

**DOMINICAN COMMERCIAL BANKS – 1H2002 RESULTS****Economic Environment**

- *GDP growth remains strong; low inflation*
- *“Free-trade” zones and largely US-dependent tourism industry continue to decline*
- *Volatile FX market and steep rise in interest rates*

In sharp contrast to the conditions that prevailed in the Dominican Republic (DR) a year ago whereby GDP growth contracted 1.5% in the first quarter of 2001 and then grew a meager 1.8% in the second quarter, in the first six-months of 2002 GDP output increased 6.0%. About 75% of the semi-annual GDP growth is accounted by four sectors: construction (grew 14.9%); manufacturing (+14.0%); commerce (+7.2%) and transportation (+6.1%). The growth in the construction sector was driven by public-sector spending in infrastructure projects, financed by the proceeds of a USD500 mln sovereign bond issue in September 2001. A very different trend was exhibited by growth in the free-trade zone areas (zona franca) and the hotel industry which contracted 11.6% and 8.5% respectively. Exports from manufacturing companies operating in the zona franca, mainly textile-producing companies, continued to decline (4.3% YoY) as demand from the U.S. remains weak. With declining tourist arrivals (-12%), hotels have been registering lower occupancy rates, hence revenues. North America is the largest market for visitors to the DR with 48.4% share (US: 30.1%), followed by Europe (43.1%).

A positive development was the low increase in the CPI index which at 2.2% for the six-month period, compares favorably with the inflation rates registered by other Latin American economies. On an annualized basis, the inflation rate was 4.05%, well below the 10.2% from a year earlier, though the restrictive monetary policy starting in the second half of 2002, has pushed-up interest rates; coupled with the increase in energy prices announced in September, inflationary pressures are growing.

**The Regulatory Environment**

- *Change in accounting standards*
- *New definitions for past-due loans*
- *Monetary Code has yet to be adopted*

Following the modification of the framework for the risk-classification and provisioning of loans in 2001, (see commentary “Dominican Republic Commercial Banks – 2001 review”), two other regulatory changes were adopted on July 1, 2002.

These pertain to (a) the reporting of financial results under accrual-basis accounting and (b) definition of past-due loans. The effect of these changes will not be seen until the banks publish their 3Q02 financials. Under the new, more internationally aligned definitions for past-due loans, banks will have to disclose (i) loans past-due 30-90 days: these recognize installments in arrears (ii) loans past-due over 90-days: these recognize the entire loan as overdue if repayment of principal has been in arrears for more than 90-days.

As of the press date of this report, the “Monetary and Financial Code”, a comprehensive and modern regulatory framework for the financial system has yet to take legal force, though a provisional deadline for early November has been set. The law which has been in the making for eight years and has stirred debates in the different sectors of the financial industry reached its final form in the current year. It was submitted by the financial community to the legislative bodies for approval on September 17, 2002, to be followed by the approval of the executive body.

**Results for the Commercial Banking Sector**

- *Strong profitability though credit expansion is slowing to more sustainable levels*
- *Rising provisioning needs but level of loan loss reserves remains low by regional standards*
- *High margins partially compensate for decline in credit demand*
- *Inefficiencies despite minor improvements*
- *Adequate liquidity turning scarce as monetary policy tightens*
- *Capitalization ratios are low to support future asset expansion or to shield banks from external shocks*

The size and the performance of the commercial Banks continued to weigh heavily in the financial system’s results during the first half of 2002. The commercial banks continued to control 74.2% of the system’s total assets, while the sector itself remains concentrated, with the four largest banks commanding 72% of the sector’s assets. Net income in the six-months totaled DOP 1,692mln, a 23.5% rise compared to the same period in the previous year. The performance of the six largest privately-owned banks shown in Exhibit 1 is representative of the sector’s performance. Banco Popular Dominicano and the State-owned Banco de Reservas which are the largest and second largest commercial banks by asset size, continue to dwarf their closest competitors as they generated 49% of

