DOMINICAN REPUBLIC COMMERCIAL BANKS – 2001 REVIEW

Economic environment

- *Sustained growth and low inflation in 2001*
- *Debut in international capital market with a USD 500 mln sovereign bond issue*
- *GDP growth remains positive in 2002 but forecast is lower than average of last eight years*
- *Pressure on FX market and rising interest rates*

For the last eight years, the Dominican economy has grown at an average rate of 6.2%, well above the levels registered by other Latin American economies. 2001 was no exception; with GDP expanding 2.7%, the Dominican Republic (DR) ranked third in terms of growth, behind Ecuador and Chile. However, growth during the year was volatile: the economy contracted 1.5% during the first quarter, recovering to 1.8% growth in 2Q and heating up to 5.5% and 5.0% in 3Q and 4Q respectively. The performance during the first half of the year reflects the shock subsequent to the tax reforms and hikes implemented at end-2000, as well as the effect of higher oil prices in the world market. Nonetheless, the DR's performance in the second half of 2001 remains outstanding given the US economic slowdown, the catastrophic events of 9/11, and the national disaster on November 12, when 235 people on Flight 587, mainly Dominicans, were killed. Despite serious concerns at the time that these events would negatively impact the flow of remittances to the country, the DR received a total of USD 1,913 mln in private remittances in 2001, up 6.9% from a year earlier. Remittances cover close to 9% of GDP.

GDP expansion was largely driven by the growth of the telecom sector (24.2%); utilities (18.4%); public-sector (8.8%) and agriculture (5.1%). In contrast, three other sectors which contribute significantly to GDP grew anemically: tourism (4.4%); construction (0.9%) and commerce (0.3%), while mining and manufacturing registered negative growth rates of 15.2% and 1.3% respectively. Mining suffered because of the decline in nickel output as world prices dropped below the DR's production costs. Manufacturing was affected by a 4.6% decline in the free-trade zone area (zona franca). Exports from this sector, mainly textile-producing companies geared to the US market, fell 4.9% from a year earlier to USD 4,538 mln. Despite the on-going arrival of new companies in the free-trade area, this sector will face competitive challenges going forward, particularly as Central America negotiates a collective free-trade agreement with North America by 2005.

DR was also one of six Latin American economies with inflation rates less than 5% in 2001. Despite the increase in two consumption taxes (ITBIS and ISC), the CPI rose 4.38% in 2001, the country's lowest level in the last five years. The rate also compares favorably with the central bank's target of 6.0% for the year, and the 9.02% rate registered in 2000. Another favorable development was the reduction of the current account deficit in the balance of payments to 3.9% of GDP from 5.2% a year earlier, given the sustained levels of foreign investment. Direct foreign investment rose 25.8% from a year earlier to USD 1,198 mln and was channeled into the sectors of energy, communications, commerce, finance and tourism. The central bank continued to build-up its international reserves which received a further boost with the USD 500 mln sovereign bond issue in September 2001. International reserves stood at USD 1,093 mln at year-end, covering about one month of imports. With the debut in the international capital markets, the country's external public debt rose 12.4% to USD 4,137 mln and private creditors now hold a larger share of the debt (28%). The foreign exchange market was fairly stable as the DOP exchange rate vs. the USD varied 3.2% during the year, at an average rate of DOP 16.80 per USD. Nonetheless, the depreciation of the Euro against the USD and hence the DOP was strongly felt in the DR as the number of tourist arrivals declined 6.8%. Europe still accounts for 48% of all the tourists the country receives.

The Regulatory environment

Authorities approved a number of significant modifications to prudential norms during 2001, with more to follow in the current year (see "Outlook"). The most important change in 2001 pertains to the resolution passed by the Monetary Board on January 9th and which the banks started implementing as of July 1, 2001. This new rule modified the framework that regulated the risk-classification and provisioning of loans which had been in effect since 1993. Under the former rule banks had been introduced to the risk-classification of loans 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. 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.

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The banks have been given a transition period of three years ending June 2004 to come into compliance with the new framework. The main features of the new 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 I).
- The definition of a past-due loan for consumer finance and mortgages has changed (Annex II).
- 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 guarantees that are permissible when calculating and discounting by different percentages the provisioning requirement. The Dominican banks have criticized as too narrow the types and discount brackets of the permissible guarantees, while Fitch views skeptically the market evaluation of such guarantees in any emerging economy considering that property values are volatile, market liquidity is minimal, and the judicial process for asset foreclosures is tedious. 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. The reserve coverage ratio for foreclosed assets therefore stood at 23.3% as of end-2001. On a gross basis, foreclosed assets grew 13.7% from a year earlier and still represent a relatively low 1.3% of the system's assets.

