
DOMINICAN BANKS – END-2002 RESULTS**Economic Environment**

- *Era of high GDP growth is drawing to an end*
- *Rising oil, electricity prices resulted to double-digit inflation in '02*
- *Price hikes will continue to drain economic performance in the year ahead*
- *After depreciating sharply in '02, the Peso fell further after agreements for artificial support were violated in February 2003*
- *Government must revise '03 budget given bond issue proceeds and other tax measures*

In defiance of the adverse economic developments that began surfacing in the second half of 2002, the Dominican Republic achieved a 4% GDP growth in 2002, the second highest rate in Latin America. The performance of the US economy, DR's largest trade partner and provider of foreign visitors, combined with prospect of war with Iraq and rising oil prices, were the main events that negatively influenced economic performance in 2002 and continue to do so. Rising prices for imports of oil and derivative products drove the country's 2002 inflation rate to 10.51% (2001: 4.4%). Inflation for the first six-months of 2002 had been reported at just 2.2%. The delay of the monetary authorities to take remedy action undermined the Dominican Peso (DOP) and domestic investor confidence.

The central bank had used USD 500mln to defend the Peso early in 2002 but later in the year allowed the currency to depreciate as its own international reserves dropped to minimal levels. In late October, in an effort to contain the DOP's slide, foreign exchange houses, remittance houses and commercial banks agreed to an artificial exchange rate ceiling of DOP 20.80 to the USD. The fixing of the exchange rate came as a surprise though to international investors since the arrangement conflicted with the adoption of the Monetary and Financial Code. Under the new law, the exchange rate is based on the principle of free convertibility. By late November, the DOP had devalued 28.5% and the DR faced a crisis not seen since August 1991.

With the arrival of 2003, foreign exchanges houses opted to let the DOP float and be traded again on supply-demand basis. The breakdown of the collective agreement caused the exchange rate to immediately rise to DOP 23.50/USD. Although the FX houses defended their action on the emergence of an informal foreign exchange market and the erosion of their market share, the lack of dollar liquidity in

the formal market persisted in the following weeks driving the DOP exchange rate up to 26.50 per USD.

Speculation fuelled much of the surge which was unwarranted by the country's economic fundamentals and was in contrast with the successful USD 600mln bond placement in the international capital markets on January 16, 2003. The bond had a maturity of 10-years and was priced to yield 493 percentage points above US Treasury bonds. Proceeds from this sale were earmarked to boost central bank reserves (USD 150mln), refinance maturing debt (USD 315mln) and repay part of the government's loan balances with the domestic banking sector (USD 135mln). These proceeds as well as other tax items are not included in the government's 2003 budget which must be revised given the less favorable economic growth outlook.

Monetary Policy Committee Measures

- *Mixed monetary policy in '02 did not contain the deterioration in economic sentiment*
- *A tight monetary policy now to remain in place*
- *Foreign exchange tax to be phased out by 2008*
- *Subsidy on FX rate for the payment of foreign debt eliminated as of March 2003*

Official reaction came on February 9, 2003 when the central bank's monetary policy committee announced a number of measures to further tighten monetary policy. Deposit reserve requirements for commercial banks which had been relaxed to 17% in October 2002 to ease liquidity shortage at the time (see Fitch report "Dominican Prudential Regulations") were restored to their historic 20% level whilst reserve requirements for savings and loans institutions (S&Ls), development banks and financial companies were raised to 15% from 10%. Historically, S&Ls invested their excess liquidity either in central bank paper or in bank deposits. However, over the next few months, the S&Ls will not be permitted to convert their central bank securities into central bank deposits to comply with the more stringent reserve requirements. Such gradual process will begin in July 2003, meaning that in the months ahead, the S&Ls will be forced to withdraw their bank deposits and further restrict the sector's liquidity. On February 9, the central bank also announced that it would issue short-term paper with maturities of 30, 60 and 90-days at above market rates. The interest rate range was set at 28%-30%. Although the banking sector had supported the efforts of the monetary authorities to stabilize the exchange rate in 2002, it strongly opposed the issuance of central bank certificates at above market rates early in

2003. The crowding-out effect combined with an outflow of deposits from the S&Ls would restrict liquidity. After negotiations with the commercial banks, the central bank finally issued DOP 1.0bln (USD 40mln) in short-term certificates at interest rates of 23%-26%.

