

Venezuelan Banks – 2004 Results**Analysts**

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■ Economic Environment

Following two years of severe economic contraction and political confrontation, 2004 was a rebound year for Venezuela, with higher economic activity (GDP Growth: 17%), less political frictions and a more relaxed foreign exchange control that boosted foreign currency availability to most of the different economic sectors. The impressive growth figures are largely supported by high international oil prices but also must be viewed in light of the dismal economic performance of 2003. In turn, the Venezuelan financial system seized the opportunity to increase its size substantially, with total invested assets (assets + ceded investments) of around USD 34 bln, representing roughly 35% of GDP. This expansion was possible, in part, because of the foreign exchange control that precluded capital flight, which had been common in previous years. While economic fundamentals have not changed dramatically (private investment remains low, imports are affected by the foreign exchange control, price controls for a number of products are still in place, etc.), the significant increase in public spending to more than 30% of GDP has triggered demand for goods and services in the country. Similarly, high inflation (22% for 2004), which erodes the value of money over time, has prompted economic agents to increase current vs. future consumption. This is reflected in a more than 100% increase in car sales and a significant rebound in real state prices in 2004. On the other hand, the huge increase in the monetary base due to mounting international reserves at the Central Bank has precluded a rebound of interest rates; as a matter of fact, the average lending rate went down to 18% (2003: 26%), while the average deposit rate plunged to 11%, both levels negative in real terms. The excess liquidity created in the market has partly been channeled into short term CDs issued by the Central Bank (USD 3.7 bln at end 2004), local currency debt issued by the government and also, into some debt issuances made by the government in foreign currency but paid using local currency (in the case of banks a small amount given the limits imposed over their net foreign position by the Central Bank).

■ Recent Events

After a difficult 2002-2003 in both political and social terms, 2004 was a more stable year, particularly after the August binding referendum that paved the way for the current administration to remain in power until the end of its term in 2006. In the first quarter of 2005, the social and political environment has been maintained but it remains somewhat fragile. While banks have been able to operate successfully in this environment, and have been able to build up a significant loan loss reserve and capital cushion, their performance is still largely dependent on the overall economic health of the country.

■ Outlook

Even though the political and social arenas have somewhat stabilized, the fragility derived from a highly polarized environment should remain a threat to the banking sector in the foreseeable future. Venezuelan banks have been conservative in the face of volatility although increasing government intervention (compulsory lending, interest rates control, ceilings on fees and commissions etc.) could have a negative impact on the system going forward. Fitch remains concerned about political interference in the banking sector but financial strength of most of the rated banks should continue supporting their ratings. Moreover, banks continue being main players in the sovereign local currency debt market while having an important role in the payments system and in the fostering of economic growth, which should strengthen their relative standing in Venezuela.

- ***Following one year of foreign exchange stability, in March 2005 the government devalued the VEB by 12%, the adjustment in prices should follow shortly***

During 2004, the Comisión de Administración de Divisas – CADIVI, the body in charge of managing foreign currency flows since the imposition of foreign exchange controls in Venezuela, improved its efficiency, allocating funds in a more timely fashion, when compared with 2003. The sectors that received foreign currency flows comprised raw materials, machinery, final goods and services, financial debt payments and repatriation of capital for foreign investors, among others. Additionally, the public was allowed to use a fixed allowance of foreign currency through credit cards. While the obvious inconsistencies and inefficiency of a foreign exchange control (or any price control) over economic growth and social welfare are widely known, a constant flow of foreign currency to the market should be able to sustain higher economic activity. Given high public sector financing needs, in March 2005 the Central Bank announced a 12% devaluation of the VEB (to VEB 2,150 per USD), which boosts its foreign currency receipts (oil exports). As has been the case in the last two decades, the Venezuelan financial system benefits from this action due its historic long foreign exchange positions and its very low exposure to foreign currency denominated loans. Following the VEB devaluation most of the prices regulated by the government will be adjusted due to the significant importance of the USD in the price structure of Venezuelan goods and services.

- ***Government exposure remains high but loan demand increased***

Local currency debt remains the second largest source of funds for the Venezuelan government, after oil exports. The sustained increase in international reserves and its expansionary effect over the monetary base has prompted the Central Bank to place short term CDs with the financial system. Given that Venezuelan banks are by far the most important institutional investor in the country, their balance sheet saw a sharp increase in securities issued by the government and/or the Central Bank. As such, the ratio of government securities to equity (including securities recorded as ceded investments) remains at 4 times (around half of which are short-term Central Bank CDs), a fairly high level. As could be expected, the large amount of securities issued by the Central Bank is placing significant pressure on its income statement, until now mitigated by the sizable foreign exchange gains recorded as a consequence of the devaluation. However, this may pressure monetary liquidity in the future.