The authorities have also began the process by which banks must start monitoring their market-risk. A resolution issued in January 2001 makes it mandatory to report such information to the Superintendence on a monthly basis. The banks have started utilizing variance-covariance methodologies, historical simulation, sensitivity and gap analysis to quantify changes in income to changes in interest rates, their asset-liability structure and currency positions. Although this new rule is an encouraging step, a much more comprehensive framework needs to be adopted for banks to inaugurate and develop adequate value-at-risk models given the limitations of the DR's macroeconomic parameters, and to allow for sufficient allocation of capital for market risks as per the Basle Committee's directives.

Another law that was adopted in late 2001 and which affects banking business, is the requirement for banks to provide tax authorities with lending information about their clients on a monthly basis. Similarly, financial statements presented to the banks and which are not validated by the tax authority as true, are not permissible for loan approval consideration. The prior adds a cumbersome step in a typically lengthy, credit approval process and which the banks are trying to accelerate. In a similar fashion, loans over DOP 3 mln (USD 177k) may not be approved unless the client presents to the bank financial statements audited by an external firm. Although this rule was an initiative to improve and standardize disclosure in the local market, it has been received with much opposition as it conflicts with existing rules and the professional practice of individual auditors. It is most probable that the authorities will have to introduce specific disclosure requirements for the corporate sector, as they did for bank reporting.

In October 2001, the Monetary Board reduced slightly the commission that banks must pay to the authorities on any foreign exchange transaction to 4.75%. The commission, an implicit tax which banks have had to bear but not the foreign exchange offices handling the bulk volume of foreign remittances, was introduced in the DR in early 1991, and has been set at 5% since late 1999. The reduction has been accompanied with a number of other steps that the monetary authorities have taken to allow for open-market forces to govern the country's foreign exchange regime. These include abandoning the receipt of FX monies generated by certain economic sectors which previously the central bank converted to Pesos and delivered to the economic agents at an "official" exchange rate, a rate different to the banking sector's. Starting November 2001, traditional export sectors such as sugar, coffee, tobacco and cacao, were excluded from this scheme, while in January 2002 authorities also excluded the reinsurance sector; maritime transport; casinos, non-resident departure tax; transportation tickets sold by local companies; and counsel fees collected for the issuance of divorces to foreigners. At present, only an estimated USD 700 mln of the foreign-currency receipts, mainly from credit-cards, telecoms and the sale of fuel to foreign vessels, are subject to the "official" exchange rate regime. However, as of April 2002, the "official" exchange rate has been calculated based on the average of the buy and sell rates of the private market; additionally, the central bank has introduced an intermediation margin (USD 0.07) when dealing in the private market, having established

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a formal mechanism (“*mesa de dinero”*) to develop interbank trading both for foreign currency, and Peso liquidity. Given the early stage of the establishment of this mechanism, its activity has been of limited significance and it remains to be developed into an effective tool on which the banks may come to depend for their daily liquidity management.

Results for the Financial System

- *Ample liquidity in the first three quarters of the year allowed for a declining interest rate environment*
- *Credit demand oscillated between highs and lows during the year, driven by consumption*
- *No official restrictions to lending activities*

Despite an environment of declining interest rates, the asset growth pace and the relatively good asset quality reported by the financial sector, yielded strong performance results. Compared to 2000, the system’s profits jumped 44% to DOP 4,730.5 mln (USD 278.7 mln). The results translate into ROA and ROE ratios of 2.39% and 17.5% respectively.

After a sharp decline in credit demand during the first quarter of 2001, lending activity recovered strongly in the second half of the year, aided by the counter-cyclical monetary policy implemented by the central bank. As a result, in 2001 the financial sector recorded robust nominal growth rates, at par with the previous year, with an increase of 22.6% and 22.0% in terms of assets and liabilities respectively. The central bank’s decision not to roll-over any issuances of investment securities (*Certificados de Participación*) was pivotal in building-up liquidity in the market. The end result was that market interest rates for loans and deposits, on average, declined 7.7% and 6.3%, reaching their lowest level historically by end-2001. In the last quarter of 2001, the central bank also exempted from deposit reserve requirements any foreign-currency, short-term borrowings received by the commercial banks. As credit demand picked-up in the local market, the monetary authorities also relaxed the limit on short-term borrowings from abroad, previously set at 30% of a bank’s equity and reserves. In contrast to previous years, the authorities did not introduce any limits regarding credit exposure to any economic sector.