On February 25, 2003 the monetary policy board also announced its decision to eliminate the foreign exchange tax that has been in effect since 1991. The tax which currently is at 4.75% will be phased out by 2008 in 19 increments starting October 2003. The tax provides about DOP 5bln (USD 200mln) annual revenue to the government and for years distorted the foreign exchange market and rate mechanism. The tax also made it prohibitive for private remittances to flow through the banking system as foreign exchange houses were exempt to this tax. Private remittances amounted to USD 2.1bln in 2002, a 10.3% increase from the previous year and cover about 9% of the country's GDP.

In a similar move, the monetary authorities also eliminated the subsidy provided to the government by bringing to market level the foreign exchange rate that was used in calculating the payments of external debt.

Government Measures

- *Fiscal reform expected to be gradual*

The Mejía administration quickly complemented the monetary measures with new fiscal measures. The objectives of the governmental measures were twofold: to limit fiscal spending by saving energy and to reduce current account pressure by further restricting consumption. The government introduced a 10% rise in the import tax to which only food, medicine, primary materials and capital goods were exempt. The tax increase was widely criticized by the business community as it violated the terms of the economic stability act signed in December 2002 between the private sector and the government. Another announcement stating that the Government would add DOP 300mln (USD 12mln) to the fiscal surplus by the end of February in addition to the DOP 100mln (USD 4mln) monthly fiscal savings agreed under the act was received more favorably. The receipts from the higher import tax are now partially funding the subsidy on cooking gas that the administration had to introduce on February 15. Nevertheless, oil prices which are not likely to subdue in the near term, will remain the single largest drain on the Dominican economy and outside the

sphere of influence of the country's administration. Gasoline and electricity prices in the Dominican market will rise further in the current year placing inflationary pressures on the small economy. Despite the unpopularity of price increases, it is unlikely to see large-scale social strife in the country though organized demonstrations against the government's economic framework have now been planned for mid-March under the initiative of former President Leonel Fernandez. More importantly, the price hikes will keep demand for USD high which suggests that the current administration's expectations to see the exchange rate stabilize at DOP 20-22/USD are stretched. On a positive note, the Peso seems to have stabilized; it closed at DOP 23.85/USD in the last week of February.

The energy saving measures announced by the Mejía administration are not seen as a serious commitment to reduce public expenditure but are rather ephemeral. The measures included a reduction in the use of air-conditioning in public buildings from February to April; suspension of motor vehicles purchases by the public sector in the first half of the year; suspension of government advertising for three months; suspension of official international trips while oil prices remain at current levels. The Presidential speech made on February 27th weighted on external factors for explaining the country's weakening economic performance which suggests that although the administration remains committed to structural reforms, the adjustment may come gradually.

Results for the Commercial Banking Sector

- *Year-end 2002 results are not comparable to previous reporting periods because of the change in accounting norms and new definition of past-due loans as of July 1, 2002.*
- *Good profitability as high interest rates helped sustain interest revenues despite the decline in credit demand in 2H02*
- *Three newly licensed banks have brought the total number of commercial banks to fourteen*

Rising interest rates, a weaker DOP and a number of measures issued by the central bank in October 2002 limiting bank lending slowed the sector's asset growth in 2H02 and eroded the size of balance sheets in USD terms. On the other hand, earnings for the sector were aided by the high interest rate environment that characterized most of 2002. As the

year progressed, it became clear that credit demand was drying out and the debt burden of existing borrowers was under stress.

The commercial banking sector posted net profit of DOP 4.3bln (USD 171.8mln) in 2002; in the first half of the year, net profit was DOP 1.7bln. Commercial banks control 75% of the financial system's assets, while the sector itself is concentrated with the four largest banks commanding 70.88% of the sector's assets. Three new players entered the Dominican banking market in 2002: BDI, Banco Professional and Banco Vimenca. BDI was formerly licensed as an investment bank; the other two banks are newly established. BDI is the largest among the new institutions with an asset market share of 1.4%. Professional's market share at year end-2002 was 1.0%. Vimenca is the smallest with just 0.1% of the sector's assets. The three banks posted less than 1% of the sector's profits.