- ***Recent measures adopted regarding compulsory mortgage lending***

Given the historically scarce supply of housing in Venezuela, many governments have tried to create different programs to boost housing and mortgage lending for medium and low income people. In January 2005 the government approved a new law that forces financial institutions (universal banks, savings and loans and other institutions entitled to grant mortgage lending) to compulsorily place a portion of their loan portfolio in mortgage lending. At the same time, these loans have to be placed at rates that are well below market prices. According to this law (Ley Especial de Protección al Deudor Hipotecario de Vivienda - LEPDHV) the government will set each year the amount of the loan portfolio that has to be placed in mortgage lending. Other issues, such as specific rules regarding interest rates and procedures regarding foreclosures, among others, were also detailed. For 2005, the LEPDHV mandates that at least 10% of the loan portfolio recorded at end-2004 be placed in this type of lending, while interest rates will depend on the income of the debtor, with a ceiling of 11.75%.

According to preliminary figures, few banks comply with this new requirement, while Fitch believes that many small banks do not count with the infrastructure and/or expertise to manage this type of lending. Although Fitch considers that many banks will comply with the new regulation by end-2005, credit risk implications and pressures over structural maturity mismatches could arise from this new law. The LEPDHV contemplates that just 3% of the total mortgage loan amount will be placed in long term loans, while the remaining 7% will be placed in short term mortgage loans (mainly loans to constructors or developers). This law also stipulates that all the mortgage loans granted under the Housing Policy Law (Ley de Política Habitacional – LPH) be transferred from local banks to a government entity. Since these loans were recorded off balance as they were funded by government funds, the impact over banks loan books will be neutral. However, the management fees of that portfolio will be lost.

In a separate issue, during 2005 many banks' presidents have been called to court because of a pending plea over the so-called Mexican credits (with continual refinancing of unpaid interest). In early 2002 the Supreme Court of Justice ruled in favor of a group of mortgage debtors against the Superintendency alleging the illegality of these loans, ordering the Central Bank to set the interest rates for these loans retroactively to 1996. The impact of this measure on banks is yet unknown.

■ Bank performance in 2004

- *An improving operating environment, sizable charge-offs and conservative lending sustained asset quality*

Similar to 2003, the loan portfolio for Venezuelan banks represented their second main source of risk, with securities being the largest asset class on their balance sheet. At end-2004 the gross loan portfolio grew by 109% compared to the previous year, boosted not only by commercial and corporate loans, but also by some leveraged positions in sovereign currency debt acquired by corporates and individuals. In turn, past-due loans decreased by 19%, while restructured loans went down by 27%, resulting in another improvement of the past-due and past-due + restructured to total loans ratios to 1.7% and 2.8%, respectively, at end-2004, both ratios being at their lowest level of the past decade. It is worth mentioning that this improvement was achieved even with a reduction by almost half (2% of average gross loans) in charge-offs compared to 2003. Recurring foreign exchange gains have provided banks with enough income to create ample loan loss reserve coverage, which, at end-2004 stood at 224% of impaired loans (130% if restructured loans are included).

- *Historically low margins have been offset by tighter cost control and revenue diversification*

As mentioned before, the excess liquidity in the system has pressured down margins within the financial system, which are likely to become narrower given compulsory lending at below market rates. The 17% increase in net interest revenue in 2004 lagged the asset expansion, which resulted in a net interest margin (net interest revenue/ total average assets, including ceded investments) of 8.4%, the lowest since 1996. Despite lower foreign exchange gains since the imposition of foreign exchange controls and some government controls over fees and commissions, Venezuelan banks have managed to increase other operating income. In 2004, securities trading and fees for services were the main source of other operating income (excluding historically sizable foreign exchange gains). Furthermore, in 2004 net other operating income represented 52% of operating costs, the highest level since 1996. The decline in net interest margins was met with strict cost control, which resulted in a cost to average assets ratio of 6.9%, one of the lowest of the past few years. In turn, loan loss provisions accounted for 2% of average lending, which was considerably below the 4% posted in 2003. At end-2004, ROA and ROE decreased to 4.7% and 42.6%

respectively, though those ratios are still adequate after discounting the effect of inflation.

