

Country Report

The Dominican Prudential Regulations**Analysts**

Agatha Pontiki
+1 212 908 0306
agatha.pontiki@fitchratings.com
Franklin Santarelli
+ 58 212 286-3844
franklin.santarelli@fitchratings.com
Gustavo Lopez-Cortes
+1 212 908 0853
gustavo.lopezcortes@fitchratings.com

■ Background

Prudential regulations were introduced to the Dominican financial system in 1947 with the adoption of the Monetary and Banking Law. The Law established the Central Bank to regulate the monetary and banking system and created the Superintendence under the Ministry of Finance to apply and administer the new regimen. The General Banking Law (Ley 708) was adopted in 1965 but it was not until the Financial Reform Act of 1992 that modern legislation was introduced. The First and Second Resolutions issued by the Monetary Board (MB) of the Central Bank in 1992 have formed the pillars of banking supervision over the last decade. The two resolutions and the decrees that followed, regulated all primary aspects of banking activity such as credit-risk, liquidity and capital adequacy. The Reform Act broadened the scope of non-banking activities in which banks could engage and allowed them to either remain specialized providers of financial services (savings and loans associations; development banks etc) or to transform into multiple-services banks. The Reform Act was an extension of government policy of economic deregulation and liberalization and a response to the financial crisis of the early-1990s which led to the failure of many small financial companies but also of some commercial banks. Consequently, depositors lost their deposits though in 2001, the administration of President Mejia announced that it would start re-paying depositors affected from that era.

After many years of debate, Law 183-02 ("*Ley Monetaria y Financiera*") was finally approved in November 2002. The Law sets a comprehensive regulatory framework for the financial system and introduces a deposit guarantee fund. An important aspect of the law is that it formalizes the independence of the Central Bank and limits its role to lender of last resort. It also confirms the autonomy and the powers of the MB and the Superintendence of Banks. The law also describes liquidation and bankruptcy procedures. Another outstanding feature is that only two types of financial institutions are authorized to operate (i) banks, which may hold sight deposits and (ii) financial societies. Other than accelerating consolidation, the prior will also change the risk-profile and balance sheet structure of the larger banks as they expand into mortgage lending. The MB remains the highest body of authority in terms of banking supervision and retains the sole power to license or to liquidate banks based on the Superintendence's recommendation. The MB also approves any regulation submitted by the Superintendence and co-ordinates the roles and functions among the Superintendence of Banks, the Superintendence of Insurance Firms and the newly-created Superintendence of Private Pension Funds and Superintendence of Capital Markets. The MB is a nine-member body, headed by the Central Bank Governor. Other members include the Minister of Finance and the Superintendent of Banks but all appointees are subject to approval by the Senate.

■ Framework

Law No. 183-02, *Ley Monetaria y Financiera*, approved on November 21, 2002 is the legal framework that currently regulates the operations of the Dominican financial sector. The law's provisions may be supplemented by resolutions (reglamentos) issued by the Monetary Board (Junta Monetaria), and/or instructives (instructivos) issued by the Central Bank and Superintendence of Banks within their respective areas of authority. The three regulatory entities are collectively known as the Monetary and Financial Administration which has functional, organizational and budgetary autonomy.

The highest body of authority is the Monetary Board. It consists of 9 members. Three of the members hold office and are the Governor of the Central Bank, who also presides the Board, the Minister of Finance and the Superintendent of Banks. The President of the Republic selects the 6 other members, whose nomination must be approved by the Senate. These members serve for a 6-year term. The Board's main functions are:

- To determine monetary and financial policies for the country including those relating to foreign-exchange
- To approve monetary policy
- To dictate monetary and financial resolutions
- To approve internal circulars of the Central Bank and Superintendence of Banks as well as their organizational structures
- To approve the budgets of the Central Bank and the Superintendence of Banks
- appoint a Comptroller for the Central bank and the Superintendence of banks
- To appoint or suspend any official from the Central Bank or Superintendence of Banks based on recommendation by the Central Bank Governor or Superintendent of Banks
- To approve or suspend the operations of any financial entity and approve of any mergers
- To approve or suspend the operations of any foreign exchange house and approve of any mergers

The Central Bank executes the monetary, financial and foreign-exchange policies approved by the Monetary Board. The Central Bank also supervises the payment systems and the interbank market and has the authority to sanction financial entities that do not meet the minimum deposit reserve requirement. The Governor of the Central Bank is nominated by the President of the Republic and approved by the Senate for a period of six years. The Governor can only serve two consecutive terms.