The two most important types of financial institutions, commercial banks and Savings and Loans (*S&Ls - Asociaciones Ahorros y Préstamos*) recorded similar asset growth rates in 2001: 23.1% for banks (2000=26.5%) and 23.8% for S&Ls (2000=20.6%). Credit expansion was the motor of this growth as loans dominate the balance sheet of the financial system (61.6%). Given the build-up of liquidity surplus in the market, it is notable that the investment portfolio of the S&Ls grew by 51%, largely reflecting the placement of excess liquidity into CDs issued by commercial banks. Overall, deposits from the local retail market which increased 27.7% from a year earlier, financed the sector’s growth.

The capitalization of the financial sector showed an improvement as total equity increased 27.9% though in terms of equity to assets, the 11.84% ratio was similar to the previous year. Nonetheless, there was an improvement in the risk-weighted capital adequacy ratio which stood at 14.0% at year-end, above the 10% minimum legal requirement. This positive trend is offset by the decline in provisions; even though they increased 22% in nominal terms, as a percentage of total loans, loan loss reserves slipped to 2.97% from 3.10% a year earlier.

Results for the commercial banking sector

- *Despite lower interest rates and lower GDP growth, performance surpassed previous years*
- *Asset quality remains adequate with a build-up of loss reserve cushions starting in 2H02*
- *Consolidation of commercial banks via mergers and acquisitions*

At year-end 2001, the Dominican financial system still had a plethora of 152 entities operating, though assets remained concentrated in the commercial banking sector, as seen in table 1. Three commercial banks (or “banks”) exited the market as a result of mergers and acquisitions. Banco Fiduciario merged with Banco BHD effective January 1, 2001. Progreso had acquired Banco Metropolitano as of end-2000, while Banco Intercontinental acquired Banco Osaka and the two merged in November 2001. A new player arrived in early 2002 after the Chilean group Altas Cumbres was authorized to establish a bank, while another development bank was also authorized to operate as a commercial bank starting early 2002.

Table 1: Financial institutions operating in the DR

Type	No. Dec-01	No. Dec-00	% of Assets
Commercial Banks	12	15	74.4
Savings & Loans	18	18	15.7
Development Banks	17	17	4.0
Mortgage Banks	1	1	0.1
Finance Companies	75	78	2.1
Small Lenders	24	26	0.2
Public FIs	5	5	3.7
TOTAL	**152**	**160**	**100.0**

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Given its dominance in the financial system, the commercial banking sector generated 70% of the system's profits, equivalent to DOP 3,264.6 mln (USD 192.4 mln). This is an increase of 15.5% from 2000, a year when the banks also saw their profits rise 41%. The result has yielded an average ROA ratio of 1.90%, similar to the previous year (2000=1.94%), though the range of ratios reported by individual banks is wide: from the 6.0% reported by Citibank to 0.60% reported by Banco Santa Cruz, a small regional bank that started operating in 2000. The improvement in earnings performance is attributable to robust loan growth, including higher yielding consumer loans, while banks maintained a wide enough margin in context of an environment of declining interest rates which allowed for an on-going creation of provisions and effective cost management though the prior was somewhat constrained by non-recurring, merger expenses. The provisioning charge of DOP 1,699 mln (USD 100 mln) equivalent to 16.1% of the net interest margin reflects a 6.1% decrease from the provisioning charge taken in 2000, though banks such as BHD and Progreso had anticipated and recognized in advance asset problems of the banks they merged with. Provisions will remain burdensome going forward, as banks have to come into full compliance with new regulations by mid-2004. It should be noted that at year-end 2001, the Superintendence gave banks the option to defer 40% of the loan loss reserve requirement that corresponded for the period Sept-Dec 2001, calculated under the new standards. Nonetheless, most of the large and medium-sized banks complied fully with the new requirement.

On a gross basis, loans to customers grew 32.8% in nominal terms in 2001 to DOP 108.2 bln (USD 6.4 bln), the primary reason behind a 19.4% growth in interest income. Given that the domestic capital market has yet to develop, the investment portfolios of banks are small in size and do not carry any instruments other than short-termed central bank papers and certificates of deposits issued by other domestic financial entities. Interest and commissions on loans therefore account for an overwhelming 97.8% of all interest income earned. The expansion into consumer and electronic banking with a wider use of plastic cards in the domestic retail market is contributing towards revenue diversification; other operating income of DOP 5,4 bln (USD 318 mln) represents one-quarter of interest income earned on loans (or 3.6% of average assets), though banks have yet to introduce fees on most of their services.

Lending which accounts for two-thirds of the banks' total assets, mainly targets the private-sector of the economy (88.2% of total loans) and this trend should remain going forward, as consumer banking develops further and the commercial banks become engaged into mortgage lending, an activity which traditionally has been reserved for the S&Ls but which have not met market demand for home financing. It should also be noted that with the exception of State-owned Banco de Reservas, other commercial banks are restricted by law to lend to public-sector companies or to accept their deposits.

