

## Special Report

**Venezuelan Banks: Unplugged****Analysts**

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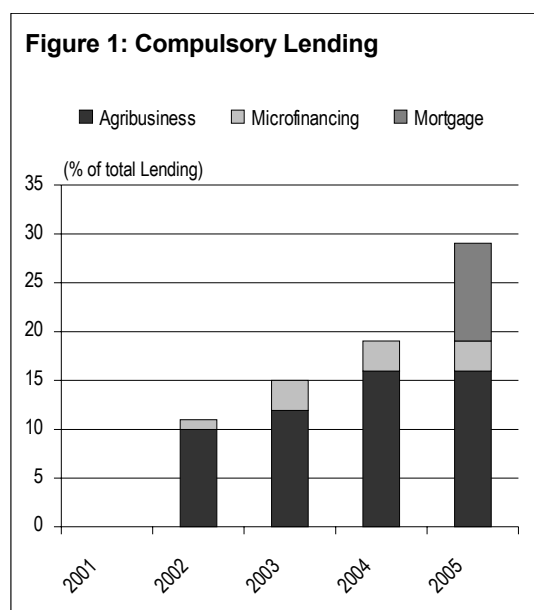
**■ Overview**

- As part of its economic policy framework, the Venezuelan government has adopted a number of measures in the past few years aimed at controlling certain activities of banks. Until recently, measures had been limited to compulsory lending requirements (mostly at controlled interest rates), which had been introduced gradually since 1999, and limiting of fees for specific products. However, it appears that the pace of these reforms and their relevance in terms of the impact that they may have on banks' financial profiles have been increasing in recent times. Currently, there are a number of new proposals that, if implemented, would further control bank operations.
- As such, Venezuelan banks have had compulsory lending requirements at government controlled rates to the agricultural sector since 1999 (currently set at a minimum of 16% of total lending), microbusiness sector since 2001 (3% of total lending but interest rates not directly controlled), and controls over fees and commissions of some products since 2003. In 2005, compulsory lending at government defined rates to the mortgage sector was introduced (10% of total lending), as well maximum and minimum levels for lending and deposit rates. In many of the aforementioned cases, interest rates charged by banks to clients are negative in real terms (nominal interest rates below inflation). Also, in 2005 the government eliminated all fees relating to the maintenance of savings accounts and charges for check processing, among others.
- Measures that could potentially be introduced in the future comprise the elimination of fiscal exemptions for banks of income from government securities (roughly 40% of total banking system's assets) and the incorporation of off-balance sheet ceded investments into the balance sheet of banks, which would negatively impact their regulatory equity to assets ratios (minimum 10%), particularly in an environment of high growth of monetary assets since the imposition of foreign exchange controls in 2003.
- There are a number of other threats to the system, such as a legal dispute over mortgage loans granted in the late 1990s, which could ultimately result (although unlikely at this stage) in a number of banks' presidents facing criminal charges, as well as the increase of compulsory lending requirements to micro-businesses and the tourism industry. In addition, the National Assembly is in the process of approving the reform to the 2001 Banking Law and other regulatory pieces that may increase government intervention in the future.
- As Fitch pointed out since the approval of the current Banking Law in 2001, government intervention remains one of the key risks for Venezuelan banks while new measures taken by the authorities gradually reduce the system's room to maneuver in case of an economic downturn. In this regard, Fitch notes that banks are the only institutional investor of any relevance in Venezuela, and therefore able to absorb often hefty domestic sovereign issuances. In Fitch's view, if the health of the banking system is endangered, the government's ability to finance itself locally may be hampered.
- The ratings of Venezuelan banks are already low reflecting the uncertain operating environment. However, Fitch has placed the international debt ratings of Venezuelan banks on negative outlook reflecting the likelihood that the newly implemented measures will further restrict their financial flexibility, which may become blatant in the coming months. Were a number of additional measures, including, but not restricted to those mentioned above, to be implemented, which in Fitch's judgment negatively impact bank performance, the international debt and Individual ratings of Venezuelan banks may be reassessed.