The performance of the six-largest privately owned banks shown in Table 1 is representative of the sector's overall performance. Banco Popular Dominicano (BPD) remains the industry leader both in terms of size and profitability. The bank, which accounts for 24% of the system's assets, generated 29.7% of the sector's earnings in 2002. Together with Banco de Reservas, the State-owned bank, they dominate the system with 46.75% and 48.78% share of assets and profit respectively. Only a small regional bank, Banco Santiago, posted a DOP 18.6mln (USD0.7mln) loss in 2002.

On average, the six privately-owned banks reported better profitability ratios than in 2001. The average ROA and ROE ratios were 2.08% and 20.69%

respectively compared to 1.97% and 20.04% a year earlier. The corresponding ratios for the industry were 2.39% and 26.09%. BPD reported its best earnings performance yet with an ROA of 2.92% followed by Bancredito's 2.07%. Wider net interest margins, 7.48% on average, explain the growth in interest revenues, whilst BPD and Banco Dominicano del Progreso (BDP) attained margins above 9%.

The six banks also reported improvements on the operating expense side. Although still high by international standards, the average ratio of cost to income declined to 60.55% from 64.71% in 2001 but there was a less marked improvement in the ratio of cost to average assets which only moved to 6.27% from 6.43%. Bancredito leads its peer group in terms of operating efficiency as the bank's ratio of cost to income slipped below the 50% level. The bank also reported x2.5 increase in provisions, leaving its net income of DOP 326.5mln (USD13mln) just 7.3% higher than 2001.

The provisioning charge taken by the other banks and which remained at similar levels to 2001 was a less favorable trend in Fitch's view. The ratio of provisions to average loans was 2.55% (2001: 2.30%) whilst most banks have yet to report 100% reserve coverage for their past-due loans. This provisioning deficiency will put additional pressure on future earnings as both revenues and asset quality weaken.

- *Asset quality, historically underpinned by GDP growth, has deteriorated; outlook remains negative in '03*

The authorities enacted new rules in 2001 and 2002 to bring loan classification and provisioning

Table 1: YE2002 Financial Highlights of Dominican banks rated by Fitch Ratings

	Popular		BanInter		BHD		Bancredito		Progreso		Mercantil		Average	
	2002	2001	2002	2001	2002	2001	2002	2001	2002	2001	2002	2001	2002	2001
ROA	2.92	2.65	2.00	1.79	1.95	2.27	2.07	2.31	1.72	1.56	1.81	1.26	2.08	1.97
ROE	27.39	26.93	21.24	20.66	19.94	22.71	19.83	22.44	16.22	15.14	19.49	12.36	20.69	20.04
NIM	9.06	8.91	5.98	5.50	6.11	7.24	6.26	6.45	9.67	6.99	7.82	7.84	7.48	7.16
Capital Ratio	n.a.	10.35	n.a.	10.02	n.a.	10.20	10.75	11.68	n.a.	11.83	10.61	11.20	n.a.	10.88
Equity/Assets	11.09	10.14	11.05	7.75	10.04	9.52	10.13	10.80	10.93	10.19	9.23	9.37	10.41	9.63
Cost/Income	64.54	66.46	58.14	66.22	59.91	67.90	49.88	58.28	63.09	66.15	67.76	63.26	60.55	64.71
Cost/AvgAssets	7.63	7.49	5.22	5.81	5.39	6.46	5.11	5.24	8.00	7.07	6.26	6.52	6.27	6.43
OpProfit/Assets	3.12	2.82	1.90	1.77	2.19	2.12	2.41	2.68	2.90	1.92	1.80	1.50	2.39	2.10
PDL/Loans	2.60	0.91	5.31	2.17	5.35	4.97	7.18	2.82	4.59	3.31	5.57	1.44	5.10	2.60
LLR/Loans	2.14	1.45	3.70	3.85	4.92	5.86	5.41	3.43	4.42	4.63	4.76	3.42	4.22	3.77

⁺ Past-due Loans as reported under local standards ++ Asset quality ratios **not** comparable to previous year

guidelines close to international norms. After the definition of past-due loans was changed to reflect the full balance of loans past-due over 90-days, the sector's true ratio of PDLs to total loans was unveiled for the first time in September 2002. The sector's ratio stood at 4.35% and loan loss reserve coverage was 82.8%. Due to additional changes in reporting requirements, the ratios of past-due loans as of year-end are not comparable to Q3 data. The December 31, 2002 past-due loan data as disclosed by the Banking Superintendence include the full balance of loans past-due over 90-days *and* loan installments past-due over 60-days. Under this definition, the system's average ratio of impaired loans to total loans was 4.92% whilst loans loss reserve coverage was relatively low at 66.4%.