In 2001, the banks also remained active in foreign-currency lending which constitutes 26.2% of their portfolio. Borrowings from abroad, particularly lines of credit from European development banks provide the means for long-term financing in the country. The matching of currency (and tenors) between the foreign funds and the underlying projects the banks finance means their FX positions are fairly closed, though there is still no local regulation that governs the latter. Growth in dollar deposits sourced from the local retail market remained robust (59%) in 2001 though this growth comes from a low base. Dollar funds still represent a relatively low proportion of total deposits (19%) if we consider the magnitude of remittances received in the Dominican economy but which do not flow directly into the banking system. The sharp increase in dollar deposits is the effect of a declining rate environment and the narrower price differential between peso and dollars accounts, as depositors opt to forego the local currency risk. The 26.3% growth in Peso deposits via traditional accounts and certificates of deposits remained at pace with asset expansion; these liabilities finance 94% of gross loans.

The asset growth rates registered by the banks as well as the definition of non-performing loans which under local standards only recognize installments and loan contractual agreements more than sixty days overdue, have preserved what appear to be sound asset quality ratios. However, the short-term nature of lending operations in the Dominican market and the percentage of interest income collected - monitored by the banks given their cash basis accounting - support relatively reasonable asset quality. Although not comparable to international standards, the ratio of non-performing loans to total loans stood at 1.65% at year-end-2001 versus 1.88% at year-end 2000 (1.91% and 2.03% respectively if State-owned, Banco de Reservas is excluded). The ratio rises to 2.60% if installments overdue more than one day are included. Reserve coverage for such overdues was 144% at end-2001. More meaningful perhaps is the ratio of loan loss reserves to total loans which at 3.2% is fairly low but which has not slipped from a year earlier despite the sector's strong nominal asset growth rate.

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Table 2 :Dominican Financial System Indicators

	Commercial Banks		Savings&Loans*		TOTAL**	
	2001	**2000**	**2001**	**2000**	**2001**	**2000**
Total Assets	165,515	132,541	35,596	28,788	217,681	175,196
Gross Loans	108,549	81,588	20,602	18,395	139,122	108,867
Total Deposits	124,918	94,836	28,042	22,578	164,010	164,010
Total Equity	16,632	12,592	5,854	4,686	25,790	20,080
Net Income	3,264	2,172	1,241	1,037	4,685	3,462
ROaA	2.19	1.81	3.85	3.94	2.38	2.15
ROaE	22.34	19.10	23.55	24.86	20.43	18.83
NIM	9.21	10.00	7.18	7.45	8.72	9.31
Cost/Income	63.54	66.10	44.31	44.56	61.61	63.52
Equity/Assets	10.05	9.50	16.44	16.28	11.85	11.46
NPL/Gross Loans***	1.65	1.88	0.73	0.83	1.70	1.92
LLRs/Gross Loans	3.17	3.35	1.82	1.82	2.97	3.11

Source: Superintendencia de Bancos de la República Dominicana

* *S&Ls are locally known as Asociaciones de Ahorros y Préstamos*
** *Includes development banks (bancos de desarollo); the State-owned mortgage bank (Banco Hipotecario); financing companies (financieras); small finance companies (préstamos menor); and public-sector institutions (instituciones públicas)*
*** *Non-performing loans: as per local definition, loan installments past-due >60 days ("créditos vencidos")*

Improving efficiency is becoming a strategic objective for all the large, privately-owned Dominican banks[1] followed by Fitch, as the banks anticipate competition to stiffen with the market consolidating further and the local economy growing at slower rhythms. Operating expenses are equally divided in personnel costs and administrative costs. Together, they rose 13.2% in 2001 driven by personnel costs. The average cost-to-income ratio remains a high 63.5% though it has improved from 66.1% in 2000 because of the higher profits achieved.

With all of the large, privately-owned banks re-investing the prior year's earnings and the State injecting fresh capital into Banco de Reservas early in 2001, the sector registered a 31.2% annual growth in terms of its equity. The average ratio of equity to assets stood at 10.0% at year-end, while the large, privately-owned banks also reported total risk adjusted equity ratios close to the 10% minimum requirement. Under local norms, this ratio is *de facto* a Tier-1, risk-adjusted capital adequacy ratio.