Under Title 1, Section 5, Article 19 of Law 183-02, the Superintendence is the supervisory body for all financial intermediaries and its main function is to verify their compliance to all applicable regulations; to require the constitution of provisions to cover risks; to rectify any non-compliance to rules and to apply the corresponding sanctions, except for those imposed by the Central Bank. The Superintendence must also submit proposals to the Monetary Board to approve or suspend any financial entities.

■ Capital Adequacy Rules

Law No 183-02, Article 38 sets the minimum capital adequacy requirement for banks. The law requires minimum capital of DOP 90mln (USD4mln) for multiple-services banks and credit entities; DOP 18mln (USD 0.8mln) for Savings and Loans and DOP 5mln (USD 0.2mln) for Credit Corporatives. The law also defines requirements for licensing approval such as eligibility of shareholders, representation at the Board of Directors, sound corporate governance and expertise in banking among others.

In addition, the banks must maintain a minimum ratio of total capital to risk-weighted assets (including off-balance sheet items) at 10%. Total capital or eligible equity (patrimonio técnico) for this calculation is the sum of primary capital (patrimonio primario) and secondary capital (patrimonio secundario). These are equivalent to the Basle's notation of Tier-1 and Tier-2 components. (See Annex I for detail on asset risk-weighting). It should be noted that before the adoption of the Monetary and Financial Law in November 2002, banks were not permitted to have any other capital than Tier-1.

The primary capital comprises the paid-in capital, the legal reserve required under the Commercial Law, non-distributable income, mandatory reserves, non-distributable voluntary reserves and capital surplus as defined by the norms. Secondary capital consists of other capital reserves, risk provisions in excess of those required, up to 1% of risk-weighted assets and contingencies, subordinated convertible debt with maturity over 5-years and asset re-evaluation, if materialized. Secondary capital must not exceed 25% of primary capital (Ley 183-02, Article 46), though two years after the publication of the Law and subject to approval by $\frac{3}{4}$ of Monetary Board members, the limit may be raised up to 100%. Should this limit come into force, any second-tier capital in the form of subordinated debt together with fixed asset revaluation may not represent more than 50% of the primary capital.

If a financial institution's capital falls below the minimum requirement, the Superintendence will

levy a penalty charge of 5-10% of the deficiency, the exact amount to be defined by the Monetary Board. The institution must return to compliance in the short-term or the charge doubles. Capital adequacy is monitored monthly on an individual basis, and every quarter on a consolidated basis.

One main difference between Basle Directives and the current Dominican capital adequacy requirement is that the calculation takes into consideration credit risk only. There has been no resolution to require banks to allocate capital for interest rate, liquidity, foreign exchange and operational risk.

■ Liquidity Requirements

The Monetary Board determines deposit reserve requirements based on the type of currency, the percentage required, the basis of calculation, the period length and their remuneration. Following the First Resolution passed by the Monetary Board on October 10, 2002, banks are presently required to maintain a legal reserve of 17% over total savings deposits, time deposits, special deposits and certificates of deposits as well as net sight deposits. The reserve is applicable for both local and foreign currency deposits. The requirement which came into effect on October 14, 2002 will remain valid until the end of January 2003 and in effect, has temporarily modified the previous 20% requirement that was adopted on January 25, 1996 via Resolution No. 8. Deposit reserves have traditionally been maintained in the form of sight accounts and cash at central bank, however, subsequent to the last change, banks may now hold 60% of the reserve in this form and up to 40% in their vault. It should be noted that although the reserve requirement was relaxed, it was also accompanied with a ceiling on local-currency lending activity, excluding credit-cards. The ceiling is calculated based on an institution's outstanding loan balances as of October 11, 2002 to which 0.5% of the required reserve requirement amount is added. The ceiling was to remain in effect through January 2003, however, following Resolution No. 5 issued by the Monetary Board on December 9, 2002, the limit will remain in effect until March 1, 2003. The Monetary Board issued another 5 resolutions on December 9, 2002 limiting the activities of the financial sector as follows:

- All financial intermediaries authorized to operate under Law 183-02 may not hold excess foreign currency for a period longer than 24 hours. All surplus must be surrendered via the open market operations conducted by the central bank. All entities are subject to sanctions if non-compliant.
- A ceiling on the lending operations (excluding mortgages) of savings and loans associations,

development banks, credit corporations, financial companies and other small-lender companies was set until March 1, 2003.