Based on year-end data disclosed to Fitch Ratings by the individual banks, BPD continues to report one of the best asset quality ratios with 2.14% of its loans reported past-due over 90-days. The other banks rated by Fitch report ratios of past-due loans over 90-days at around 5% of their total loans. Bancredito which focuses on credit-card lending, was at the upper range as suggested by the 7.18% ratio published by the Superintendencia. Although in Fitch's view all of the rated banks should improve reserve coverage especially in light of the changing macroeconomic environment, BanInter's 73.38% reserve coverage ratio for loans past-due over 90-days makes it a clear laggard in its peer group.

As noted in research published in 2002, Fitch Ratings anticipated that asset quality deterioration of the Dominican banks would quicken in 2003, not just the effect of new reporting requirements – which brought more transparency to the system – but because of the weakened payment capacity of borrowers. Wholesale and retail sale establishments comprise the commercial banking sector's largest credit exposure (39.79%) followed by community, public and social services (19.61%), central government (11.10%) and construction (8.90%). The government arranged several bridge loans with the commercial banks at year-end and although 85% of all government lending is reported short-term, government debt represents 68.7% of the sector's total equity, a considerable exposure. Loans represent the only class of sovereign asset on the bank's balance sheets.

- *The shift into dollar lending increments concern over future asset quality*

Throughout 2002, there was a clear shift from DOP denominated assets and liabilities into dollars. USD deposits accounted for 36% of system deposits at December 2002. Similarly, USD loans accounted for 31.4% of all loans. The ratio of USD loans to liabilities was x1.18. Despite the absence of formal limits on the size of open FX positions, Dominican banks have traditionally maintained net asset positions. The sector's net asset position at year-end was about USD 171mln, or 20% of equity.

The punitive interest rate environment and the sharp DOP devaluation in Q4 and so far this year, will make it more difficult for local borrowers to service their debt putting further pressure on the asset quality of banks. In addition, USD loans particularly those provided to borrowers that do not generate foreign currency revenues (c. 30% of USD loans) will be affected the most. The central bank now prohibits banks to finance in USD non dollar-generating firms though this measure may have come too late. Based on year-end data, 27.5% of all loans reported as past-due (per Superintendencia definition) were USD denominated.

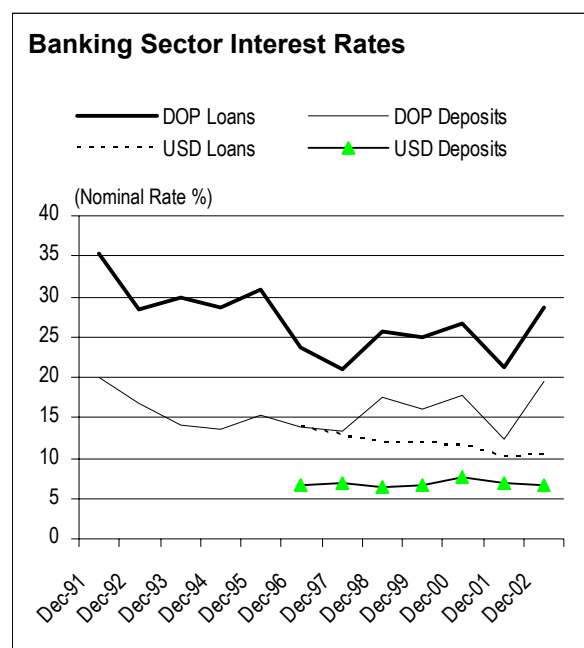
- *Capital strength is undermined by the level of past-due loans and their growth potential in the short-term*