**May 17, 2005**

## ■ Compulsory Lending

The current government has identified different key sectors in need of development in order to reduce the local economy's dependence on oil exports. As such, it has launched initiatives aimed at promoting flows of funds into these sectors, which not only include budgetary allocations but also place requirements on commercial and universal banks to support these sectors through specific loan programs. Currently, the government has ruled that 29% of the banking system's total loan portfolio be comprised of loans to segments which it has decided to support (see Figure 1). The programs that are in place in Venezuela are as follows:



- **Agricultural Loans**

The first mandated lending program was launched in 1999. As stipulated in the Agricultural Credit Law (ACL), all financial institutions are required to allocate a percentage of their total lending to agriculture. At the beginning of each year the government and the financial institutions must reach an agreement on the volume of loans to be channeled to the agricultural sector. The ACL stipulates, however, that if an agreement is not reached, the government has the right to determine unilaterally the percentage that must be allocated to agricultural lending, which could reach up to 25% of total loans. For 2005, the government and banks agreed to lend to the agricultural sector (requirement that has to be fulfilled by year-end) a total of 16% of the gross loan portfolio posted at end-2004. This agreement implies new loans to the sector for around USD 300 million, in addition to the outstanding balance of around USD 1,300

million. On the other hand, banks are required to lend to the agricultural sector at preferential rates, equal to 80% of the average lending rates charged by the country's six largest commercial and universal banks. This rate is published by the Central Bank and interest is payable by the borrower at the end of the period instead of in advance, in contrast with the majority of commercial loans in Venezuela.

- **Micro Loans**

Under the 2001 Banking Law, the country's commercial banks, universal banks, and savings and loans institutions (S&L) must also allocate a percentage of their lending to "microloans" or make placements in financial institutions specializing in this type of lending. The percentage was initially fixed at 1% of total lending but after a two year period of adjustment the percentage was raised to 3% of total loans, while recent discussions regarding the reform to the current Banking Law could result in the increase of this percentage going forward. Micro-companies are (broadly) defined as those with annual sales lower than 9,000 *unidades tributarias* (currently equivalent to around USD 120,000). Also, micro-companies should not have more than 10 employees. Interest rates are not directly controlled by the government (except for the recent maximum lending rate imposed by the government, see "Interest Rate Controls" below). At end-2004, micro loans represented around 3% of total lending (USD 300 million) although the short term nature of these loans require a constant effort by banks to continue meeting this requirement.

- **Mortgage Loans**

In January 2005 the government approved the *Ley Especial de Protección al Deudor Hipotecario de Vivienda* (LEPDHV). This law requires universal banks and savings and loans institutions to allocate a portion of their loan portfolios into mortgage loans; the government re-sets the amount of the loan portfolio to be placed in such type of lending annually. Other issues, such as specific rules regarding interest rates and procedures regarding foreclosures, among others, were also detailed in the law. For 2005, the LEPDHV mandates that at least 10% of the loan portfolio recorded at end-2004 has to be placed in mortgages. At the same time, interest rates on this product are tied to the income of the debtor, with a nominal ceiling of 18%. Each year the government sets the annual interest rate cap according to its own formula, which resulted in a maximum annual interest rate of 11.75% for 2005.

According to the law, the aforementioned 10% of loans will be distributed as follows: at least 7% for short term loans (not more than 3 years) to finance housing projects and not more than 3% for long term loans (up to 15 years) to finance the acquisition of first mortgages by individuals. It is interesting to note that, to date, relatively few banks have targeted this segment due to its inherent riskiness, and many institutions will have difficulty in meeting the 10% of total lending allocation. This could potentially result in poor exposure selection and, consequently, deteriorating asset quality. Additionally, this will result, in Fitch's view, in structural maturity mismatch due to the inexistence of long term funding in Venezuela. At end-2004 long term mortgage loans represented only 2.4% of total lending (USD 625 million lower than the amount required by the law at end-2005). While the short term mortgage portfolio is not explicitly identified in sectorial data, based on Fitch's assessment, it is highly likely that the financing to this sector is currently way below the 7% requirement.

- **Extent of compliance of current loan portfolio requirements and other prospective measures**

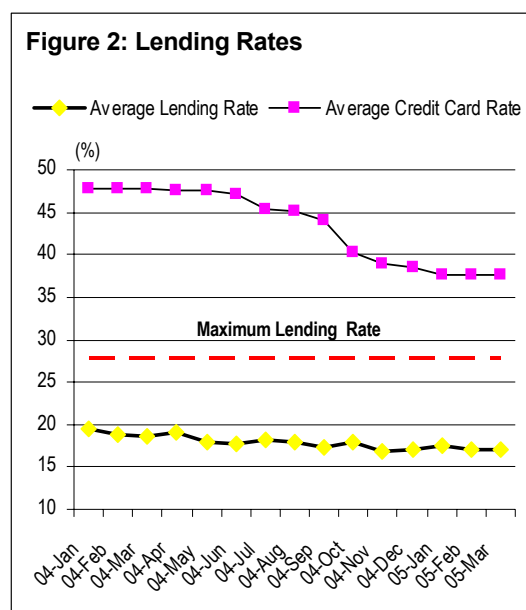
To date the majority of banks have complied with agricultural and microfinance lending requirements. On the other hand, almost no bank complies with the recent mortgage lending regulation. In this regard, Fitch expects that many of the large banks will be able to comply with the latter requirement by year end, however an increase in the riskiness of their loan portfolios is to be expected as lending to the aforementioned sectors requires specific credit risk tools and certain infrastructure, which may be currently lacking at some players.

