

VENEZUELAN BANKS – 2001 RESULTS

- *Continuing capital outflow and a lower deposit base have brought stronger pressure on liquidity and driven up interest rates.*
- *Recently enacted laws affecting the financial sector and other sectors of the economy could make the operating environment more challenging for Venezuelan banks.*
- *In spite of the economy's instability in recent years, the system should continue to have adequate asset quality and capitalization levels.*

The Economic Climate

A negative trend prevailed in the oil market in 2001, in response to which the Venezuelan economy's growth rate faltered and the country's external accounts weakened, with the current account surplus dropping and capital outflow intensifying. As a result, the monetary base contracted and system liquidity tightened. This monetary restriction was reflected in a substantial upturn of interest rates during the year's last quarter, which will further inhibit economic growth if it persists. At the same time, the government's growing need for financing to compensate for falling oil revenues has forced it to place bond issues. This has been done more on the domestic than on the international markets in view of the country's relatively low sovereign rating. The resulting growth of internal debt by more than 28% (to USD 12.0 bln at end-September 2001) has not only intensified the upward pressure on interest rates but also partially crowded out the private sector from the bank credit market. In 2002, the Venezuelan government is likely to continue raising funds through the issuance of internal debt, though the recently announced reduction of estimated internal borrowing could relieve the resulting pressure to some extent. Continuation of low oil prices throughout 2002 and reduction of public spending could have a negative impact on the economy's performance, further depressing the demand for credit in the short run.

Recent Events

- *The economic policy change adopted in 2002 has subjected the money market to intense instability.*

Capital outflow intensified at the beginning of the year, funded by deposit withdrawals, which have deprived the financial system of liquidity. In response, as of February 13, 2002 the Central Bank put an end to the exchange rate band system in force since 1996, replacing it with a freely floating exchange rate system. The Central Bank can participate in the foreign exchange market as both a buyer and a seller, but it offers no more than USD 60 mln per day; foreign exchange purchases going beyond that limit must rely on dollars generated by private sources. As a result of the policy change, the bolivar has depreciated by 30% from its year-end 2001 level. This implies massive foreign exchange profits for the system, given the net asset position in foreign currency that the Venezuelan banks have historically maintained. The reduction of monetary liquidity prior to the economic policy shift, together with the new arrangement's initial effects, drove lending rates up to nearly 100% during the early weeks of the latter's application. Interest rates should subside once economic agents familiarize themselves with the new foreign exchange system and assuming the government keeps its promise to cut public spending, thereby avoiding the negative impact of high rates on economic activity and the banking system's asset quality.

- *A new Banking Act and a new Central Bank Act now regulate the Venezuelan financial system.*

The new Banking Law covers areas previously regulated by other laws and makes progress in bank regulation, but it also imposes certain rigidities on the operation of the banking business. In addition to the aforementioned laws, others recently enacted might adversely affect the banking industry's performance by changing the legal treatment of private property: the Lands Law (LL) and the Coasts Law (CL) (see Fitch Ratings' Latin America Quarterly, article entitled "Changes to Venezuela's Banking Law: Socially Desirable, but Economically Sound?" January 2002).

- *There is a growing likelihood of stricter controls on interest rates.*

In early 2002 the Supreme Court of Justice ruled in favor of a group of mortgage debtors against the Superintendency alleging the illegality of the so-

called Mexican credits (with continual refinancing of unpaid interest). It ordered the Central Bank to set the interest rates for the housing financing market retroactively to 1996 in view of the alleged non-existence of a competitive market allowing for the setting of free rate's setting. In the same ruling the Court also ordered the Central Bank to set lending rates for car loans with reservation of domain (retroactive to 1998). At the date of this report the Central Bank was still evaluating this ruling, and its scope has not yet been clarified. Mexican credits and car loans with a so-called balloon installment represented close to 4% of total system credit at end-2001.