- *Significant asset growth has resulted in declining capital ratios, though these are still adequate*

After a few years of modest growth, capital ratios were affected in 2004 by the ramp up in loan demand and securities investment, resulting in a decline in the equity to assets ratio to 12.5%, from 14.3% at end-2003; the regulatory minimum in Venezuela is 10%. Recently, discussions have been held regarding the possibility of reclassifying off-balance sheet ceded investments into the balance sheet of the banks. If this draft succeeds, capital ratios will decline significantly as a result of the increase in assets. As a matter of fact, Fitch believes that some banks could have a hard time complying with local minimum requirements, although this measure, if implemented, would be phased-in over a certain period of time.

■ Performance of the Leading Banks

Banesco: During 2004 Banesco pursued an aggressive expansion strategy that resulted in the bank becoming the largest financial institution in the country (third largest if excluding ceded investments), with a market share by total invested assets (total assets + ceded investments) of 14.2 % at year-end. Contrary to other expansion periods, asset growth was partly propelled by a significant loan portfolio increase (+99%, similar to the market average), but even with this increase gross loans represented just 21% of invested assets, the lowest among larger banks. The increase in gross loans and the reduction of the past-due loan portfolio allowed the bank to reduce its past-due to gross loans ratio to 1.2%, slightly lower than the market average but similar to its peer average. Despite this improvement, restructured loans still represent a further 3.8% of the portfolio, which yields an adjusted asset impairment ratio (past-due + restructured / total loans) of 5%, significantly lower than the previous period (13%) but still higher than the market average (3%). Conservative loan loss provisions allowed the bank to improve its loan loss reserve coverage to 400%, while if restructured loans are factored in this ratio was 92%, below the 130% market average. Similar to its peers, the bank's net interest margin declined to 6.7% in 2004, the second lowest among the nine largest banks. In order to compensate for lower margins, the bank was successful managing operating costs and boosting other operating income. At end-2004 operating costs rose 20%, slightly below average inflation, while operating costs to average assets declined to 5.9%. This

resulted in ROA and ROE ratios of 5.4% and 55%, respectively. Similar to other banks, the increase in assets reduced the bank's equity to assets ratio to 12%, a ratio undermined by sizable goodwill stemming from previous mergers. If ceded investments are factored in, the ratio declines further to 9.5%. Previous mergers with different savings and loans institutions put Banesco in a comfortable position regarding the new mortgage lending requirements.

Banco de Venezuela (BdV, a wholly owned subsidiary of Spain's Banco Santander Central Hispano): Despite the instability of the operating environment, BdV succeeded in increasing its invested assets market share to 14.2% at end-2004, making it the second largest bank in the country (largest if excluding ceded investments). At the same time, the bank was able to preserve its historically strong profitability and better than average asset quality. At end-2004, BdV's past-due to gross loans ratio declined to 1.2%, while loan loss reserve coverage remained ample at 174% (2.2% and 97%, respectively including restructured loans). Lower overheads and adequate income diversification (for local standards) has sustained BdV's profitability, with ROA and ROE ratios of 5.0% and 45%, respectively. Capital ratios remain sound even with the 64% asset increase. At end-2004 the equity to assets ratio declined to 11.5%, while if ceded investments are factored in, the ratio stood at 10.4%. The bank has a fairly strong infrastructure to be able to meet the new mandatory mortgage lending rules, while agribusiness and microfinance lending have yielded positive results until now.

Banco Mercantil: A conservative expansion strategy yielded a 700 bps contraction in the bank's invested assets market share to 13.5% at end-2004. While the bank is the third largest in the country (second largest if excluding ceded investments), it remains a market leader in lending, trust funds and other market segments. Strict cost control has yielded good results for the bank, with a 1,350 bps reduction in the cost to average assets ratio to 7.1%. In turn, the bank's net interest margin reached almost 9%, which, coupled with higher other operating income and lower loan loss provisions resulted in an ROA of 4.7% in 2004. Asset quality remains good among the diversified loan portfolio of the bank; past-due loans declined to 1.1% at end-2004, while loan loss reserve coverage increased to 313% (2.4% and 113% respectively including restructured loans). Despite a cash dividend increase capital remains the strongest among its peers, with an equity to assets ratio of 12.4%, which declines to 11.4% when

including ceded investments. The historic participation of Banco Mercantil in the mortgage market and leadership in the agribusiness market should allow it to cope with new mandatory loan regulations.

