

Comment

The Failure of BanInter: A Blessing in Disguise?**Analysts**

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■ Introduction

On April 7, 2003, the financial authorities of the Dominican Republic announced that Banco Intercontinental (BanInter), the country's second largest private commercial bank (c. 13% market share) was being intervened. That action in effect revoked a previous agreement signed on March 24, 2003, whereby the shareholders of Banco del Progreso, the country's seventh largest private commercial bank, had stated their intention of purchasing BanInter. The swift intervention of BanInter caught market participants by surprise while, to date, the information that has been made public on this issue has been limited and fragmented. This comment aims to shed light on some of the issues surrounding the developments in the BanInter case. Additionally, Fitch's view on this issue, as well as consequences and perspectives for the financial system are presented. This comment follows a press release dated 9 April, 2003 when Fitch affirmed the bank's foreign currency ratings at long-term 'BB-' and short-term 'B' as well as its support rating of '4T', while downgrading its individual rating from 'D' to 'E'.

■ Background

BanInter was a multiple service bank established in 1985 whose traditional focus had been corporate banking. In common with a number of banks in the system, BanInter was family owned, with its majority shareholders, the Baez family, having interests in news media and insurance, among other sectors. Also in common with other Dominican banks, in recent years BanInter had grown rapidly, both organically and through acquisitions. This growth had left the bank with a tight capital base, which led to the downgrade of its individual rating from 'C/D' to 'D' in July 2002. On the other hand, the bank's liquidity indicators, as well as asset quality and profitability remained in line with the rest of the system and in accordance with its internationally comparable debt and individual rating levels up to the date of its intervention. While performance issues alone did not account for BanInter's intervention, it appears that the bank's financial statements, audited by one of the big international accounting firms and which were largely fed from an IT system developed in-house, may have been suspect and led to misleading indicators.

■ Actions taken by the authorities upon intervention

While the aforementioned irregularities may have led to BanInter's intervention, the financial authorities of the Dominican Republic acted swiftly and decidedly to guarantee BanInter's liabilities, which maintained confidence in the sector and averted the possibility of deposit runs in other banks. On the contrary, a number of the large and medium-sized banks in the system benefited from flight to quality in the first few weeks following the intervention. More recently, the central bank has continued to honor BanInter's liabilities with "*certificados de inversión especial*", issued directly to depositors at maturities that generally vary between 90 days and one year at the option of the depositor. These securities pay interests above the average for the financial system (around 28% compared with an average 20% time deposit rate for commercial banks) and, in addition, have fiscal incentives for institutional holders, making their after-tax yield even more attractive to depositors. The wider span of maturities provides the central bank with a more flexible monetary tool, as at present the system remains fairly liquid.

Given the relatively low loan demand in the Dominican Republic, explained by the slower economy and the commercial banks' inability to channel these funds to the private sector (a loan portfolio growth ceiling imposed by the authorities was only lifted by mid-April), the central bank has also issued "*certificados de participación*", with maturities ranging from 30 days to one year, to banks that received deposits from BanInter. In general, the central bank's aggressive stance on issuance of short-term securities is intended to control the system's liquidity, which in turn helps to address a gradually depreciating and volatile exchange rate and rising inflation. In this regard, it must be noted that around 20% of the Dominican banking system's assets and liabilities are denominated in USD and the exchange rate is pressured as the central bank exchanges FX to repay deposits denominated in USD. Some pressure on the FX market has been relieved as depositors opt to be paid with "*certificados de inversión especial*" denominated in Dominican Pesos (DOP) instead of USD given the attractive effective yields on the former.

On the other hand, while it is clear that BanInter's deposits have left, or are in the process of leaving the bank, its assets are expected to be sold in whole or in part to interested financial institutions. In this regard, it is important to mention that BanInter had a broad and well established branch network and an attractive asset base. So far, an undisclosed number of financial institutions have demonstrated interest in entering a due diligence process to purchase all or parts of BanInter. Fitch expects that this sale will take place in the short to medium term, as authorities make a concerted effort to prevent the deterioration and consequent loss of value of BanInter's assets. Moreover, the authorities' main concern is to diminish the cost to the tax-payer of the rescue of BanInter, which should also lead to sizeable cost cutting at BanInter while it remains in government's hands.