The Financial System's Performance in 2001

- *Credit demand has contracted drastically.*

After growing by over 20% in 2000, the system's credit portfolio¹ expanded by only 10% in all of 2001, trailing behind the 12% inflation rate. This was a reflection of the slowing pace of economic activity, and in part, the upward path of interest rates since July 2001. These two factors also explain the slight deterioration of the asset quality indicators: the impaired to total loans ratio rose half a percentage point to 5.1%, while the loan loss reserves to impaired loans ratio fell to 127%, 6 percentage points below its 1999 level.

- *The instability in money markets and stronger competition continue putting pressure on margins.*

The weaker demand for credit, the system's liquidity squeeze, and competition for market share among the financial institutions have continued to put pressure on the banking system's overall Net Interest Margin (NIM), causing it to narrow by almost a percentage point, to 9.8%. That trend is likely to continue in 2002, forcing the banks to be more aggressive in diversifying their sources of income and controlling their costs. Though the Venezuelan banking system has reaped higher income from activities other than intermediation in the last two years, those income sources still contribute far less than the Latin American average. The ratio of other operating income to total assets came to 3.1% in 2001.

- *Cost reduction efforts are beginning to bear results.*

The initiatives launched by the banking system since late 1999, and the major payroll cuts it has carried out (-13% since end-1999), have relieved pressure in operating costs. The system's cost base rose by only 13% in 2001, approximately the same as the inflation rate, allowing the cost/average assets ratio to decline to 8.9%, one percentage point less than in 2000 and slightly less than three percentage points than in 1998. Maintenance of strict cost control policies will be the key to offsetting the lower profitability of intermediation activity.

- *The massive capital flight was reflected in a stagnation of deposits from the public.*

Despite the considerable expansion of public spending, capital outflows undermined monetary liquidity, with deposits growing only 1.7% in nominal terms in 2001. The money market's instability has made itself felt in a reduction of the system's liquidity; the average banking system's surplus reserves with the Central Bank fell by slightly over 30% vs. the level of 2000, to VEB 280.9 bln (USD 368 mln). However, due to the large share of total assets held in the form of government securities (17% at the end of 2001), the Cash and Marketable Securities to total funding ratio remained at 60%, considered an adequate level. The Central Bank has played an active role as supplier of funds to the system in early 2002, engaging in open market operations to mitigate the liquidity squeeze stemming from the growing volume of foreign currency purchases in the period.

Recent rating actions

During February 2002 Fitch Ratings downgraded the long-term foreign currency, local currency and national ratings of a number of Venezuelan banks. This action was triggered by the downgrade of Venezuela's sovereign long-term foreign currency rating to 'B+' (Outlook Negative) from 'BB-' and long-term local currency rating to 'B' from 'B+'. In addition, Fitch Ratings placed the Individual ratings of five Venezuelan banks on Rating Watch Negative in view of the deteriorating operating environment. Recently, the Venezuelan banking system has been affected by the country's lower economic activity and the measures taken by the Central Bank aimed at restricting bank liquidity in order to relieve the

¹ Adjusted for the effect of reclassification of the Housing Policy Program mortgage loan portfolio and the conversion of some institutions to universal banking status in the course of the year.

pressures in the foreign exchange market. In addition, further restrictive measures such as the imposition of compulsory lending to officially designated sectors, ceilings on fees and commissions to be charged by banks, elimination of raffles as a tool for attracting deposits and the setting of controlled interest rates for specific sectors, among others, are narrowing the Venezuelan financial institutions' room for maneuver, hence, increasing their operating risk. Nevertheless, Fitch Ratings acknowledges the benefits of the ample participation of foreign banks in the system, generally sound capital levels, asset quality ratios that compare favorably with other Latin American countries, and the significant improvement in supervision in recent years. Additionally, Fitch Ratings believes the experience built up by the Venezuelan financial institutions in previous periods of greater government control and volatile economic cycles contributes to partly mitigating the negative effects of the current environment. Table 1 shows the ratings currently assigned by Fitch Ratings to Venezuelan banks.