Banco Provincial (subsidiary of Spain's Banco Bilbao Vizcaya Argentaria): With a market share by invested assets of 13.3% at end-2004, Banco Provincial remains the fourth largest bank in Venezuela. Prudent risk control and a lending increase resulted in an improvement in the bank's past-due to total loans ratio to 0.9% (1.1% including restructured loans), the lowest among the largest banks. In turn, loan loss coverage climbed to 366% (275% including restructured loans). Despite cost control and lower loan loss provisions, narrower net interest margins reduced Banco Provincial's profitability. At end-2004 the bank's net interest margin declined to 8.9%, although it is still the second highest among large banks thanks to loan diversification. Capital remains sound, with an equity to assets ratio of 11.4% and 10.2% if ceded investments are factored in. Recent penetration in the mortgage market will ensure the bank enough tools and expertise to address the mandatory mortgage loan requirements.

Banco Occidental de Descuento (BOD): The significant ramp up in oil production in 2004 compared with the low levels of 2003 positively affected BOD's traditional market niche, the Zulia Region (the main oil producing area in Venezuela). As a result, the bank posted a 125% increase in its total loan portfolio, the highest among the five largest banks. In turn, past-due and restructured loans remained relatively stable in 2004, benefiting the bank's past-due to total loans ratio, which declined to 2.2% (2.5% including restructured loans). Additionally, loan loss reserve coverage increased to 190% (171% including restructured loans). Stable net interest margins, cost control and some improvement in income diversification allowed the bank to compensate for higher loan loss provisions during 2004, with resulting ROA of 2.6%. However, this level is still below the market average. The significant asset increase and sizable cash dividends in 2004 resulted in a sharp decrease in capital ratios. At-end 2004, the equity to assets ratio declined to 11.6% from 17.3% the previous year, while some goodwill and a high fixed asset concentration undermine the quality of equity. If ceded investments are factored in, equity to assets declined to 7.5%, the lowest among the nine largest banks. The merger with a regional savings and loan institution in 2002 could provide the bank with an adequate client base to cope with the new mandatory mortgage lending.

Corp Banca: Stiff cost control since 2002 has yielded an improvement in the bank's cost to average assets ratio, which declined to 6.5% at end-2004. In turn, the bank's net interest margin, which reached 8.1% in 2004, boosted its ROA to 5.0% (including ceded investments), compared with 3.3% at end-2003. Asset quality ratios were positively affected by an increase in loan charge-offs and more dynamic collections given the stability of the gross loan portfolio. At end-2004 the past due to total loans ratio declined to 0.9% and 2.9% if restructured loans are factored in. Despite the decrease in loan loss reserves (due to the aforementioned charge-offs), loan loss coverage went up to 264% (84% including restructured loans), a level that compares favorably with its peers. Thanks to higher profits and conservative cash dividends, the equity to assets ratio went up to 12.4% (10.8% including ceded investments).

Venezolano de Crédito: Strict cost and risk controls and its positioning in the corporate market resulted in Venezolano de Crédito having among the best profitability in the system. The bank's privileged position in the corporate market allowed it to easily expand its loan portfolio while keeping a conservative risk profile. As such, the bank's past-due to total loans ratio declined to 0.5%, while loan loss reserve coverage increased to almost 307% (1.0% and 169%, respectively including restructured loans). The reduction in the bank's net interest margin to 9.2% (2003: 10.3%) and lower foreign exchange gains resulted in an ROA of 5.4% in 2004, which is above the market average but significantly lower than its 2003 level (7.2%). At end-2004, the bank's equity/assets ratio was 11.8%.

Banco del Caribe: After a few years of focusing in an overhaul of the risk control area, Caribe posted

some of the best asset quality ratios of the nine largest banks in 2004. At end-2004, the past-due to total loans ratio declined to 0.3% (0.5% including restructured loans), while loan loss reserve exceeded 1,300% (624% including restructured loans). Profitability improved based on cost control and income diversification, which offset the decline in the bank's net interest margin (2004: 8.9%; 2003: 12%). As such, in 2004 ROA and ROE increased to 5.8% and 58%, respectively. The 2004 asset increase reduced the banks equity to assets ratio to 13.6%, a level still above the market average. The bank's ample position in the agribusiness sector has allowed it to cope with recent mandatory loan regulations though mortgage lending is still a small part of the portfolio.