Banco Popular Dominicano (BPD)

BPD remains the forerunner of the banking industry as it commands 24.8% and 25.3% of total assets and deposits respectively. Its closest competitor by size is State-owned Banco de Reservas which trails it with a 5% market share differential. The next competitor among privately-owned banks has c.10% differential. In 2001, BPD reported another strong performance based on its 24% asset expansion, on-going penetration in the consumer market, the monitoring of operating costs and strong asset quality. Net income rose 32% to DOP 976,4 mln (USD 57.5 mln) which resulted to a solid ROA ratio of 2.39%, which is also the leading ratio among the large private banks followed by Fitch. Similarly, the bank had the leading ROE ratio of 28.39%, in line with its 28.79% ratio in 2000. The bank's equity grew 32.7% year-on-year.

Despite declining interest rates, BPD increased net interest revenue 27.5% in 2001, thereby preserving an interest margin of 10.7% (2002=11.4%). The margin also benefits from the bank's funding mix and below market-average funding cost. BPD which has the largest distribution network is well-positioned in the consumer market. Consumer loans grew 34% based on year-end balances, though commercial loans continue to dominate its loan mix (79%) without any specific concentrations. Asset quality remains superior to its peers; as a percentage of total loans, all installments overdue more than one day (as per local standard) stood at 1.40% at year-end, while the reserve coverage for these was 104%. However, considering the tight capitalization of all the large banks, BPD's loan loss reserve coverage needs to be improved as it represents just 1.45% of gross loans, a thin ratio for an emerging market with volatile economic cycles that quickly can stain asset quality. For this reason, and although BPD has demonstrated in the past few years an extraordinary capacity to generate earnings, which in turn have been retained to

[1] Banco Popular Dominicano, Banco Intercontinental, Banco BHD, Bancredito, Banco Progreso, Banco Mercantil. Together, these accounted for over 72% of the commercial banking sector's deposits and assets at end-2001.

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support asset growth, the bank could benefit from a capital infusion. Fresh capital is also essential since BPD's objective is to continue to expand its asset market share up to 34% in the medium-term. Its ratio of equity to assets stood at 10.1% at end-2001; the risk-weighted capital adequacy ratio, *de facto* a Tier-1 ratio was 10.35%. The balance sheet remains fairly liquid: the market's stringent deposit reserve requirement as well as BPD's policy to preserve ample liquidity, result to a minimum of 20% of assets held as cash and cash equivalents. The magnitude and the structure of its retail deposit base remain outstanding features of the bank.

Banco Intercontinental (BanInter)

Subsequent to acquiring and merging Banco Osaka's operations late in the year, BanInter's asset market share expanded to 15.5% from 12.1% at end-2000 and the bank continues to rank third in terms of size. Total assets (and loans) rose 61% in 2001 with c.33% accounted for by the merger. The bank's net profit for the year amounted to DOP 370.8 mln (USD 21.8 mln), an 18.9% increase compared to DOP 312 mln (USD 18.4 mln) reported in 2000. In its 2001 results, BanInter only recognized income generated by Osaka's business post their effective date of merger, November 29. Meanwhile, BanInter took operating control of Osaka in July 2001, thereby reflecting in its profit and loss account non-recurring expenses such as the remodeling of the acquired branch network. Consequently, its ROA and ROE ratios of 1.45% and 18.01% respectively, have weakened from 2.22% and 21.88% in 2000.

Since BanInter's first significant merger at end-1997 with Bancomercio, which transformed its size and diversified its business into the retail segment, the bank has been tied-up in consolidating its market position. In contrast, in 2002 the bank will focus on reviewing the processes of its core activities to capitalize on efficiencies-of-scale. It will also continue to broaden its electronic distribution network, adding 60 to 70 ATM's and will launch new products for the retail market, such as mortgage loans.

The loan mix changed little in 2001 with 88% of loans destined to the commercial sector. The bank remains active in trade and project finance and on-lends funds received under special facilities of development banks abroad. DEG, the German development bank, is a minority shareholder in BanInter, with a 4.2% stake.

Around 35% of BanInter's loans are dollar-denominated. The bank was a first to tap the international markets for USD funds via a Euro-CD program which is expected to be renewed in 2002. Although the program pushed BanInter's funding cost higher than its peers, the availability and stability of such funding are absent in the local market. The acquisition of Osaka and organic growth allowed BanInter to penetrate further the local deposit market. Total funds sourced from the local market grew 82.5% in 2001, with funds in traditional accounts and foreign currency 60.6% and 55.3% respectively. Certificates of deposit which carry higher an interest rate premium more than doubled and account for nearly-half of all deposits. This means that BanInter's margin, already one of the narrower in the market, will remain under pressure, while the availability of such short-term contractual funds may not be as easy should liquidity in the local market tighten.