Performance of the Leading Banks

Banco Provincial (Provincial, majority owned by Banco Bilbao Vizcaya Argentaria (BBVA)): The growing wave of bank mergers and acquisitions under way since 2000 has triggered strong competition for leadership in the Venezuelan market. Though Provincial continues to be the leader in terms of deposits in Venezuela, the bank is no longer the country's largest financial group. The merger between Banco Mercantil and Interbank in 2001, and the merger between Banco de Venezuela and Banco Caracas expected to take place this year, will relegate Provincial to third place in terms of funds under management. Provincial has continued to follow a conservative policy, focusing on improving profitability and maintaining asset quality as its top-priority goals. Hence, Provincial's assets contracted by 2.8% over the course of 2001, while its impaired to total loans ratio remained unchanged at 3.8%. The rise of 23% in net interest revenue allowed Provincial to offset the growth of operating costs and the higher spending on provisions required to raise loan loss reserve coverage by 10 percentage points, to 166%. ROA rose slightly, to 3%. The different risk control tools and the pursuit of conservative liquidity policies allowed the institution to cope with no difficulties massive deposit withdrawals in late January (in response to baseless rumors about its soundness, possibly motivated by the climate of political instability prevailing in the country), relying on its

own funds. The institution's historically high liquidity levels allow Provincial to minimize the structural asymmetry of maturities that characterizes the Venezuelan financial system. In addition, it benefits from prospective liquidity support from its parent.

Banco Mercantil (Mercantil): Following its operational merger with Interbank, Mercantil has followed a conservative growth policy in response to the rising political and economic instability in Venezuela. During 2001, Mercantil has focused on integrating the two institutions and retaining Interbank's former customer base, together with more intensive monitoring of asset quality and efforts to control the institution's still high operating costs. The incorporation of Interbank's customers (chiefly middle market clients) in 2001 yielded a one percentage point improvement of Mercantil's NIM to 12%. This, together with the higher other operating income, made it possible to offset the pressure of operating costs and a lower level of extraordinary earnings than the previous year. ROA reached 2.5%, similar to the previous year's level. As far as asset quality is concerned, Mercantil improved its impaired to total loans ratio from 4.1% to 3.6%, while raising loan loss reserve coverage to 180%. Reflecting a change in the accounting manual issued by the Banking Superintendency, Mercantil reclassified nearly VEB 240 bln of loans, representing almost 8% of total assets at end-2000, to memorandum accounts; this artificially reduced the institution's asset growth.

Banco de Venezuela (BdV, majority owned by Banco Santander Central Hispano): BdV achieved a 16% growth of assets in 2001, thanks mainly to a larger volume of lending. The corporate profile of its portfolio, and the different risk control systems in place, allowed the bank to reduce its impaired to total loans ratio once again, this time to 1.3%, while expanding its coverage of impaired loans to 178%. The fierce competition in the corporate banking sector made itself felt in a steady reduction of NIM, to just 8%. In response, BdV has pursued a strict control of operating costs in recent years, and has also substantially increased other operating income; these trends have more than offset the NIM decline and kept profitability higher than the average for the large banks' segment. BdV's ROA rose to 3.4% in 2001, while its costs to average assets ratio was only 7%, one of the system's lowest. The merger between BdV and Banco Caracas is expected to be completed in 2002, and the resulting institution will take first

place in the national ranking, with a 19% market share for deposits and a strong presence in both the corporate and middle markets.

Unibanca Banco Universal (Unibanca): Unibanca's most important achievements in 2001, after completing the merger between Banco Unión and Caja Familia Entidad de Ahorro y Préstamo, were the establishment of its new trademark and a major improvement of profitability stemming from aggressive cost cutting and a more proactive policy regarding fees for services. Net earnings surged to VEB 35.8 bn, from less than VEB 4 bn the previous year. Given the importance of credit card and mortgage lending to the institution, Unibanca's impaired to total loans ratio was far above the market average (7.6%), but thanks to the reserves accumulated at the time of the merger, coverage of impaired loans increased to 155%. Though the institution's equity to assets ratio was slightly over 15.0% (much higher than the regulatory minimum), Fitch Ratings is concerned about the quality of the equity created at the time of the merger, particularly as regards valuation of the new institution's expected cash flow. As long as the shareholders refrain from distributing cash dividends, Unibanca's equity can improve in quality over time. Unibanca's merger with Banesco Banco Universal is expected to be completed in 2002, creating the country's fourth largest financial institution with 11% of total system deposits.