**Exhibit 1: Financial Highlights of Dominican commercial banks based on June 30th data**

	Popular		BanInter		BHD		Bancredito		Progreso		Mercantil		Average	
	2002	2001	2002	2001	2002	2001	2002	2001	2002	2001	2002	2001	2002	2001
ROA	2.09	2.47	1.38	1.41	1.72	1.91	1.41	1.58	1.75	1.17	1.11	1.31	1.58	1.64
ROE	22.0	27.6	17.5	14.9	17.7	19.0	14.2	14.6	16.9	11.3	12.9	12.1	16.9	16.6
NIM	8.51	8.61	4.59	5.23	6.16	7.21	5.65	5.38	9.35	6.62	7.81	8.03	7.01	6.85
Capital Ratio	10.0	10.0	10.8	11.8	11.6	11.1	11.3	14.4	12.3	12.8	10.9	14.5	11.2	12.4
Equity/Assets	8.86	8.44	8.02	8.90	9.90	9.56	9.13	11.86	10.5	10.09	7.89	10.31	9.06	9.86
Cost/Income	69.0	65.0	69.3	60.1	66.3	69.1	60.4	66.5	59.1	70.8	63.6	57.1	64.6	64.8
Cost/AvgAssets	7.44	7.06	4.80	5.36	5.30	6.57	4.74	5.68	7.12	7.21	6.10	6.53	5.92	6.40
OpProfit/Assets	2.17	2.62	1.20	1.38	1.81	2.00	1.65	1.60	2.40	1.32	1.50	1.59	1.79	1.75
PDL/Loans	1.28	0.87	2.01	2.76	5.50	3.50	2.81	3.22	2.85	3.49	4.47	1.32	3.15	2.53
LLR/PDL	140.6	168.5	176.6	196.3	102.3	193.2	132.0	131.4	208.3	142.5	88.2	321.4	141.3	192.2
LLR/Loans	1.79	1.47	3.54	5.41	5.62	6.76	3.71	4.23	5.94	4.97	3.94	4.25	4.09	4.51

<sup>+</sup> State-owned Banco de Reservas, the second largest bank by assets not included. <sup>++</sup> Past-due Loans as reported under local standards

the sector's earnings. The ranking of the banks in terms of performance resembles closely their ranking by asset size, with the exception of Citibank (not included below) which despite its small operation in the DR (3.1% asset mkt share), it ranks third by net income, generating 12% of the system's earnings. There are only two majority-controlled, foreign banks operating in the DR, the other being Scotiabank, and their asset market share is 5.8%.

The composition of the banks' balance sheets remained unchanged in the first half of the year with banks continuing to rely on lending operations for revenues. Loans represented 64% of assets, followed by cash and cash-equivalent items (20.9%), fixed assets (4.5%), securities (2.9%) and other assets (7.7%). Although the 8% growth rate for gross loans in the first semester has declined from 10.4% a year earlier, growth for the 12-month period remained robust at 28.2%. Net income in 1H2002 benefited from the stability in funding costs (which had declined in 2001) while from April 2002 onwards, banks started repricing their assets upwards. Net interest revenue therefore grew 25% from a year earlier yet the growing proportion of dollar-denominated loans in the loan mix (1H02:27.7%) contained the improvement in the net interest margin. Despite the growth in net income, banks provisioned moderately in the first semester of 2002; the provisioning charge was up 5.8% compared to a year earlier, equivalent to 16.4% of net interest revenue (1H01:19.4%). The banks stepped up their provisioning as of late 2001 because of the introduction of more stringent provisioning requirements but which are being phased-in over a three year period. Efficiency ratios remain weak by international standards and although most banks now have well-established,

nationwide distribution networks, fierce competition for personnel and technology related investments, including deferred amortization charges from year 2000, continue to dampen bottom line earnings. Among the six largest privately-owned banks, Bancredito stands out in terms of cost management as the bank's operating costs increased 12% on a year-on-year basis versus the 18% peer average. At the upper end of the range was Banco Popular Dominicano though this is explained by its significantly larger network of 144 branches and the investment made in 2001 in a new technological platform that constitutes the backbone for a new strategy at the Group level. Banco BHD's results continue to bear the influence of the merger with Fiduciario at the start of 2001.

Asset quality ratios showed some deterioration in 1H02 but it should be noted that for most banks the improvement seen at end 2001 compared to the year before, was largely attributed to vigorous asset growth. More importantly, the ratios of impaired loans shown in exhibit 1 are not internationally comparable and underestimate the true asset quality of the Dominican banks since they only incorporate installments past-due 60-days or more. Meaningful comparisons with other Latin American banks can not be made until after the banks release their 3Q02 financials and they start reporting impaired loans under new definitions that were adopted in July. Despite the discrepancy in the disclosure of past-due loans, the favorable economic environment that has prevailed in the DR in recent years, the short-term nature of lending operations and the limited exposure private banks traditionally have had to the public sector point provide some comfort towards the low level of asset impairment reported. In the absence of any need to reschedule loans on a systemic basis or to foreclose a large volume of

assets, the balance sheets of the Dominican banks appear at first sight to rate better than their counterparties in Latin economies beleaguered with recession and currency devaluation. However, the 55.1% rise in past-due loan balances that surfaced between June 2001 and June 2002 raises concern. The sector's ratio of past-due loans to total loans has moved up to 2.42% as of June 2002 from 1.99% a year earlier.