Recent discussions over the regulatory framework of the banking system have raised the possibility of an increase to the microloans portfolio as well as a new requirement to lend to the tourism sector, which has been rumored in previous weeks to be between 2.5% and 10% of the banking system's total loan portfolio.

## ■ Interest Rate Controls

Under article 49 of the *Ley del Banco Central de Venezuela*, the Central Bank is the only agency empowered to regulate interest rates in the financial system. In the exercise of its power, the Central Bank may set maximum and minimum levels for lending and deposit rates for banks and other financial institutions. Although the Venezuelan banking system operated under strict interest rate

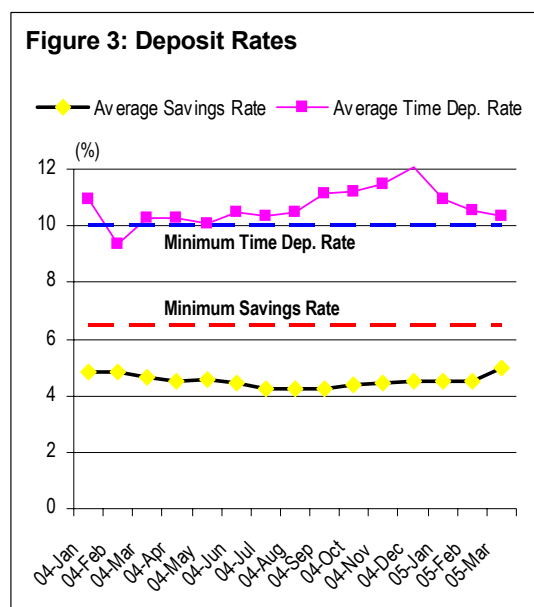
controls prior to 1989, from that year until 2005 lending rates were regulated for only two business segments: a) agricultural loans and b) mortgage loans funded by the government. However, in April 2005 the Central Bank imposed a ceiling for lending rates fixed at the rate charged by the Central Bank in assistance operations to banks minus 50 bps (currently 28%). Additionally, savings rates were also assigned a floor calculated as the rate paid by the Central Bank for its 28-day deposits minus 500 bps (currently 6.5%) while time deposits was set a floor at the rate paid by the Central Bank for its 28-day deposits minus 150 bps (currently 10%).



The excess liquidity observed in the system since the implementation of the foreign exchange control in early 2003 has resulted in a significant decline in interest rates, reflected in the average lending and term deposit rates for 2004 reaching 18% and 11%, respectively. Although these rates are in line with the recently imposed floors and ceilings, when individual rates are assessed some products will have to adjust their rates in order to comply with the new rules. For instance, the average savings rate for 2004 was 4.5% while credit card loans had an average annual rate of 44%. It is worth pointing out that credit card loans account for around 10% of total lending, which is still a relatively low proportion of the overall loan portfolio. Regarding funding costs, the impact of the recent measures should be significant, since there was a wide dispersion in the rates paid in savings and term deposits, depending on the size of individual deposits, while they will be brought to the same levels regardless of amounts. For this reason, Fitch

expects an increase in the average funding costs for the system. At end-2004, savings and time deposits represented 19% and 38%, respectively, of total managed funds. In general, while the system's net interest margins should decline, this will happen from still reasonably high levels of 8.4% at end-2004 (including *inversiones cedidas*, see below).

It is also interesting to note that in many instances banks are charging negative real interest rates on a number of products, since inflation was 22% in 2004 and is likely to hover around 18% in 2005. This inevitably erodes bank profitability.



## ■ Control over Fees and Commissions

Similar to the trend followed by other banks in Latin America, Venezuelan banks have recently started charging fees and commissions aimed at diversifying revenue sources. While fees charged by Venezuelan banks are still moderate (less than 10% of total revenue in 2004), the government has argued that fees have been increasing rapidly since 2001. As a consequence, in 2003 a ceiling was placed on fees relating to services such as maintenance of checking accounts and penalties derived from returned checks, among others. Since 2005 the government decided that banks should eliminate all fees relating to the maintenance of savings accounts and charges for check processing. In turn, some “packaged products” cannot be offered, as the authorities argue that the client has the right to request each service separately.

