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**VENEZUELAN BANKS - 2002 RESULTS**

- *Despite higher oil prices, the Venezuelan economy suffered its second worst recession in the last 50 years*
- *Mounting political confrontation has damaged the operating environment for Venezuelan banks and more government intervention cannot be ruled out*
- *The recent foreign exchange control will limit alternative sources of income for banks though it will contribute to ease liquidity pressures*

**The Economic Climate**

Political confrontation, constant protests and an attempted coup d'état severely hurt the Venezuelan economy in 2002. Gross Domestic Product fell by 8.9%, the fourth recession in the last 5 years and the second worst in the last 50 years. Higher oil prices were constrained by lower than average oil exports while there was a significant 8% plunge in the non-oil economy mostly as a consequence of political unrest. In an attempt to avoid a further weakening of the country's external account and reduce pressure over international reserves due to capital flight, the Central Bank tightened monetary policy. Similar to prior years, Venezuela's debt programs were conducted almost 100% locally, with banks being the main holder of public debt. The combination of these factors resulted in increased pressure over interest rates, which reflected in an average lending rate of 38% for 2002, compared with 24% for 2001. In late 2002, the government completed a local currency debt exchange in order to mitigate the cash flow pressures of the 2003 and 2004 budget; this swap was partially completed extending maturities up to 2007. Given the higher than expected cash needs of the government, new swap operations have continued taking place in 2003 (albeit at a smaller scale) and may continue going forward.

**Recent Events**

In the period December 2002-early February 2003, a general strike aimed at forcing President Chávez out of office took place in Venezuela. While the strike subsequently eased and most of the private sector resumed activities, a significant portion of PDVSA's (Venezuela's national oil company) operations has not returned to normal. This halt in economic activity could potentially result in the worst economic recession in Venezuela's contemporary history.

Moreover, significant shortfalls in government revenues and an unstable economic environment should generally affect the creditworthiness of economic agents and therefore the asset quality of the banking system.

- *The government suspended the free convertibility of the Venezuelan Bolivar (VEB) in early 2003*

A foreign exchange control was adopted in February 2003 in an attempt to control capital flight and the VEB devaluation. Even though the formal mechanism to obtain foreign currency is not up and running, past experiences in Venezuela suggest that foreign currency assignments from the government to importers and to service external debt could be inefficient, which could potentially affect the performance of a number of companies. Jointly with the foreign exchange control, the government set price ceilings to some essential goods and services in order to keep inflation at bay. It is worth mentioning that past experiences of prices and foreign exchange controls in Venezuela and other countries have not yielded the desired results as capital flight, devaluation and inflation generally lag behind such measures. As Fitch has stated in previous opportunities, the banking system will continue in the short term to be exposed to a growing risk of politically motivated interference.

- *Local government debt: a very risky exposure*

Low loan demand, higher financing needs from the government and the lack of access to the international capital markets has provoked a significant increase in local currency sovereign debt placements since 1998, with Venezuelan banks being the main bond holders. At end-June 2002 sovereign local currency securities held by the banking system (including ceded investments) represented around 30% of total managed funds (assets + investment funds) and 219% of the system's equity, the highest level since 1997<sup>1</sup>. It is important to mention that in early 2003 Fitch Ratings downgraded Venezuela's local currency rating from B- to CCC, reflecting the pressures on government finances due to the severe disruption of

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<sup>1</sup> Exposures to government debt are not yet available for end-2002. Any mentions of government exposures throughout this report, either systemic or per bank, refer to the end-June 2002 figures.

the economy, particularly the oil sector. Also, as a consequence of the aforementioned local currency debt exchanges, the average maturity of this portfolio is higher than in previous years. Fitch Ratings remains concerned regarding the increased likelihood of a default or distressed debt exchange of these securities and its effects over the system's liquidity and solvency.

## The Financial System's Performance in 2002

- *Asset quality ratios are hampered by a critical economic and political situation*

Low economic activity severely affected loan demand during 2002, which reflected in a stagnation of gross loans (in nominal terms) while inflation climbed by 31%. On the other hand, higher interest rates and the worsening of the operating environment resulted in an increase of the system's impaired to total loans ratio to 6.8%, the highest level since the financial crisis of 1994-1995. If restructured loans are included, the "adjusted" impaired to total loans ratio increased to 9.2% almost 200 bps higher than at end-2001. Despite large charge-offs, loan loss reserves grew due to higher FOREX profits which were used to increase loan loss provisioning. At end-2002 loan loss reserve coverage was 133% (98% when restructured loans are included). However, this could be insufficient given the deteriorated economic environment, which will put to the test the historical conservatism of Venezuelan banks regarding loan loss reserve coverage.