- A ceiling on the size of the investment portfolios (excluding central bank securities) of multiple-services banks, savings and loans associations, development banks, credit corporations, financial companies and other small-lender companies was set until March 1, 2003.
- The ceiling in effect for multiple-services banks regarding loans to the public-sector was extended to March 1, 2003 (from December 31, 2002).

Resolution No.6 issued on December 9, 2002 also extended to June 30, 2003 the maturity of central bank securities known as "certificados de participación". The securities, which were originally issued in early 2002 but with an undetermined term, were expected to mature in March 2003.

Starting in January 2001 and pursuant to Resolution 4 of the Monetary Board, Dominican banks are also required to formally monitor and report on a monthly basis to the Superintendence their exposure in terms of liquidity, interest and foreign exchange risk. Liquidity, both in Peso and USD terms, is monitored under three parameters (i) a liquidity ratio which is the relation between liquid assets and demand obligations (both adjusted) (ii) liquidity position, calculated as the difference between liquid assets and demand obligations (iii) liquidity gap that measures the maturity mismatch between assets and liabilities. The liquidity ratio allows the inclusion of all maturing debt instruments; nevertheless, the primitive nature of the local capital market has meant that banks have been unable to invest in any securities other than certificates of deposits issued by the central banks or domestic financial entities. New Laws on the Capital Markets and Private Pension Funds are likely to change the current situation and to bring more players in the Stock Exchange.

Liquidity risk calculations are applicable for both the short-term (30 to 90 days) intervals and long-term. For short-term, under (i) and (ii) above, they are expressed in absolute values as well as in percentage terms. The gap is stated in terms of months, using duration analysis.

■ Concentration/Diversification Of Risk

Limits on lending to economic groups and related parties are prescribed in Article 47 of Law No. 183-02. Lending to a single economic group is limited to 10% of bank capital and may reach 20% if real

collateral or other tangible collateral exists. Aggregate related party lending cannot exceed 50% of equity. Related parties are defined as individual or legal entities that are shareholders owning over 3% of a bank's shares, board members, directors, and employees; for all physical persons, spouses and relatives are also defined. After two years from the issuance of the Law and subject to the approval of ¾ of the members of the Monetary Board, the limit may change the limit.

In addition, Article 48 of the Law limits investments in fixed assets to 100% of equity.

■ Loan Loss Classification & Reserve Requirements

The Dominican authorities have published various regulations regarding loan classification and allowances for loan losses. The most recent rules on credit-risk classification are described in a resolution passed by the Monetary Board on January 9, 2001 and which came into force July 1, 2001. The new rule modified the framework that regulated the risk-classification and provisioning of loans that had been in effect since 1993. Under the former rules, banks were introduced to the risk-classification of 100% of their loan portfolio under certain criteria, such as the borrower's capacity and timeliness of repayment, and were given an eight-year transitory regime ending June 2001, to build-up specific loan loss reserves. The banks now have a transition period of three years ending June 2004 to come into compliance with the new regulatory framework. It should be noted that starting September 2000, it became mandatory for banks to review, risk-classify and provision accordingly their loans on a quarterly basis rather than on a semi-annual basis.

The Superintendence has set out specific risk-classification and reserve methodology for each type of loan: corporate, consumer and mortgage. The main features of the recent rules are:

- The number of loan risk-categories has been reduced from seven to five: categories C1+C2 have been merged into a single category known as "C"; categories "D1" and "D2" have been merged into a single category known as "D".
- The provisioning requirements for each category have changed (Annex II).
- The definition of a past-due loan for consumer finance and mortgages has changed (Annex III).
- The definitions of the loans that qualify for each category have become more restrictive.