Asset quality appears to compare favorably with the sector's average. All loan installments overdue by one day (as per local standard) represented 2.90% of gross loans, with a corresponding reserve coverage ratio of 132%. Loan loss reserves stood at 3.85% of total loans at year-end 2001, albeit the ratio of equity to loans slipped to a historically low of 7.7%. The 10.2% risk-weighted capital adequacy ratio also converged to the minimum requirement. The bank is capitalizing all of its 2001 earnings, but Fitch believes this is insufficient to support the bank's projected asset growth as well as to comfortably build-up provisions as required by the new prudential norms. BanInter was one of the banks that in December 2001 deferred 40% of the newly calculated provisioning requirement corresponding to that period.

Bancredito (formerly Banco Nacional de Crédito)

In terms of asset size, Bancredito slipped to 5th position in 2001 due to other mergers concluded in the market. Nonetheless, as its larger peers focused on the rationalization of their activities, Bancredito marketed its products and services aggressively, luring away customers. Its asset market share therefore grew to 9.2% from 8.5% a year earlier. Total assets grew by 35.5% (2000=39%) to DOP 15,135 mln (USD 892 mln). Growth in net income was higher at 37.3% (24.4% in 2000) while the net result of DOP 304,4 mln (USD18 mln) yielded ROA and ROE ratios of 2.01% and 22.4% respectively.

Bancredito underwent a significant change in 2001 in that it changed its commercial name and corporate logo to identify itself with a group of affiliate companies, all controlled by the Perellano family. Among these companies is the country's largest insurance firm, formerly Companía Nacional de Seguros, presently known as Segna. However, there has been more done than an image metamorphosis to integrate the Group members. The bank and insurance

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arm (as well as the telecom company, Tricom) are already active in cross-sales of their products. For a number of years, Bancredito has been shifting its focus in the more lucrative, consumer market but which is fast developing. The bank is the largest issuer of credit-cards in the Caribbean (excluding Puerto Rico) and has invested heavily in technology to support its strategy. As such, 35.6% of Bancredito's loans at year-end were to the consumer sector. Nonetheless, heavy investments in electronic infrastructure will put some pressure on future performance as the recognition of amortization costs is accelerated under new accounting rules to be introduced in the DR in the second half of 2002. This has provided the bank an incentive to further improve its cost management while asset growth, projected at 30% in 2002, remains key to term strategy. Although the bank has not been actively engaged in M&As, this could also change going forward, while the Group remains open to foreigners with an interest for a minority investment.

The bank received USD 25mln in fresh capital in early 2001 which temporarily inflated equity ratios. However, the ratios returned to historic levels as the asset base expanded; the risk-weighted capital adequacy ratio stood at 11.68% at year-end. The relatively high proportion of improductive assets that tie-up Bancredito's equity remain a constrain on the bank's Individual rating. In addition, under the market's new definition of past-due loans, the deterioration in Bancredito's asset quality ratios may be sharper than its peers, given the typically higher delinquency ratios reported in the credit-card business. Provisions increased 24.2% in 2001 leaving the reserve coverage ratio for gross loans a relatively low 3.4% at year-end.

Banco Mercantil

Banco Mercantil, which ranks seventh in terms of asset size, grew at a pace similar to its larger peers. Total assets increased 32% to DOP 6,645 mln (USD 391.6 mln). Its market share therefore grew slightly to 4.0% from 3.8% a year earlier. In contrast, earnings increased just 10.3% (15.2% in 2000), the net result being DOP 73.8 mln (USD 4.3 mln). Profitability ratios slipped to ROA of 1.26% and ROE of 12.36%. What appears to be a weakened performance is due to a 24% growth in operating expenses and the provisioning charge, which doubled to DOP 135.5 mln (USD 8 mln). On an operating basis, before provisions and taxes, Mercantil's revenues were up 41.7% fueled by a 51.3% rise in net interest income. Given its focus in the consumer market, Mercantil benefited largely from a declining interest rate environment in 2001. Pricing of consumer products such as car loans and credit-cards, has so far been inelastic in the local economy, while declining interest rates contained funding costs even as Mercantil's funding base expanded 34.8%. The bank still relies heavily on term-funds which comprise 62% of its funding mix. Their maturities do not exceed 30-60 days, typical for the Dominican market, though most funds are continuously rolled-over. The prior also creates an asset-liability maturity mismatch since the bank is actively engaged in car finance, and such loans can be extended to three years.

The steep increase in provisions was necessary for the bank to maintain its loan loss reserve cushion to 3.42% of gross loans (2000=3.72%). Fitch projects that Mercantil's asset quality ratios will change materially in the second half of 2002, after the new definitions of "past-due" loans is adopted given the bank's activities in the consumer market. Consumer loans account for 22.8% of the bank's loan book. The bank reports an 11.73% risk-weighted capital adequacy ratio, above the local minimum requirement.