- *Capital flight pressured again deposits and liquidity*

After deposits plunged 11% in nominal terms during the first half of 2002, in the second half of the year Venezuelan banks' total managed funds (deposits + investment funds) recovered the level of previous years, aided by higher inflation and seasonal factors. Despite the instability in the money market, the funding mix remained similar to previous periods. During 2002 and early 2003, the Central Bank participated actively providing liquidity to the banking system although during this period there was a good deal of dispersion in liquidity ratios among financial institutions due to capital flight and "flight to quality". The imposed foreign exchange control could ease capital flight, which could result in some deposit growth, at least while the control is in place.

- *Devaluation gains boosted profitability*

The historically long FOREX position of Venezuelan banks and the 83% devaluation of the VEB in 2002 yielded significant gains, which were mostly used for loan loss provisioning. The VEB devaluation and other trading gains boosted to 5.7% the other operating income to average assets ratio, compared with the 3.1% for 2001. Due to the FOREX control imposed in February that fixed the exchange rate in VEB 1,600 per USD (14% devaluation during the first two months of 2003), going forward, Venezuelan banks should not be able to benefit from one-off gains related to FOREX trading. This, together with the expected higher loan loss provisioning and operating expenses, should pressure profitability in 2003.

## Recent Rating Actions

During 2002 and January 2003 Fitch Ratings downgraded the long-term foreign currency, local currency, individual, support and national ratings of a number of Venezuelan banks. The rating actions were triggered by the downgrade of Venezuela's sovereign ratings, the severe deterioration in the local operating environment, the increased likelihood of a default or distressed debt exchange by the banking system's largest borrower – the government – and the increasing possibility that actions motivated by the unsettled political environment could interfere with the economy's payment system. The lowering of the bank's long-term local currency rating to a level one notch below the sovereign reflects the risks outlined above and also the two notch differential in the long-term foreign currency reflects the foreign exchange restriction imposed by the government to the banks and other individuals since end-January 2003. The lowering of the individual and national ratings reflect the much higher risk inherent in the volatile and deteriorated operating environment, and the likelihood that the recession could be protracted. Also, the lowering of the support ratings reflects our belief that potential interference with the banking system could influence decisions shareholders may face if their institutions were to require further support to navigate the months ahead. Table 1 shows the ratings currently assigned by Fitch Ratings to Venezuelan Banks.

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**Performance of the Leading Banks**

**Banco Mercantil** (Mercantil): Thanks to its privileged position in the middle market and the importance of its branches abroad, Mercantil was able to almost double the system's asset growth (23% vis-à-vis the system's 12%) and to reach the top spot in the ranking of Venezuelan banks in terms of assets under management. Despite the 14% total lending increase and some charge offs, the impaired to total loans ratio went up to 4.72% the highest level since 1995 although still a deal lower than the market average. As a result of the higher level of impaired loans, loan loss reserve coverage went down to 149% from 179% at end-2001 despite the fact that a large proportion of the higher income stemming from the devaluation and wider spreads was used to build up loan loss reserves. Mercantil has among the lowest exposures to the government of any Venezuelan bank, accounting for 80% of equity (including ceded investments).

**Banco de Venezuela** (BdV, majority owned by Spain's Banco de Santander Central Hispano): The completion of the merger with Banco Caracas allowed BdV to increase its assets by almost 30% compared with end-2001. The instability of the money market and the expansion into the middle market as a consequence of the merger allowed the bank to enhance its spread up to 12%, almost 300 bps higher than in 2001. This improvement in the spreads, the higher business volume and the sizable FOREX gains during the year, resulted in a 116% increase in net income. As in previous years and aided by its fine risk control tools and the corporate profile of its customer base, BdV kept its impaired to total loans ratio under the market average at 4%, nevertheless this is the highest level since 1996. Loan loss reserve coverage remained ample at 167%. As a consequence of the merger with BCS and lower loan demand, BdV increased its exposure to government debt, which (including ceded investments) accounts for 145% of equity.