Additionally, there has been a significant change to the treatment of guarantees which are now considered in the creation of loan loss reserves. The authorities have defined three classes of permissible guarantees when calculating and discounting the different percentages for the creation of loan loss reserve. The valuation of assets held in guaranty remains a challenging task though as property values are volatile, market liquidity is minimal and the judicial process for asset foreclosures is tedious in the emerging economy. The authorities have not made any changes regarding the rules on the disposal of foreclosed assets other than granting automatically a one-year extension after the two-year period which the banks already had in selling or writing-off such assets. Therefore, the banks have a generous three-year period under which they must provision 100% the asset (50% by the end of the second year), if it is not sold.

Generic reserves or the combination of generic and loan specific reserves may not fall below 1%. Specific reserves may not automatically be reversed when a borrower is reclassified to a lower risk category but are subject to Superintendence approval.

■ Other Significant Regulations

a) Accounting Issues

• Reporting

The reporting frequency for banks ranges from one month to one year depending on the type of information required by the Superintendence. For the purpose of audited financial statements, all banks are required to submit these based on the calendar year (Law 183-02, Article 54). A significant change came with Resolution 12-2001 of the Banking Superintendence which modified the use of accounting principles from cash-basis to accrual. Dominican accounting standards as described in Resolution 13-94 of the Banking Superintendence follow international accounting standards however, there are some important differences. (See annex IV)

• Accounting for Loans past due

Banks classify as past-due (*vencido*) any loan which has an installment more than 30-days overdue. However, banks classify the entire balance on any loan as past-due if any payment of principal is more than 90-days overdue. Interest accrual must be suspended.

b) Legal reserve

Banks are required to allocate a minimum of 5% of annual net income to a legal reserve account (equity

reserve) until the reserve reaches 10% of subscribed capital. (Article 58, Código de Comercio) Dividend payments can not be made from this reserve and monies are only available in the event of winding-down operations.

c) Deposit insurance

Under Article 64 of Law 183-02, the central bank is to establish a Contingency Fund to provide some degree of protection to depositors. In the event of a liquidation as cited in Article 63, the Contingency Fund will cover up to DOP 500,000 of the funds deposited in banks accounts by an individual or legal entity, equivalent to USD 20,000 as of end-2002. In total, the Fund will cover up to 30% of senior-debt obligations of the institution in liquidation. All Dominican banks are currently required to contribute to the Fund by paying quarterly premium of 0.1% of total funds received from deposits, checking accounts, and the issuance of certificates of deposit and bonds. The central bank automatically deducts the premium amount from the accounts each bank holds with the central bank. With the approval of $\frac{3}{4}$ of the Monetary Board members, the premium rate may be revised.

d) Money laundering

All financial entities first became subject to money-laundering regulation under Law 50-88 (Ley sobre Drogas y Substancias Controladas) adopted in May 1988. Articles 7 through 15 of the law outlined disclosure and reporting requirements for financial transactions suspicious of money laundering, however, the legislation focused on funds derived from drug trafficking. In May 2002, Congress passed a new law to supplement and strengthen the previous measures. The new legislation was expanded to include funds derived from criminal activities. Articles 12 and 13 of the new law refer specifically to financial institutions and among others, require them to:

- Be familiar with clients' business, scope of activities and types of transactions;
- Introduce internal controls and procedures to prevent money laundering;
- Keep a record of all individual or multiple cash transactions exceeding the equivalent of USD 10,000 and report these to the Financial Analysis Unit (Unidad de Análisis Financiero) on a regular basis and within 15 days of each month;
- Closely monitor any unusual transactions, cross checking them with the clients' profile;
- Report immediately any suspicious activity by a client
- Maintain all records for a minimum period of 5 years

The Financial Analysis Unit is an autonomous unit, specially created under this Law. Its primary function is to supervise and monitor the market information it receives, establishing a central database, thereby allowing efficient interaction and co-operation among the various controlling and supervisory agents, as well as the police and the judicial system. The Unit is administered by a Board whose members are the Minister of Finance (President of the Board), the central bank governor, the Superintendent of Banks, the General Director of Internal Revenue Service; and two representatives from the financial industry (one to represent banks and the other savings and loans associations), each one designated by the President of the Republic.

According to Article 31, money laundering, as well as intentionally omitting the enforcement of controls is a criminal offense punishable with fines and imprisonment of up to 10 years.

