of the recent increase of corporate lending rates in exchange for lower lending rates for individuals and the middle market. Better asset quality and higher other operating income contributed to raise net earnings by 22%. BdV is now in the midst of a merger with Banco Caracas, which is expected to be completed in the first half of 2002. Adaptation of Banco Caracas' risk control systems and operating platform - characterized by smaller size and less sophisticated customers on the asset side and rate seekers and high-income customers on the liability side- are the greatest challenges to maintenance of asset quality and profitability.

**Banco Unión Caja Familia** (Unibanca): The merger between Banco Unión and Caja Familia EAP was authorized in February 2001, leading to the birth of Unibanca. The capitalization of Caja Familia by its old shareholders allowed Unibanca to overcome the equity sufficiency problems of its predecessor Banco Unión; the equity to assets ratio rose to 14% at end-June 2001, 2 percentage points higher than the legal floor level and almost 9 points higher than Banco Unión's at end-2000. However, Fitch still has reservations about the quality of Unibanca's equity base, since a large part of it consists of stock issue premiums not paid for in cash but based on future cost savings. Unibanca has the country's largest credit card financing portfolio and the second largest mortgage lending portfolio; these two segments generate high margins but also high arrears in payment. In spite of the progress made in asset quality, the institution still has a 9.3% impaired to total loans ratio, nearly doubling that of the system; coverage of impaired loans stands at 125%. The growth of business volumes and control over operating costs, along with lower loan loss provisioning, allowed net earnings to surge by over

<sup>5</sup> Instruments which, under current regulations, are backed by securities issued or guaranteed by the Nation or by deposits in other financial institutions and are not required to maintain reserve requirement in BCV.

83%, more than doubling its ROA ratio in the first half of 2001. The institution has had a great deal of success in the introduction of a new trademark, but improvement of risk control tools and cost containment will be the keys to strengthening its financial profile.

**Banco Caracas** (Caracas, majority owned by BSCH): Since the arrival of the BSCH group in late 2000, Banco Caracas has been engaged in an aggressive program to improve asset quality, reduce the burden of operating costs, and improve funding costs. During the first half of 2001 the institution more than doubled its loan loss reserve coverage to 196%, while keeping the ratio of impaired to total loans at 6%. The 10% nominal reduction of operating costs, improved NIM and the growth of other operating income generated by an upward adjustment of fees and commissions, along with higher earnings from securities trading, led to an expansion of net earnings of more than 44%. During the first half of the year Caracas benefited from BSCH's financial and operating support, which has allowed it to take advantage of economies of scale, together with BdV, while improving its cost of funds. The institution is now in the midst of merging with BdV, a process expected to be completed in the first half of 2002. This merger will give rise to the country's largest financial institution, with an almost 19% share of deposits (local operations).

**Banco Occidental de Descuento:** BOD's aggressive growth strategy (74% growth in assets in the last 18 months), plus the strong competition in the sector and the instability of the Venezuelan economy, have provoked a sustained deterioration of its main financial ratios. Despite its 41% growth in lending in the first half of 2001, the higher volume of restructured loans has prevented any improvement of asset quality; the ratio of restructured + impaired to gross loans remained at 6.4%, a level slightly below the market average. Rising operating costs, in conjunction with a lower NIM (8.7% for June 2001, vs. an average 11.8% in the 1998-2000 period), continue putting pressure on profitability. Lower Venezuelan oil production volume at a time of declining oil prices could have a negative impact on BOD's leading area of influence; this will again put a premium on management's familiarity with the area, a key to maintaining and improving the institution's financial performance. Continued capital contributions by shareholders have relieved pressure

on capital ratios, though they are still below the sector average.

**Banesco Banco Universal (BBU):** After achieving rapid growth in 2000, BBU's asset growth rate slowed down to 9% in the first half of 2001, mainly due to the creation of Unibanca, a member of the Banesco Organización Financiera financial group. Though BBU's integration with Unibanca was temporarily postponed, the institution has kept up its policy of applying drastic impaired loan write-offs that cut the ratio of impaired to gross loans by almost 3 percentage points to 4.4%, a point below the sector average. It is important to note that BBU has followed a strict operating cost reduction policy since end-1999, and its cost to income ratio has come down from almost 80% in 1999 to 64% in the first half of 2001. Note that BBU's expenses in 1998 and 1999 were negatively impacted by the acquisition of several savings and loan institutions from which Caja Familia EAP (another member of Banesco Organización Financiera) was built up. The institution's operating structure focused on improving operating processes and the merger of these institutions. Management indicates that the merger with Unibanca will be completed once the two institutions' quality standards are equaled; quality of service to the customer base is among BBU's leading areas of strength.