In parallel, the Dominican banks have been building-up their loan loss reserves, albeit from a low base. FitchRatings believes this trend should continue if the banks are to prudently reserve against their loans and in view of the changing macroeconomic panorama. The banks' exceptional margins which are unlikely to change in an environment of high interest rates, allow the creation of higher provisions. With the exception of Banco Popular Dominicano which has always reported pristine asset quality ratios compared to its local peers and the smaller-sized Banco Dominicano del Progreso, the ratio of loans loss reserves to gross loans for the other private-owned banks appears to have weakened as of June 2002 compared to a year earlier. The trend is similar for the sector as a whole; its ratio declined to 3.3% at end June 2002 from 3.6% at end-June 2001. FitchRatings also views this with concern though we note that the switch from cash-basis accounting to accrual accounting starting July 1, 2002, would have yielded a reserve which the banks could have used to partially offset their provision needs.

With steeply rising market interest rates and the reversal in the conduct of monetary policy, the liquidity of the commercial banking sector began to tighten towards the end of the first half of 2002. To accommodate credit growth, banks made some reductions in their small investment portfolios which typically comprise certificates of deposits issued by other local financial entities, mainly savings and loans associations. High deposit reserve requirements held in cash at the central bank, have traditionally provided a safety-net to the liquidity of bank balance sheets. However, in September 2002, the monetary authorities eased the reserve requirements as the liquidity crunch was accelerated in the third quarter of 2002. Based on July data, the restrictive monetary policy is projected to result to a DOP 6.4bln reduction in the country's money supply. This is in contrast to the policy followed during the second half of 2001 when the central bank did not roll-over the maturity of its securities known as *certificados de participacion*, thereby allowing money supply to expand by DOP 3.1bln. This year's demonetization has been accompanied with ad-hoc injections of

foreign-currency to relieve further growing pressure on the DOP which is evident to have now depreciated at the fastest rate in the last 5 years. As a result, the central bank's foreign currency reserves have been depleted. Until the interest rate environment stabilizes, market credit demand will continue to decline, whilst the commercial banks will move towards dollarising their loan portfolios at a faster pace. Although most banks claim to lend to companies with strong dollar cash flows, in view of a low sovereign rating and implied transfer risk, coupled with limited tools the central bank has to execute its monetary policy, FitchRatings views dollar-lending operations as heightened risk for the banks. In terms of asset-liability management, the banks have traditionally held long foreign currency positions though at present, there are no formal limits that regulate FX operations and open positions. Historically, the growth in retail deposits (7.8% in 1H02 vs. 17.0% in 1H01) has supported the banks' asset expansion though the bulk of these funds are placed short-term and create sizeable asset-liability maturity mismatch on the balance sheets. Nonetheless, deposits in USD account for 20% of all retail deposits, growing 7.9% in 1H02 (37% YoY), while USD borrowings from abroad increased 27.4% in the 12-month period. With competition in the retail funds market intensifying during the third quarter of the year, it is expected that banks will come to depend more on lines from abroad to meet their financing needs as their pricing has become more competitive while special funds received from foreign development banks allows them to engage in project finance.

Although deposits financed 75% of total assets as of mid-2002, banks have grown aggressively their loan portfolios over the last few years, at twice the pace of macroeconomic growth. Private shareholders have shown their support towards the banks by reinvesting dividends, albeit most banks maintain equity levels at regulatory minima (10% on a risk-weighted basis). It should be noted that under local norms, only Tier-1 capital is permitted. As of June 2002, the banking sector's average risk-weighted capital adequacy ratio was 40 bps below the 11.16% average ratio reported by the banks in Exhibit 1; in its turn, this ratio had slipped from 12.43% from a year earlier. FitchRatings considers that the equity levels of the rated Dominican banks are low; our opinion is based not only in view of the inherent risks of a sub-investment grade economy, but also in context of the banks' operating flexibility, whereby most of capital and reserves is tied-up by non-earning assets (mainly past-due loans and fixed assets). For the four largest privately-held banks, the average ratio of

non-earning assets to statutory capital and reserves was 84% as of June 2002.

## Rating Outlook

### Exhibit 2 – Fitch Ratings’ Dominican Bank Ratings

Bank	Individual	Support	Foreign Currency	
			Long Term	Short Term
Banco Popular Dominicano	C/D	4T	BB-	B
Banco Intercontinental	D	4T	BB-	B
Bancredito	D	4T	BB-	B
Banco Dominicano del Progreso	D	5T	B+	B
Banco Mercantil	D	5T	B+	B

The long-term foreign currency debt ratings at the BB- category are in line with our assessment of the creditworthiness of the sovereign. The current outlook on the debt ratings shown in Exhibit 2 is stable. This reflects our view that we do not foresee any changes to the current ratings in the near-term though concerns remain over the operating environment and any adverse effects on asset quality.

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