Under the Monetary and Financial Code adopted in November 2002, the minimum capital requirement for a commercial bank was set at DOP 90mln which today translates into USD 3.6mln. Banks are required to maintain a 10% risk-weighted capital adequacy ratio though the calculation of the ratio under local guidelines does not incorporate market risk. Most of the banks in Fitch's rating coverage were close to the limit at year-end while their ratio of equity to total assets stood at 10.41% vs. 9.63% at end-2001. It should be noted that Dominican banks did not report Tier-II capital components in their capital structure at year-end. The sector's average ratio of equity/assets stood at 10.67% while loans represented 63.88% of all assets. As loan loss reserve coverage for most banks remains below 100% and asset quality is projected to weaken in the year ahead, Fitch Ratings believes stronger capital cushions are desirable. The proportion of fixed assets on bank balance sheets also remains disproportionately high. Fixed assets accounted for 4.5% of the sector's total assets and were funded by 42.2% of equity.

Outlook

- *The banking system is poised for a credit crunch in 2003 which in turn will affect the country's economic growth*
- *Should lack of domestic confidence persist, it may turn into an ailment for the longer term health of the economy*

The Dominican banking system, undoubtedly among the star performers in Latin America in recent years, needs to quickly adjust to the country's new macroeconomic realities. Although the weaker DOP could help lift the tourism industry and exports, credit growth will remain subdued in 2003 because of the prohibitive interest rate environment and uncertainty over the US economic performance and conflict with Iraq. The measures announced by the Dominican central bank early in 2003 triggered another overshooting in market interest rates. Hefty interest margins are therefore unlikely to offset the decline in credit demand during 2003. This combined with a low, albeit growing, proportion of non-interest revenues (23.5% of total revenue) and higher provisions will ultimately depress sector profitability. The monetary authorities and the Mejía administration will also continue to face challenges as they need to maintain prudent policies both in the monetary and fiscal fronts, ahead of next year's presidential elections.



Rating Outlook

The BB- long-term, foreign currency debt ratings assigned to the banks in Table 2 are in line with our assessment of the creditworthiness of the sovereign. The outlook on all debt ratings is stable. This reflects our view that we do not foresee any changes to the ratings in the short term though concerns remain over the operating environment and its negative effects on banks' asset quality.

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

In November 2002, Fitch Ratings launched a national ratings service in the Dominican Republic, assigning an 'A+(dom)' National Long Term rating and a 'F-1(dom)' Short Term National rating to Banco BHD. FitchRatings also assigned an 'A+(dom)' National Long Term rating and a 'F-1(dom)' Short Term National rating to Bancredito.

The national rating scale provides a relative measure of creditworthiness for rated entities only within the country concerned. Under this rating scale, a "AAA" Long-term national rating is assigned to the best relative risk within that country, which in most, though not all, cases, will be the sovereign state. The national rating scale is not based on default probabilities: it merely ranks the degree of perceived risk relative to the best credit risk in that same country. National ratings exclude the effects of sovereign and transfer risk and exclude the possibility that investors may be unable to repatriate any due interest and principal repayments. National ratings are not internationally comparable and they are identified by the addition of a special identifier for the country concerned, such as "AAA(dom)" for the national ratings assigned in the Dominican Republic. National ratings therefore allow for broader differentiation among rated entities in emerging market countries where credit ratings tend to converge into one or two rating categories either at, or below a low sovereign rating ceiling.

As is the case with other Latin American countries, the Dominican Republic introduced a modern Capital Markets Law back in May 2000. Under the new regulations, national credit ratings have been made mandatory for public debt issues starting in 2003.

Contact:

Agatha Pontiki, New York	1-212-908 0306
Gustavo López, New York	1-212-908 0853
Franklin Santarelli, Caracas	58-212-286-3356

Copyright © 2003 by Fitch, Inc. and Fitch Ratings, Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004.

Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. All of the information contained herein is based on information obtained from issuers, other obligors, underwriters, and other sources Fitch believes to be reliable. Fitch does not audit or verify the truth or accuracy of any such information. As a result, the information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified, and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed, suspended, or withdrawn at any time for any reason at the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services Act of 1986 of Great Britain, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.