**Caribe:** This institution's advantageous position in the middle market has allowed it to maintain a higher than average NIM (13%). However, rising operating costs and a sluggish pace of operations have brought about a deterioration of its efficiency indicators; the cost to income ratio rose again to 82% in the first half of 2001, while the cost to assets ratio was 14%; both of those figures are substantially higher than the market average. It should be noted that this growth of operating costs has been influenced in large measure by the aggressive program of upgrading the institution's IT platform, personnel training, and development of new products under way since 1999. Greater exploitation of the institution's comparative advantages in its principal market (the middle market) will enable Caribe to cope with the rising competition in the sector and achieve a larger volume of business along with optimization of its operating costs.

**Banco Exterior** (Exterior): The 14% growth of productive assets allowed Exterior to increase its net interest revenue by 27% despite the decline of

interest rates in the Venezuelan money market. However, external pressure on the financial spread slightly undercut the institution's high margin, and its NIM contracted to 17% in the first half of 2001. The higher business volume made it possible to offset the 27% increase of operating costs. The cost to income ratio came to 52%, similar to the figure for the first half of 2000. In the third quarter of 2001 the institution's majority shareholder (the Fierro group of Spain) completed a public offer of acquisition for a package of Exterior stock, though this did not imply any change in the institution's decision-making structure. At present the Fierro group controls approximately 85% of Exterior, and the remaining 15% is held by minority shareholders.

**Corp Banca:** After completing a reorganization plan launched in 1999 that included not only a merger with Banco del Orinoco but also a rationalization of personnel, offices, and operating costs, Corp Banca has greatly improved its profitability. In the first half of 2001 its ROA had risen to 3.3%, almost double its 1998 level and nearly a percentage point higher than the market average. That gain was achieved thanks to the concentration of lending to the retail market, which has allowed the institution to maintain its NIM over the last 18 months at 13%, and strict control of operating costs; the latter actually declining in nominal terms since 1999. As regards asset quality, Corp Banca has cut loan delinquency to levels close to the market average, but its ratio of impaired to gross loans rose by 1 percentage point over its December 2000 level to 5.7%. Loan loss reserve coverage stands at 96%, below the market average. It is important to note that Corp Banca handles the American Express credit card in Venezuela (nearly

10% of the institution's total loan portfolio), which has accounting methods that differentiate it from the typical consumer credit cards (payment cards, not financing cards). While this generates transitory pressure on the portfolio's arrears ratios (since both interest and capital are accounted for as past-due from the first day of non-payment), the rate of loss is a good deal lower than the average for consumer loans in Venezuela.

**Banco Venezolano de Crédito (BVC):** The stronger condition of the large corporation market has permitted an 8% growth in lending, while asset quality indicators keep their historical strength. In contrast to the sluggish activity in the middle market and loans to individuals, the large corporation segment in which BVC operates has shown substantial growth in the level of competition. In combination with the higher cost of funds brought about by intensifying capital flight, this has caused a slight reduction of BVC's NIM to 9%, almost 2 percentage point below the level of the first half of 2000. Additionally, the 1,275% increase in the tax burden produced by the exhaustion of tax losses available for carryforward, together with the reduction of other operating income, more than offset the drop in operating costs. ROA and ROE fell to 5% and 26%, respectively, though they continue to be among the highest in the industry. The institution revived its application to convert to a universal bank toward the end of the first half of 2001, as a result of which BVC is expected to merge with the specialized financial institutions of the Vencred group (investment bank, financial leasing company, and liquid asset fund) in 2001.

Bank	Individual	Support	Foreign Currency		Local Currency		Outlook	National
			L/Term	S/Term	L/Term	S/Term		L/Term
Banco Provincial	C	3T	BB-	B	B+	B	Stable	AA+(ven)
Banco Mercantil	C▼	4T	BB-	B	B+	B	Stable	AA+(ven)
Banco de Venezuela	C	3T	BB-	B	B+	B	Stable	-
Unibanca	D/E	4T	B	B	-	-	Evolving	-
Banco Caracas	D	4T	B+	B	-	-	Positive	A+(ven)
Banco Occidental de Descuento	C/D	4T	B+	B	B+	B	Stable	-
Banco del Caribe	D	4T	BB-	B	-	-	Stable	AA-(ven)
Banco Exterior	C	4T	B+	B	-	-	Stable	-
Banco Venezolano de Crédito	C	4T	BB-	B	B+	B	Stable	-