**Banco Provincial** (Provincial, majority owned by Spain's Banco Bilbao Vizcaya Argentaria): During 2002 Provincial focused on reducing credit risk and enhancing liquidity. As a result, assets grew by only 6% while total loans declined by 1%. Thanks to a more proactive loan collection policy and some charge-offs, Provincial was able to keep its impaired to total loans ratio almost unchanged at 4%, while loan loss reserve coverage went up to 220%. Unlike the average of the system, FOREX gains were not the

main driver of Provincial's improvement in profitability. Instead, this was mostly related to wider margins and tight cost control. During 2002, Provincial's net interest margin was 17%, 499 bps higher than in 2001. As a result, the bank's net income increased by 76%, while its ROA and ROE were 5.2% and 35.7% respectively. The bank has a large securities portfolio, mostly made up of government debt, which accounts for around 190% of equity including ceded investments.

**Banesco Banco Universal** (BBU): During 2002 the bank completed the merger with Unibanca Banco Universal, which in turn was the result of the merger with Banco Unión and Caja Familia Entidad de Ahorro y Préstamo. This merger not only increased Banesco's size by 273% but also broadened its market scope as the significant mortgage business of Unibanca contributed to diversify Banesco's mostly retail and middle market clients. The sizable credit card portfolio of Unibanca and the unstable economic environment required significant charge-offs to contain the increase in the impaired portfolio. At end-2002 the impaired to total loans ratio was 6%, 136 bps higher than end-2001 but 208 bps lower than the ratio at the moment of the merger. Loan loss reserve coverage is ample and the highest among the larger banks (256%). BBU's aggressive M&A strategy initiated in 1997 resulted in sizable goodwill pending to be amortized. This goodwill, equivalent to 51% of equity at end-June 2002, was created on the basis of a calculation of the present value of the different merged institution's future cash flows. As a general rule, Fitch considers that capital increased based on cash contributions has better quality than that based on present value of future cash flows, especially in a climate of macroeconomic instability. Its ample participation in the ceded investments market has resulted in a sizable government debt exposure which accounts for nearly 250% of equity (including ceded investments) and is mostly comprised of Venezuelan Brady Bonds.

**Banco Occidental de Descuento** (BOD): As the most important regional bank in Venezuela and focused in the Zulia Region, a prominent oil industry region, BOD's aggressive expansion strategy has resulted in a significant market share increase and a more nationwide distribution of its operations. At end-2002 BOD merged with another regional bank (Norvalbank Banco Universal) and became the country's fifth largest bank nationwide with a market share of around 9% of total invested funds (assets + ceded investments), which compares favourably with

the 1.5% market share at end-1996. However, this expansion strategy dating back to 1997 resulted in some pressures over the bank's profitability and asset quality. Even though operating costs during 2002 were significantly reduced in nominal terms, asset quality deteriorated. At end-2002, the impaired to total loans ratio was almost 5%, more than 110 bps higher than in 2001 despite the more than 50% increase in total loans. During 2000 and 2002 the local regulator required the bank to increase its loan loss reserves to cover some potential trouble loans to the oil sector, which brought loan loss reserve coverage to 175% at end-2002. The merger with Norvalbank significantly increased BOD equity's easing the thin capitalization ratio that has characterized the bank in the past few years, nevertheless some goodwill has been recorded. BOD's intermediation activity and management's strategy to back liquidity ratios with foreign denominated and low risk securities has allowed the bank to keep government exposure at bay, accounting for a relatively small 48% of equity.

**Corp Banca Banco Universal (Corp Banca):** Higher interest rates and FOREX gains benefited the bank's performance during 2002 and allowed it to improve asset quality ratios due to higher loan loss reserves and some charge offs. Net interest revenue grew by 21% while the net interest margin improved to 13% (+73 bps) as a result of the instability in the money market and actions taken by the bank to reduce funding costs. Also, other operating income almost doubled as a result of the FOREX gains and some improvement in fee income, which allowed the bank to increase loan loss provisions by 58% while covering the 16% increase in operating expenses. Since early 2002 Corp Banca tightened its credit risk control policies, lowering exposures and charging off troubled loans. The bank's impaired to total loans ratio went down to 5.6% (-43 bps), nevertheless restructured loans more than tripled during the year resulting in a modified impairment figure of 10.1%, 100 bps higher than the market average. Even though loan loss reserve coverage has improved since 2001 (to 119%), if restructured loans are factored in, coverage goes down to 66% while the market average was 98%. Corp Banca's strategy to lower funding cost through its participation in the ceded investments market and the low loan demand increased its government exposure to almost 330% of equity (including ceded investments).