ANNEX I

RISK WEIGHTING OF ASSETS AND COMMITMENTS

Risk Weighting: 0%

- Cash;
- Deposits at Banco Central de la República Dominicana (i.e. Central Bank);
- Inter-branch balances;
- Securities issued by the public sector;
- Deposits with domestic Savings and Loans;
- Term deposits with public-sector financial institutions;
- Securities issued by public-sector financial institutions;
- Repos with public-sector entities and public-sector financial institutions;
- Securities held in guaranteed from public-sector entities and financial institutions;

Risk Weighting: 15%

- Cash-collateralized loans with deposit held at lending institution;
- Loans with irrevocable guarantees from a local bank or a prime foreign bank;

Risk Weighting: 40%

- Mortgage loans with insured collateral ;
- Operations with domestic financial institutions (sight-deposits, inter-bank loans; securities; repos; equity participation);
- Sight deposits with prime foreign banks;
- Deposits with “mother” bank or branches;
- Securities issued by foreign banks;
- Equity participation in foreign banks;

Risk Weighting: 60%

- Mortgage loans (non-insured);
- Contingencies (acceptances, guarantees, letters of credit);

Risk Weighting: 65%

- Letters of credit confirmed by prime foreign banks;

Risk Weight: 70%

- Loans backed with real security that is insured;

Risk Weight: 100%

- All other loans;
- Assets received in lieu of payment;
- Accounts receivable;
- Fixed assets;
- Deferred charges.

ANNEX II

RISK-CATEGORIES AND PROVISIONING REQUIREMENTS (AS % OF RISK ASSETS)

	COMMERCIAL		CONSUMER		MORTGAGES	
	Previous	New	Previous	New	Previous	New
A	0	0	0	0	0	0
B	1	2	1	2	1	2
C1	10	--	10	--	--	--
C2	20	20	20	20	20	20
D1	40	--	40	--	--	--
D2	60	60	60	60	--	35
E	100	100	100	100	--	50

ANNEX III

RISK-CATEGORY OF LOANS BASED ON DEFINITION OF LOANS IN ARREARS

	CONSUMER		MORTGAGES	
	Previous	New	Previous	New
A	0-45	0-30	0-5	0-30
B	46-60	31-60	5-180	31-60
C1	61-90	--	--	--
C2	90-120	61-120	>181	61-180
D1	121-180	--	--	--
D2	181-270	121-180	--	181-270
E	>271	>180	--	>270

1. Categories C1 and C2 consolidated into a single category "C"

2. Categories D1 and D2 consolidated into a single category "D"

ANNEX IV

Differences between the accounting policies established by Dominican banking regulators and the generally accepted international accounting principles (IAS).

- Loan portfolio losses are reserved based on a generic reserve of 1% of total credit portfolio or in accordance with the risk-classification of the portfolio, whichever is higher, instead of provisioning based on an on-going evaluation of the balances of doubtful collections.
- Losses generated from the securities portfolio are based on the evaluation and risk-classification of the instruments instead of provisioning throughout the year for consistent loss of the investment (mark-to-market) or for the investment balances of doubtful realization based on an evaluation of the portfolio.
- Losses on properties received in lieu of loan repayment are reserved according to the difference between their carrying valuation and realization value rather than for the loss of value throughout the year(s) carried on balance sheet.
- Properties received in lieu of loan repayment must be disposed of within two years following their acquisition; if any time extension for their disposal is obtained by the Monetary Board, the assets must be reserved 50% during the first two years and 50% during the year of the extension.
- Reductions and provisions have been defined for the excess of fixed assets above the 100% level of equity and for the excess of their carrying value over the market value, instead of accounting at cost of acquisition or realization.
- Secured loans past-due for more than 36 months, and unsecured loans past-due for more than 24 months are charged off; banks may not have any unsecured, single credit exposures that exceed 10% of capital and reserves, or secured credit exposures that exceed 20%; there are no limits defined under IAS.
- Liquid assets are defined as cash held in vault and at banks, placements with the central bank and remittances-in-transit. Under IAS, marketable assets with maturities less than three-months are also considered liquid.
- Overdrafts in current accounts registered for more than two-days must be classified as loans; if not classified as loans, the amounts must be provisioned for 100% and reported as loans past-dues over 60-days. When classified as loans, if they are not secured with real guarantee, they must be reserved for 60% of their value.
- Expenses related to the upgrading of computer systems for Y2K compliance are amortized under the straight-line method over a period of five years. Under IAS, these expenses should have been recognized as incurred.

Copyright © 2002 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.