■ **Short-term consequences for the system**

As mentioned above, a number of banks in the system have received large amounts of deposits from BanInter. While this has not posed a major operational problem for most of these institutions, so far these funds have been intermediated to the central bank. It must be noted that the short-term impact of this phenomenon on capital ratios of the banking system is likely to be minimal given that central bank securities are zero risk-weighted. In addition, the impact on banks' net interest margins should also be negligible given the high yields of the central bank securities. Going forward, however,

the challenge will be for banks to channel these funds to the private sector, within a difficult operating environment, which is unlikely to be helped by the global economic environment and the political uncertainty in the Dominican Republic, derived from the upcoming Presidential elections in 2004. On the other hand, at end-April 2003 many institutions had already achieved their growth targets in terms of deposits for the whole of the year, which should ease the pressure for growth at these institutions and allow them to consolidate their positions. It is important to note that if banks were to purchase significant portions of BanInter's assets, or grow organically, it is likely that further capital injections would be needed given the higher risk-weightings of private sector assets.

■ **Medium-term consequences for the system**

In the medium to long-term it is likely that the failure of BanInter, although painful to the taxpayer and detrimental to the country's short-term prospects, will bring much needed reforms to the financial system. Several aspects call for improvement, some of which are outlined below:

Corporate governance

While most banks in the system are professionally run, the fact that a number are still closely held may hinder the decision-making process, particularly in institutions that are dominated by a few strong personalities. While in many cases this is not necessarily detrimental to an institution, greater importance should be given to minority shareholders and independent boards of directors.

Stronger supervision

One of the main tasks going forward is to strengthen the supervision of the banking system. Historically, the banking superintendency has been largely dependent on the central bank for its decision-making process. It has become clear, however, that while both institutions should operate in a coordinated fashion, their activities should be clearly differentiated so as not to encumber the process of supervision and regulation. The new "Monetary Code", approved in late 2002 grants more independence to the central bank and to the various supervisory bodies in the Dominican Republic.

Strengthening of banks' financial profile

For a number of years, Fitch has been stating that the capital bases of Dominican banks should be enhanced in light of the volatility inherent to emerging economies. While asset quality is relatively weak by

international standards, most of the banks have not achieved 100% loan loss reserve coverage, which also pressures the capital base, along with a high level of fixed and non-earning assets. Fitch foresees that this event will prompt banks to raise their capital bases not only to remain in compliance with the minimum requirements, but also to provide a cushion for the unexpected. In this regard, the Monetary Code allows banks to raise Tier II capital, which should help the system obtain additional capital.

Raise public awareness

Although all liabilities of BanInter are being honored by the central bank, it is likely that BanInter's shareholders and at least some holders of liabilities of some of the bank's subsidiaries (mostly the off-shore subsidiary of BanInter in the Cayman islands, BanInter & Trust Company), will lose their investments. This painful experience should contribute to raise the risk/reward awareness among the public and help establish market discipline by increasing disclosure, which is in line with Pillar 3 of the new Basel Capital Accord (targeted to take effect in member countries in 2007).

Consolidation

Aided by the introduction of the Monetary Code, which contemplates only two types of financial institutions, namely banks and financial companies, the Dominican financial system should witness a trend of consolidation going forward. It must be remembered that around 150 financial institutions operate in the Dominican Republic, although around three quarters of the system's assets are largely held by 12 commercial banks.

Accountability

Given that the cost of the rescue is likely to be sizeable in terms of GDP, as the audited books appear to have been understated, it should be expected that the financial authorities place greater emphasis on accountability of bank managers and shareholders, in order to avoid such events from reoccurring in the future.

Strengthening of internal control systems

Since it appears that an issue with the accounting software developed in-house by BanInter was partly to blame for the bank's demise, it is likely that such systems will be forbidden in the future. In this regard, most of the large and medium-sized banks have standard systems so should not be affected by any such measure that may be imposed by the authorities. Internal control systems and audits should become more relevant.

Conclusions

While Fitch Ratings expects that the causes of the failure of BanInter should be particular to this bank and thus should prove to be an isolated case, it is clear that the system will benefit from many of the reforms mentioned throughout this comment. As such, the ratings of Dominican banks shown in Table 1 are expected to remain unchanged in the foreseeable future. The ratings of BanInter are maintained as in Fitch's view there has been no economic loss for depositors or other holders of liabilities and this should continue to be the case for as long as the authorities continue to guarantee and honor the bank's obligations. The bank's 'E' individual rating is also maintained, reflecting our view that BanInter continues to require external support. Fitch Ratings will continue to monitor closely the developments in the Dominican financial system and act accordingly.

Table 1. Rating of Dominican Banks

Bank	Individual	Support	Foreign Currency	
			Long Term	Short Term
Banco Popular Dominicano	C/D	4T	BB-	B
Banco Intercontinental	E	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

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