**Banco del Caribe (Caribe):** During 2002 the bank continued to improve asset quality and contain

operating costs. Despite the increase in assets under management and the 23% average inflation of the period, operating costs went up by just 17%, resulting in an improvement in its efficiency ratios. Regarding asset quality, some charge offs and a more proactive collection policy resulted in a 5% reduction in total impaired loans, while restructured loans declined by almost 8%. The bank's loan loss reserve coverage of 224% is a deal better than the market average. Caribe also benefits from ample capital supported by an unconditional USD 58.5 mln commitment from Canada's Bank of Nova Scotia. Caribe's balance sheet is highly exposed to government debt, which accounts for nearly 385% of equity; the bulk of its exposure is related to its participation in the ceded investment market.

**Banco Exterior (Exterior):** Despite the political and economic turmoil, Exterior's financial profile has been much less affected than the market average, showing once again strong asset quality and some of the highest profitability ratios in the system. At end-2002 Exterior's assets grew by 19%, mostly propelled by an almost 30% loan growth and funded by a 17% increase in deposits. Some troubled loans and the general negative environment resulted in an increase of 65% of impaired loans, nevertheless the bank's impaired to total loans ratio is still the lowest among the 10 largest banks in Venezuela (0.92%). Moreover, at 347%, loan loss reserve coverage is the highest among the ten largest banks. Like other banks in Venezuela, the instability in the money market and the devaluation resulted in higher profits for Exterior. Considering that Exterior is mostly concentrated in the profitable middle market, its net interest margin increased to 19%, well above the market average. This, coupled with a 163% increase in other operating income (mostly due to the devaluation) allowed the bank to cope with the 25% increase in operating expenses and still post net income 112% higher than in 2001. Like many other participants in the ceded investments market, Exterior shows a significant exposure to government debt of around 265% of equity.

**Venezolano de Crédito Banco Universal (Venezolano):** During 2002 Venezolano experienced vigorous growth, not only as a result of its merger with some other financial institutions owned by the same shareholders, but also due to a significant organic expansion during the second half of the year. At end-2002 total assets grew by 101% compared with the previous year. However, as a result of the acquisition of the loan portfolio of the merged

institutions, impaired loans grew by more than 110%, resulting in an impaired to total loans ratio of 2.13%, compared with 1.8% at end-2001. Despite the significant growth of impaired lending, Venezolano kept a conservative loan loss provisioning policy and loan loss reserve coverage reached 196% at end-2002. Even though Venezolano posted higher operating expenses (+75%) and loan loss provisions, the significant FOREX gain allowed the bank to

increase net income by 222%. The bank's ROA and ROE more than doubled in 2002 to 13% and 75%, respectively. Venezolano has historically kept a very conservative approach regarding its exposure to the government. By policy the bank does not offer deposits to government entities and also is not an important participant in the government securities market, which results in a government debt to equity ratio of less than 50%.