Banco Caracas (Caracas, majority owned by BSCH): In 2001 Caracas launched a far-reaching program to improve its financial profile, based on aggressive cost cutting, a clean-up of its credit portfolio, and integration of operating areas with Banco de Venezuela to prepare for the merger scheduled to take place in 2002. Loan loss reserve coverage was raised to over 150% (from 96% in 2000), and impaired loans were reduced by one percentage point to 5%. These actions were accompanied by the risk area's integration with that of Banco de Venezuela. Payroll cutbacks and more proactive treasury and service fee collection efforts allowed Caracas to raise its net earnings to VEB 38.9 bln, almost double the previous year's figure. It should be noted that the improvement process described above has not had a significant impact on its customer base; the institution's assets grew by 6% over their 2000 level.

Corp Banca Banco Universal (Corp Banca): Corp Banca has continued to focus on the primary

objective of strengthening its profitability, and has concentrated its efforts on its target market - the middle market. This strategy allowed the institution to keep its NIM virtually unchanged at 13%, while a new reduction of total costs improved the operating costs to average assets ratio to 11.5%, nearly 2 percentage points below the previous year's figure. This offset a reduction of other operating income and a more than 1800% surge of tax expense as a result of the reduction of tax losses available for carryforward; net earnings rose by 6%, with which ROA (2.9%) and ROE (28.3%) were almost unchanged. In spite of this, Corp Banca experienced a growth of its impaired to total loans ratio to 6%, slightly above the market average and exceeding its own figure at end-2000. It is important to note that Corp Banca handles the American Express Card in Venezuela (nearly 10% of the bank's total loan portfolio), which has accounting methods that differentiate from the typical consumer credit cards (payment cards, not financing cards). While this generates transitory pressure on the portfolio's impaired loan ratios (since both interest and capital are accounted as past-due from the first day of non-payment), the rate of loss is a significantly lower than the average for consumer loans in Venezuela.

Banco Occidental de Descuento (BOD): In 2001 BOD continued to pursue its expansion strategy, both in its region of origin (Zulia State) and nationwide. The institution has followed an aggressive strategy of middle market participation, and has targeted the corporate market to a lesser extent. One component of its strategy is aggressive pricing, which significantly drove down its once-high NIM to 7.7%, compared to 10% the previous year and lower than the market average. This reduction of NIM and the pressure on operating costs typical of a period of expansion resulted in a substantial decline of profitability, which was offset over the course of the year by the sale of some real properties and which contributed large extraordinary gains. The growth of gross lending by nearly 80% produced an improvement of the impaired to total loans ratio to 4.7%, from over 6% at end-2000 although impaired loans grew by 10% in the year. The institution's aggressive growth has required injections of capital to fulfill the legal minimum requirements, but capitalization is still below the industry average (a 10% Equity to Assets ratio, vs. a 14% average).

Banesco Banco Universal (BBU): In 2001 BBU continued its expansion, with assets growing by 19%. BBU focused on improving asset quality during the

year, by taking major portfolio write-offs and increasing loan loss provisions. The impaired to total loans ratio had fallen to 4.7% by the end of 2001, compared with 7.4% at end-2000. The loan loss reserve coverage ratio increased to 220%, almost 60 percentage points higher than the previous year's figure. BBU must still complete its ongoing efforts to improve asset quality, especially in a climate of strong economic instability. The institution's profitability benefited from a higher volume of business and from the operating cost savings produced by the integration of BBU's operating platform with that of Unibanca Banco Universal, which belongs to the same economic group. This offset the reduction of NIM to 12%. The merger process among BBU, Unibanca Banco Universal, and smaller institutions owned by Banesco Organización Financiera (BBU's leading shareholder and a shareholder of Unibanca) and Grupo Unión (a Unibanca shareholder) will start in 2002, creating the country's fourth largest financial institution with a dominant position in the personal finance market and a strong one in the middle market. Significantly, both BBU and Unibanca have weaker financial profiles than their competitors, suggesting the need for further efforts to cope with the unstable conditions expected to prevail in 2002. The management has focused its attention on improving asset quality and containing operating costs.