Banco Exterior: As in previous years, Banco Exterior remained the most profitable bank in 2004, while maintaining the best asset quality ratios among the largest 9 banks. The bank's past-due to total loans ratio declined to just 0.2% while loan loss reserve coverage climbed to almost 857% (0.2% and 651% respectively if restructured loans are factored in). The reduction of almost 120 bps in the cost to average assets ratio of the bank and lower loans loss provisions more than compensated for the decline in its net interest margin and lower other operating income (due to lower foreign exchange gains), resulting in a solid 6.3% ROA. At end-2004 the equity to assets ratio declined slightly to 13.2%, which declines further to 10% if ceded investments are included. Up to now the bank has been able to manage agribusiness and microfinance compulsory lending while Fitch Ratings expects that it should be able to meet the new mortgage portfolio requirements in accordance with the timetable set by the authorities.

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

Table 2 – Financial indicators for Venezuelan banks

	Assets (VEB bln)		Assets (USD bln.)		Equity (VEB bln.)		Equity/Assets (%)		NPL/Total Loans (%)		LLR Coverage (%)	
	Dec-04	Dec-03	Dec-04	Dec-03	Dec-04	Dec-03	Dec-04	Dec-03	Dec-04	Dec-03	Dec-04	Dec-03
Banco Mercantil	8,239,952	5,807,116	4,292	3,629	1,018,467	774,035	12.36	13.33	1.10	3.05	313.39	256.45
Banco de Venezuela	8,502,129	5,188,233	4,428	3,243	976,350	722,613	11.48	13.93	1.22	2.57	173.59	168.04
BBV Banco Provincial	7,874,295	5,627,240	4,101	3,517	896,699	713,332	11.39	12.68	0.86	3.20	366.27	253.79
Banesco Banco Universal	7,928,283	4,453,681	4,129	2,784	957,467	644,551	12.08	14.47	1.21	3.73	400.29	302.42
Banco Occidental de Descuento	3,805,798	2,075,522	1,982	1,297	441,514	358,535	11.60	17.27	2.22	4.94	190.17	130.69
Corp Banca	2,009,187	1,396,440	1,046	873	249,292	161,018	12.41	11.53	0.92	3.46	264.18	114.32
Banco Venezolano de Crédito	1,628,245	1,296,368	848	810	192,592	161,464	11.83	12.46	0.54	2.21	306.93	202.37
Banco del Caribe	1,523,793	951,207	794	595	206,985	148,363	13.58	15.60	0.26	1.50	1,308.85	437.48
Banco Exterior	1,540,057	1,014,229	802	634	203,277	141,260	13.20	13.93	0.15	0.29	856.79	793.60
Commercial and Universal Banks	56,272,866	35,998,277	29,309	22,499	7,029,797	5,159,162	12.49	14.33	1.65	4.47	224.45	179.50

	Net Income (VEB bln)		Net Int. Rev./avg. Assets* (%)		ROA* (%)		ROE (%)		Cost-Income (%)		Cost/avg. Assets* (%)	
	Dec-04	Dec-03	Dec-04	Dec-03	Dec-04	Dec-03	Dec-04	Dec-03	Dec-04	Dec-03	Dec-04	Dec-03
Banco Mercantil	355,733	236,779	8.97	12.38	4.68	4.54	39.69	37.16	50.95	42.21	7.11	8.46
Banco de Venezuela	384,502	259,513	8.54	11.34	5.03	5.32	45.26	41.05	51.36	55.11	6.31	7.85
BBV Banco Provincial	355,966	291,513	8.89	13.76	4.85	6.12	44.22	46.49	58.11	55.51	6.93	8.98
Banesco Banco Universal	438,394	241,639	6.67	8.52	5.41	4.97	54.73	40.74	50.32	60.46	5.90	8.20
Banco Occidental de Descuento	130,761	85,010	7.28	7.66	2.63	2.65	32.69	26.27	60.70	66.37	5.16	5.82
Corp Banca	101,574	52,810	8.11	9.15	5.03	3.31	49.51	36.01	54.34	66.64	6.53	8.02
Banco Venezolano de Crédito	78,869	83,797	9.17	10.25	5.39	7.16	44.55	52.53	49.87	47.09	6.13	6.55
Banco del Caribe	102,453	61,759	8.87	12.21	5.76	4.72	57.66	44.95	58.25	62.69	8.32	9.13
Banco Exterior	107,313	100,049	11.25	14.95	6.30	8.85	62.29	74.91	41.50	39.11	5.34	6.50
Commercial and Universal Banks	2,598,238	1,800,087	8.40	11.39	4.72	5.19	42.63	42.94	56.02	56.74	6.92	8.61

Consolidated Figures.

Average Inflation: 2004: 22.1%; 2003: 31.1%

Exchange Rate: Dec-04: 1,920; Dec-03: 1,600

* Adjusted by investment funds

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