## ■ Other Regulatory Issues

### • Legal settlement over mortgage loans

The Venezuelan government has, in recent years, ruled against the banks over the so-called Mexican loans (with continual refinancing of unpaid interest). In early 2002 the Supreme Court of Justice ruled in favor of a group of mortgage debtors against several banks and the Superintendency, alleging the illegality of these loans and ordering the Central Bank to calculate the interest rates for those loans retroactively since 1996. In addition, the decision mandated the banks to recalculate those loans using the new interest rate, which resulted in almost every case in a significant reduction of outstanding balances while debtors who had paid their loans before this decision had the right to receive a reimbursement. While these loans did not represent more than 4% of total lending at the time of the initial plea (2002), constant recalculations since then have required significant charge-offs for many banks, the latest recalculation taking place in 2005. As a consequence, a number of banks' presidents (including some of the largest banks) have been called to court to testify, while they could potentially face criminal charges that carry penalties of imprisonment. If charges are pressed, the proceedings are likely to be protracted and would have further negative impact on the business environment in Venezuela.

### • *Inversiones cedidas*

Recently, government officials have stated the need to change some accounting rules related to the so called *inversiones cedidas* (ceded investments or investment funds). This product is offered by universal banks and “*Fondos del Mercado Monetario*” and amounted to around USD 5,600 million at end-2004, or 17% of total invested funds (Assets + Investment Funds). *Inversiones cedidas* consist of the sale to the public of participations in securities portfolios, with the bank having the obligation to repurchase them at a specified date (but possibly even on demand), usually at a fixed yield. The securities portfolio ceded to the investors is deducted from the banks' investment portfolio and the funds raised through the sales are recorded in an off balance sheet line. With this product, investors have the same protection as a regular bank deposit provided by the Deposit Guarantee Fund (FOGADE). On the other hand, it is an attractive product for banks since these funds do not need to comply with the 15% cash reserve requirement mandated by the Central Bank for on-balance deposits.

The authorities' proposal is to bring the *inversiones cedidas* on balance sheet. If this takes place, the inclusion of these funds into the balance sheet will significantly increase the size of the system's assets (by around 21% at end-2004) and therefore will pressure regulatory capital ratios. However, it is important to note that while the risk adjusted capital ratio would not be affected by this change (since most of this portfolio is made up of zero-risk weighted government securities), the Venezuelan Banking law requires also a minimum 10% of equity to total assets for the banks. If these funds are moved on balance sheet, the banking system's equity to assets ratio, using end-2004 figures, would decline from 12.6% to 10.4%. In turn, some large and medium sized banks would fall below the legal minimum requirement. According to some government officials this process will likely be phased in progressively giving enough time for banks to adjust their balances and equity to the new requirements, while some progressive adjustments would be made to the cash reserve requirements of those funds in the future. In the past, Fitch Ratings has noted the quasi deposit nature of *inversiones cedidas*, given the reputational risk for banks of not promptly repaying these funds at the request of the depositor. For this reason, a progressive incorporation of these funds into the balance sheet would be desirable. However, the timing and the

phasing in period for the implementation will be crucial as this measure could result in a severe blow to many of the banks, particularly given the increase in monetary liquidity in Venezuela as a result of the foreign exchange controls and fiscal expenditures, which are also pressuring equity to assets ratios of most institutions.

- **Changes to the fiscal treatment of new local currency debt issuances**

In recent weeks, some government officials have stated the need to increase the tax burden for banks, since a significant part of their income is tax exempt (income received from government securities has been historically tax free for Venezuelan residents). As a consequence, the tax authorities are contemplating proposing legislative changes to make this income taxable for Venezuelan banks. However, this is still in early discussions and at this point in time it is not clear how this change would be imposed nor whether it would only affect new debt issuances or also pre-existing government securities. At end-2004, total government securities (including *inversiones cedidas*) represented roughly 40% of total invested funds. If the aforementioned proposal is implemented in the future, the profitability of Venezuelan banks could be further threatened by this measure.

**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	5	B+	B	B+	B	Negative	AA(ven)
Banco Mercantil	C/D	5	B+	B	B+	B	Negative	AA(ven)
Banco de Venezuela	C/D	5	B+	B	B+	B	Negative	AA(ven)
Banesco Banco Universal	D	5	B	B	-	-	Negative	A-(ven)
Banco Occidental de Descuento	D/E	5	B-	B	B-	B	Negative	BBB(ven)
Banco del Caribe	D	5	B+	B	B+	B	Negative	A+(ven)
Banco Exterior	C/D	5	B+	B	B+	B	Negative	AA-(ven)
Banco Venezolano de Crédito	D	5	B+	B	B+	B	Negative	A+(ven)
Corp Banca	-	-	-	-	-	-	-	A-(ven)
Banco Nacional de Crédito	-	-	-	-	-	-	-	BBB-(ven)

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