Banco del Caribe (Caribe): Caribe's advantageous position in the middle market and stronger commercial efforts yielded a growth in the institution's size, and hence, in its market share. Caribe's total assets expanded by 25% in 2001. This growth in a climate of intense competition has depressed the institution's historically high NIM, though it is still above the industry average. Amortization of IT investments and staff training have kept Caribe's efficiency indicators under pressure since 1999, but its efforts to cut operating costs reduced its cost to average assets ratio by almost one percentage point to 13% in 2001. In mid-2001 Caribe decided to set aside VEB 2.8 bln (50% of net earnings for the first half of the year) to strengthen its loan loss reserves in anticipation of a potential weakening in 2002, reflecting the impact of the expected economic instability.

Banco Exterior (Exterior): Exterior has become one of the most profitable financial institutions in Venezuela thanks to a conservative growth strategy and strict control of operating costs. At end-2001 Exterior's ROA had risen to 6.4%, compared to a 2.6% market average. Its strong position in the middle market and retail market have allowed it to maintain a NIM significantly higher than the market average (17% in 2001), though it has been declining in recent years as a result of its competitors' increasing focus on that market segment. Exterior has followed a conservative lending policy, which reflect in some of the best asset quality indicators of the system; at end-2001 its impaired to total loans ratio was only 0.7%, close to the previous year's figure, and it held loan loss reserves amounting to over 500%. Moreover, since mid-2001 Exterior has been further strengthening its credit controls to cope with the deterioration in the economic environment.

Banco Venezolano de Crédito (BVC): The growth of demand for corporate credit, and its portfolio of investments, together with the government's pressure on the banking system to reduce interest rates on consumer loans at the expense of rates on corporate loans, produced a slight improvement of NIM to 10.3%. This improvement of NIM and the institution's control of expenses were more than offset, however, by the higher expenses stemming from the expiration of a large proportion of tax losses available for carryforward, which raised those expenses to VEB 1.9 bln from a mere VEB 0.3 bln the previous year. This situation made itself felt in the form of a reduction of ROA to 6.4%, though that figure is still more than double the market average. The quality of BVC's assets underwent no significant change vis-à-vis their historic trend (one of the best in the Venezuelan financial system) during the year. The ratio of impaired to total loans rose slightly to 1.8% at end-2001, but loan loss reserve coverage exceeded 200%. At the outset of 2002 the regulatory authorities authorized BVC's conversion to a universal bank, by means of a merger among BVC, Soficrédito Banco de Inversión, and Sogecrédito Empresa de Arrendamiento Financiero, all belonging to the Vencred group and controlled by a stockholding structure similar to BVC's. This merger is expected to be completed in the first half of 2002.

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▼	3T	B+	B	B	B	Negative	AA(ven)
Banco Mercantil	C▼	4T	B+	B	B	B	Negative	AA(ven)
Banco de Venezuela	C▼	3T	B+	B	B	B	Negative	-
Unibanca	D/E	4T	B-	B	-	-	Stable	-
Banesco Banco Universal	D/E	4T	B-	B	-	-	Stable	-
Banco Caracas	D	3T	B+	B	-	-	Negative	-
Banco Occidental de Descuento	D	4T	B	B	B	B	Stable	-
Banco del Caribe	D	4T	B+	B	B	B	Negative	A+(ven)
Banco Exterior	C▼	4T	B+	B	B	B	Negative	A+(ven)
Banco Venezolano de Crédito	C▼	4T	B+	B	B	B	Negative	-