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

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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 (%) |               |
|-----------------------|-------------------|-------------------|-------------------|------------------|--------------------------|------------------|-------------------|--------------|---------------------|-------------|------------------|---------------|
|                       | 2,002             | 2,001             | 2,002             | 2,001            | 2,002                    | 2,001            | 2,002             | 2,001        | 2,002               | 2,001       | 2,002            | 2,001         |
| Banco Mercantil       | 3,912,650         | 3,177,008         | 500,176           | 391,348          | 1,866,633                | 1,650,401        | 12.78             | 12.32        | 4.72                | 3.69        | 149.38           | 179.03        |
| Banco de Venezuela    | 3,698,214         | 2,885,133         | 541,722           | 450,556          | 1,606,579                | 1,323,517        | 14.65             | 15.62        | 3.76                | 1.25        | 167.47           | 177.72        |
| BBV Banco Provincial  | 3,463,756         | 3,283,953         | 540,727           | 445,029          | 1,557,513                | 1,621,851        | 15.61             | 13.55        | 4.07                | 3.84        | 219.85           | 165.96        |
| Banesco               | 3,065,654         | 822,292           | 541,724           | 96,255           | 747,320                  | 236,224          | 17.67             | 11.71        | 6.01                | 4.65        | 256.28           | 220.00        |
| Occidental            | 1,619,070         | 889,156           | 288,762           | 90,662           | 543,747                  | 378,794          | 17.84             | 10.20        | 5.35                | 3.93        | 175.36           | 118.56        |
| Corp Banca            | 1,215,446         | 947,419           | 132,310           | 104,658          | 509,330                  | 557,290          | 10.89             | 11.05        | 5.64                | 6.07        | 118.67           | 80.92         |
| Venezolano de Crédito | 1,043,952         | 519,184           | 157,585           | 101,927          | 352,902                  | 197,013          | 15.10             | 19.63        | 2.13                | 1.79        | 195.95           | 210.46        |
| Caribe                | 809,821           | 731,642           | 126,400           | 96,183           | 412,089                  | 412,488          | 15.61             | 13.15        | 5.14                | 5.54        | 223.73           | 159.19        |
| Exterior              | 697,878           | 587,985           | 125,853           | 89,303           | 457,634                  | 355,750          | 18.03             | 15.19        | 0.92                | 0.71        | 346.48           | 549.19        |
| <b>System Average</b> | <b>24,277,864</b> | <b>21,607,609</b> | <b>3,853,527</b>  | <b>3,020,436</b> | <b>9,152,776</b>         | <b>9,415,248</b> | <b>16.08</b>      | <b>14.13</b> | <b>6.76</b>         | <b>5.14</b> | <b>132.64</b>    | <b>126.74</b> |

|                       | Net Income (VEB bln) |                | Net Int. Rev./Assets (%) |              | ROA (%)     |             | ROE (%)      |              | Cost-Income (%) |              | Cost/avg. Assets (%) |             |
|-----------------------|----------------------|----------------|--------------------------|--------------|-------------|-------------|--------------|--------------|-----------------|--------------|----------------------|-------------|
|                       | 2,002                | 2,001          | 2,002                    | 2,001        | 2,002       | 2,001       | 2,002        | 2,001        | 2,002           | 2,001        | 2,002                | 2,001       |
| Banco Mercantil       | 173,133              | 76,538         | 14.15                    | 12.32        | 4.88        | 2.48        | 38.84        | 20.58        | 55.97           | 70.86        | 11.13                | 10.73       |
| Banco de Venezuela    | 196,483              | 91,077         | 11.55                    | 8.13         | 5.97        | 3.39        | 39.60        | 20.33        | 50.59           | 61.28        | 9.60                 | 7.05        |
| BBV Banco Provincial  | 176,021              | 100,177        | 16.70                    | 11.71        | 5.22        | 3.01        | 35.71        | 23.97        | 59.29           | 71.34        | 11.48                | 10.21       |
| Banesco               | 141,295              | 32,388         | 13.05                    | 11.80        | 7.27        | 4.12        | 44.29        | 36.57        | 57.95           | 60.79        | 14.17                | 9.73        |
| Occidental            | 42,712               | 17,018         | 11.73                    | 7.70         | 3.41        | 2.24        | 22.51        | 22.00        | 36.00           | 81.03        | 4.03                 | 7.77        |
| Corp Banca            | 47,240               | 27,584         | 13.45                    | 12.72        | 4.37        | 2.92        | 39.87        | 28.30        | 64.24           | 73.32        | 11.63                | 11.49       |
| Venezolano de Crédito | 97,690               | 30,348         | 13.24                    | 10.47        | 12.50       | 6.41        | 75.29        | 33.19        | 38.39           | 54.59        | 8.70                 | 8.23        |
| Caribe                | 38,556               | 11,467         | 17.42                    | 13.19        | 5.00        | 1.74        | 34.64        | 12.27        | 61.18           | 79.21        | 13.18                | 13.21       |
| Exterior              | 71,849               | 33,941         | 19.17                    | 16.84        | 11.18       | 6.43        | 66.79        | 61.54        | 43.09           | 52.08        | 10.00                | 9.74        |
| <b>System Average</b> | <b>1,116,035</b>     | <b>559,650</b> | <b>12.24</b>             | <b>10.87</b> | <b>4.60</b> | <b>2.59</b> | <b>28.96</b> | <b>18.53</b> | <b>58.18</b>    | <b>70.44</b> | <b>10.44</b>         | <b>9.85</b> |

Consolidated Figures.

Inflation: 2001:12.3%; 2002 31.2%

Exchange Rate: Dec-01: 763.00; Dec-02: 1,401.25

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