In March 2002, Mercantil announced its intent to acquire Banco Global. Upon approval from the authorities, the two banks will merge by mid-year. Global had c. 1% asset market share as of end-2001 and will help Mercantil consolidate its position as competition in its niche market has grown. Mercantil had quickly captured market share by introducing auto-financing in the local market and the bank is still regarded as an innovative institution by its larger peers. The main challenge going forward and which has been identified by Mercantil as a strategic goals, is to continue to grow, reaching a critical mass, without foregoing adequate risk-management. The goal will become more difficult to achieve as domestic economic growth slows down, and larger peer banks could initiate a pricing competition.

Banco BHD[2]

In terms of asset size, Banco BHD has come to occupy fourth place among commercial banks after its merger with Banco Fiduciario on 1.1.2001. BHD had assets of DOP 18,039 mln (USD 1,062 mln) at year-end 2001, equivalent to an 11% market share. It reported net income of DOP 310.8mln (USD 18.3 mln). BHD was absorbed in merger-related matters most of 2001. The merger has transformed the bank's risk profile. As result, asset quality and efficiency ratios have been impaired, albeit BHD aims to recover

[2] Fitch expects to assign ratings and to publish research on Banco BHD and Banco Progreso, in the current year.

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them quickly. Past-due loans as defined under local standards, represented 4.97% of gross loans but were more than 100% provisioned. The risk-weighted capital adequacy ratio also slipped in 2001 and stood at 10.20% by year-end. Banco Popular de Puerto Rico, the former controlling shareholder of Fiduciario remains a minority shareholder in the BHD Financial Holding which controls 100% the bank. Spanish banking group, Sabadell, also retains a 20% equity stake in the Holding. Although none of these two foreign investors is considered strategic, both have executive and managerial representation in BHD.

Banco Progreso

Progreso which is the smallest of the medium-sized commercial banks and ranks sixth in overall size, has expanded rapidly in the local market. Its asset market share reached 7.4% at end-2001 from 4.1% at end-1998. After acquiring Banco Metropolitano, a small bank focusing on the corporate market, at the end of 2000, Progreso continued with its organic growth in 2001 (20% asset growth). The bank has demonstrated its capacity to generate strong profits in recent years, though its absolute size, costs related to the broadening of the franchise as well as investments made in new technology to support electronic products, have drained ROA ratios. Nonetheless, ROA strengthened to 1.56% in 2001 but remains below the sector's average. The corporate market is still the bank's primary niche for business though Progreso wants to broaden its presence in the middle-market and consumer segments as it would allow the bank to generate additional fees and diversify its revenue stream. Furthermore, these segments are less sensitive to interest rate movements. The bank has developed brand recognition in the local market, being the exclusive issuer and acquirer of American Express Cards in the Dominican Republic. Its shareholders which include prominent, local economic groups, have shown commitment towards the bank, supporting its growth by foregoing dividends. Although Progreso meets the local requirements on capital adequacy, existing capital levels need augmenting. As a result of the merger, the bank has sizeable holdings of fixed assets which tie-up all of its equity. The ratio of loan loss reserves to gross loans stood at 4.6% at end-2001 and compares favorably with larger peers, though as a smaller entity, the bank inherently has higher credit-risk concentration.

Outlook

- *Rising interest rates will help preserve margins which are needed to enrich loan loss reserves but may dampen asset growth and quality*
- *Asset quality ratios will deteriorate significantly under new regulatory definitions, albeit they will become internationally comparable*
- *There is some likelihood for Congress to approve the long-awaited Monetary Code*