▼ Rating Watch 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 (%)	
	2001	2000	2001	2000	2001	2000	2001	2000	2001	2000	2001	2000
BBV Banco Provincial	3,284.0	3,378.8	445.0	390.8	1,621.9	1,458.3	13.55	11.57	3.84	3.86	165.96	154.64
Banco Mercantil*	3,160.1	3,002.8	391.3	352.5	1,646.6	1,524.4	12.38	11.74	3.55	4.06	180.07	152.87
Banco de Venezuela	2,885.1	2,484.3	450.6	445.5	1,323.5	1,028.2	15.62	17.93	1.25	2.01	177.72	155.35
Banco Unión (Unibanca) ^a	1,686.6	1,640.6	258.3	89.1	621.7	585.6	15.32	5.43	7.61	4.56	154.87	149.74
Banco Caracas	1,373.0	1,292.1	146.4	129.4	516.4	629.8	10.66	10.01	5.13	6.02	153.58	96.35
Corp Banca	947.4	945.0	104.7	90.3	557.3	511.3	11.05	9.56	6.07	4.57	80.92	111.23
Banco del Caribe	731.6	586.4	96.2	90.8	412.5	317.0	13.15	15.48	5.54	5.99	159.19	150.27
Banesco	822.3	690.0	96.3	66.3	236.2	213.4	11.71	9.61	4.65	7.39	220.00	153.91
Banco Occidental de Descuento	889.2	632.7	90.7	64.1	378.8	211.9	10.20	10.13	3.93	6.14	118.55	137.26
Banco Exterior	588.0	467.5	89.3	68.0	355.8	276.5	15.19	14.54	0.71	0.61	549.17	692.71
Banco Venezolano de Crédito	519.2	427.7	101.9	81.0	197.0	179.7	19.63	18.93	1.79	1.66	210.46	225.34
System	21,607.6	18,795.0	3,020.4	2,364.8	9,415.2	7,880.1	14.13	12.86	5.14	4.69	126.74	132.95

	Net Income (VEB bln)		Net Int. Margin (%)		ROA (%)		ROE (%)		Cost/Income (%)		Cost/Avg. Assets (%)	
	2001	2000	2001	2000	2001	2000	2001	2000	2001	2000	2001	2000
BBV Banco Provincial	100.2	74.6	11.71	10.53	3.01	2.47	23.97	20.51	71.34	78.48	10.21	10.10
Banco Mercantil*	76.5	69.8	12.31	11.27	2.48	2.71	20.58	22.50	71.16	78.50	10.72	10.68
Banco de Venezuela	91.1	61.6	8.13	8.87	3.39	2.95	20.33	19.46	61.28	65.09	7.05	7.84
Banco Unión (Unibanca) ^a	35.8	3.5	11.49	n.a.	2.15	n.a.	20.61	n.a.	73.24	81.99	11.47	n.a.
Banco Caracas	38.9	13.1	10.81	11.50	2.92	1.15	28.20	11.13	58.39	77.48	7.03	10.61
Corp Banca	27.6	26.0	12.72	13.34	2.92	2.94	28.30	29.02	73.32	76.39	11.49	13.39
Banco del Caribe	11.5	14.9	13.19	13.45	1.74	2.67	12.27	17.39	79.21	76.28	13.21	14.27
Banesco	28.5	18.3	12.26	15.50	3.77	3.16	35.10	30.36	62.05	66.34	10.10	12.22
Banco Occidental de Descuento	17.0	10.0	7.70	10.10	2.24	1.83	21.99	19.78	81.03	71.29	7.77	7.79
Banco Exterior	33.9	24.1	16.84	18.11	6.43	6.21	43.16	38.03	52.08	52.33	9.74	10.57
Banco Venezolano de Crédito	30.3	29.0	10.34	9.63	6.41	6.99	33.19	36.75	54.59	55.67	8.23	8.93
System	559.7	430.1	10.87	11.11	2.59	2.29	18.53	18.19	70.44	74.05	9.85	10.69

Consolidated Figures.

^a Results for 2000 come from Banco Unión's unconsolidated figures.

* 2000 figures adjusted to equalize the effects of Interbank's merger.

Inflation: 2000 - 13.2%; 2001 - 12.3%

Exchange Rate: 2000 - 699.75; 2001 - 763.00