▼ Rating Watch Negative

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

	Assets (VEB bln)		Equity (VEB bln.)		Loans (VEB bln)		Equity/Assets (%)		NPL/Total Loans (%)		LLR Coverage (%)	
	Jun-01	Jun-00	Jun-01	Jun-00	Jun-01	Jun-00	Jun-01	Jun-00	Jun-01	Jun-00	Jun-01	Jun-00
BBV Banco Provincial	3,080.7	2,669.4	415.2	336.5	1,471.9	1,102.0	13.48	12.61	4.57	5.81	135.22	138.33
Banco Mercantil	3,016.2	2,234.1	367.0	290.7	1,534.5	1,256.6	12.17	13.01	4.05	3.84	158.88	150.91
Banco de Venezuela	2,451.5	1,799.2	476.8	197.7	1,017.1	870.1	19.45	10.99	1.47	2.02	190.38	164.43
Banco Unión (Unibanca)*	1,728.2	1,488.3	241.8	89.1	731.3	536.5	13.98	5.99	9.33	4.91	124.65	138.21
Banco Caracas	1,266.8	1,290.9	143.5	128.4	521.0	664.0	11.33	9.95	6.01	5.23	195.91	99.20
Corp Banca	817.7	822.8	96.0	88.9	476.1	466.5	11.74	10.80	5.71	5.07	96.08	107.27
Banco del Caribe	644.3	494.8	92.5	84.5	343.6	251.9	14.36	17.08	5.56	7.35	158.93	137.26
Banesco	749.4	599.9	81.8	61.4	235.3	215.4	10.92	10.23	4.41	7.18	246.68	135.56
Banco Occidental de Descuento	794.2	496.9	83.0	45.4	298.7	199.2	10.45	9.13	4.97	5.57	123.46	169.02
Banco Exterior	525.1	371.1	76.3	66.4	321.5	214.2	14.54	17.91	0.85	0.91	479.96	536.22
Banco Venezolano de Crédito	473.1	402.4	93.0	76.9	194.8	145.8	19.65	19.11	1.77	1.35	197.37	380.99
<b>System</b>	<b>18,900.6</b>	<b>15,476.4</b>	<b>2,742.1</b>	<b>2,051.0</b>	<b>8,091.8</b>	<b>6,695.3</b>	<b>14.68</b>	<b>13.71</b>	<b>5.44</b>	<b>5.44</b>	<b>133.32</b>	<b>114.47</b>

	Net Income (VEB bln)		Net Int. margin (%)		ROA (%)		ROE (%)		Cost-Income (%)		Cost/avg. Assets (%)	
	Jun-01	Jun-00	Jun-01	Jun-00	Jun-01	Jun-00	Jun-01	Jun-00	Jun-01	Jun-00	Jun-01	Jun-00
BBV Banco Provincial	41.8	39.6	10.83	12.40	2.59	3.10	20.76	23.80	75.56	75.80	10.23	11.80
Banco Mercantil	22.4	19.9	11.67	12.43	1.49	1.81	12.46	14.23	78.66	77.78	11.21	11.68
Banco de Venezuela	38.4	31.5	8.22	10.43	3.11	3.61	16.63	32.66	63.36	63.65	7.28	9.25
Banco Unión (Unibanca)*	13.2	7.3	10.90	10.12	3.50	1.31	18.50	18.38	78.14	83.04	10.40	13.28
Banco Caracas	17.3	11.9	11.80	11.17	2.70	2.08	25.31	20.29	57.58	74.08	8.06	10.03
Corp Banca	14.3	9.7	13.43	13.75	3.25	2.36	30.75	21.02	73.81	79.26	12.10	14.33
Banco del Caribe	5.5	8.2	13.05	15.34	1.79	3.21	12.00	19.91	82.34	73.84	14.15	15.38
Banesco	10.7	7.4	12.91	14.86	2.98	2.75	28.96	25.41	63.47	73.60	10.19	13.10
Banco Occidental de Descuento	10.5	4.9	8.66	10.51	2.95	2.06	28.63	23.96	84.02	79.02	7.44	9.26
Banco Exterior	14.7	11.8	16.88	19.36	5.92	6.94	40.75	37.66	52.39	51.01	9.62	11.08
Banco Venezolano de Crédito	11.2	15.9	8.85	11.04	4.96	8.78	25.68	43.51	57.95	53.84	7.89	10.34
<b>System</b>	<b>228.2</b>	<b>218.5</b>	<b>10.90</b>	<b>15.82</b>	<b>2.38</b>	<b>3.05</b>	<b>17.80</b>	<b>25.10</b>	<b>73.30</b>	<b>73.34</b>	<b>11.30</b>	<b>11.88</b>

Consolidated Figures.

\* June 2000 results come from Banco Unión unconsolidated figures.

Inflation.- IH00: 6.8%; IH01: 5.9%

Exchange Rate.- June-00: 682.00; June-01: 718.75

**Venezuelan Banks: September 2001**

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