Although credit demand is expected to slow in 2002, the rapid reversal of market interest rates upwards which was experienced in the first quarter, implies that banks could maintain profitability and margins similar to levels recorded in previous years. Dominican banks have the ability to immediately re-price both their asset and liabilities adjusting them to market movements. Commercial lending rates therefore escalated 2.3% since end-2001, settling at 30%-32% in nominal terms, while the prime rate has settled to 24%-26% from 18%-20%. Rates on mortgage loans have also followed suit, rising 2.91% in the three-month period and now stand around 25%. Although it is not expected for market interest rates to crawl further in the months ahead, their sudden reversal came as a result of the change in monetary policy. In a surprising move, in February 2002 the central bank announced its intent to issue DOP 2,500 mln (USD 147 mln) in local securities, thereby restricting liquidity. The amount represents approximately 85% of the monies that the authorities allowed to return into the system in 2001 therefore nullifying the effect of their previous policy. The foreign exchange market also showed instability in the first quarter of 2002 with the central bank intervening occasionally, to inject liquidity and artificially restrict the depreciation of the Peso/Dollar exchange rate which in the open market had reached 18.0. Private estimates had placed Q1 economic growth 6%-8% but official figures now show a 4.3% rate. The growth is being led by communications (+29.3%), manufacturing (+13.2%), construction (12.5%), and commerce (+9.6%). These sectors constitute 50% of the country's GDP. The short-lived decline in world oil prices, as well as the recovery of the North American market are both factors that influenced positively the Dominican economy during this period. Preliminary data also show a quarterly inflation rate of 1.75%, or 3.92% year-on-year, with only Chile, Mexico and Brazil reporting lower quarterly rates in Latin America. Bank loans and deposits which always register their slowest growth rate in the first three months of the year, grew 4.0% and 5.5% respectively, below the 6.9% and 8.0% corresponding rates in 1Q01.

As already mentioned in other sections of this commentary, starting July 1, 2002, the banks will have to comply with the announced changes to prudential norms, in regard of (a) financial reporting under accrued-basis accounting and (b) new definition of past-due loans. Fitch will opine on the effect these

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changes will have on the operations, and potentially the ratings, of the Dominican banks in our coverage, as the company profiles are updated in the months ahead. Overall, accrued-basis accounting will allow banks to recognize interest income prior to being collected which will elevate their net interest income, though net earnings are unlikely to show any material increases as other accounting principles, such as the accelerated recognition of amortization costs, are also implemented. Under previous standards, banks had been given five years to amortize Y2K costs, while the amortization periods for merger-related costs and goodwill, have also been generous. Overall, the small size by internationals standards of the banks and the local economy, will remain a constrain on how successful the banks can be in cutting costs, thereby improving currently weak, efficiency ratios. The high deposit reserve requirement banks have to comply with, which is only partially remunerated at a low rate, is also prohibitive to their profitability.

The existing equity levels of banks, in view of low loan loss reserve cushions and future asset quality impairment, remain as Fitch's principal concern. In line with the country's GDP growth, banks have also grown aggressively both in nominal and real terms in recent years, while the DR's small albeit, fairly open to foreign investment, economy remains susceptible to both internal and external factors. Fitch projects a sharp rise in the levels of past-due loans reported by the banks as they will come to recognize both the principal and installment, once an installment is in arrears more than 90-days. The ratios currently reported for all loan installments overdue by 1-day i.e. to include what locally are known as "*en mora*" and "*vencidos*", at minimum, will more than double, while the effect on the ratios of the banks active in consumer and credit card lending is likely to be more severe. The ratios of loan loss reserves to past-due loans will therefore weaken, though in the medium-term, provisioning levels which depend on the risk-classification of the asset and the underlying security, will reflect the changes in prudential norms made in year 2001.

Another significant development in 2002 could materialize if Congress finally approves the Monetary Code, what is effectively a comprehensive, regulatory framework for the financial system. Although the central bank's Monetary Board ("*Junta Monetaria*") has so far exercised discretionary power, and together with the Superintendence have regulated the system by issuing various decrees, the Code will formalize the role and powers of the regulators. Under the new code, the independence of the central bank and Superintendence will be legally endorsed, while the central bank is expected to no longer have a role in the regulation and supervision of the financial system, other than being "lender of last resort". The Monetary Board's existence will continue and the Board will remain the body of highest authority, though the Superintendence of the Banks in co-ordination with the Superintendence of the Capital Market, Insurance Companies and Pension Funds, all currently being set-up, will supervise the financial market on a universal basis. Other important aspects of the code include the definition of only two types of entities authorized to engage in financial intermediation ("banks" which can hold sight deposits, and "financial societies") and their respective minimum capital requirements; professional qualifications for the executives serving on the boards of the banks; penalties for non-compliance with prudential norms (the latter have been criticized as excessive by the commercial banks and are currently under reconsideration); as well as the mechanism for the liquidation of troubled entities.

Fitch Ratings will continue to monitor developments in the Dominican financial industry and will comment accordingly as events materialize.

			Foreign currency		
Bank	**Individual**	**Support**	**L/Term**	**S/Term**	**Outlook**
Banco Popular Dominicano	C	2T	BB-	B	-
Banco Intercontinental	C/D	4T	BB-	B	-
Bancredito	D	4T	BB-	B	-
Banco Mercantil	D	5T	B+	B	-

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ANNEX I
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 II
RISK-CATEGORIES AND DEFINITIONS OF PAST-DUE LOANS (DAYS 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

Source: Banco Central, República Dominicana

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