

Latin America
Special Report

What a Difference a Year Makes: Latin American Banks Review and Outlook 2010

Analysts

Peter V. A. Shaw
+1 212 908-0553
peter.shaw@fitchratings.com

Alejandro Garcia
+5281 8399-9100
alejandro.garcia@fitchratings.com

Eduardo Santibanez
+562 499-3300
eduardo.santibanez@fitchratings.com

Franklin Santarelli
+1 212 908-0739
franklin.santarelli@fitchratings.com

Maria Rita Goncalves
+ 5521 4503-2600
maria.goncalves@fitchratings.com

Santiago Gallo
+5411 5235-8100
santiago.gallo@fitchratings.com

Related Research

Applicable Criteria

- *Global Financial Institutions Rating Criteria, Dec. 29, 2009*

Other Research

- *Brazilian Banks (Semi-Annual Review and Outlook), July 2, 2009*
- *Mexican Banks Review and Outlook, Sept. 28, 2009*
- *Colombian Banks: Bracing for the Storm (Review and Outlook), July 24, 2009*
- *Uruguayan Banks: Annual Review and Outlook, Aug. 28, 2009*

Overview

What a difference a year makes. A year ago, the outlook for the year ahead was bleak; many countries in the region saw their economies contract significantly in 4Q08, significant job cuts raised the specter of widespread unemployment, and the outlook for the region's major economies pointed towards negative growth over the rest of the year. Now, although the downturn was sharp, in most countries, it proved short, and many of the region's economies are rebounding with an outlook for accelerating growth.

Then, the region's banking systems had seen their fundamentals hold up adequately during the prolonged growth cycle that preceded the global financial crisis, but solid balance sheets were threatened with the potential for serious asset quality problems. Now, while income statements have suffered, banks remain profitable, even after taking the significantly higher loan loss provisions required to maintain solid loan loss reserve coverage of a spike in impaired loans. Systemic balance sheets remain solid. Going into the downturn, capital had been bolstered by sustained profitability and infusions of new capital, requiring no need for the often massive adjustments seen in the face of significant questions surrounding the valuation of assets at many of the developed world's leading banks. Capital ratios in most banking systems remained steady or improved, given limited growth. There is some disparity among capitalization indicators across the region, but indicators generally compare at least adequately, on a global basis, with Tier 1 ratios usually north of 8%. Wide margins had proven adequate to support growth-driven increases in loan loss provisions, which have generally remained ahead of credit losses, with reserves in excess of impaired loans.

Then, there was fear that the funding pressures that had plagued many developed-world banking systems would overflow into the region, and local capital markets had seized up. Now, systemic deposits have generally remained steady, and local capital markets are more receptive; little exposure to foreign funding meant little contagion from foreign creditors retreating to their home shores. While entities that depended on wholesale funding, such as Mexico's nonbank mortgage lenders and Brazil's medium-sized banks, underwent serious liquidity crunches, prompt and effective actions by local authorities helped restore liquidity.

Then, amid huge losses by the world's leading banks, the threat of significant asset quality deterioration in the face of gloomy economic outlooks loomed over bank results, threatening to significantly reverse a sustained run of strong profits across the region. Now, while results have suffered from a sustained rise in loan loss provisions, revenues proved strong enough to absorb these provisions and still support ROAs and ROEs that, although well down from historical highs, continued to compare favorably on a global basis. Asset quality indicators suffered, as expected, as the combination of abrupt economic slowdowns and a screeching stop to loan growth led to deterioration of asset quality ratios across the region. Banks responded with aggressive provisioning for this increase in impaired assets and generally maintained reserve coverage at levels that appeared adequate and more than sufficient to absorb losses. Fiscal and other stimulus

Downturn in the region was sharp but generally short. Most major economies returned to growth by year-end 2009, with decent prospects for 2010. Bank performance reflects the downturn, but banks remained solidly profitable. State-owned banks showed strong counter-cyclical growth.

measures across the region, most notably in Brazil and Chile, helped keep credit available through the trough of the cycle; notable was the role played by state-owned development banks, especially in Brazil, Chile, and Mexico.

In short, the global crisis, which has sent the world's largest economies deep into recession and facing anemic recoveries, seems to have had a more benign effect on Latin economies and their banking systems, appearing more like a sharp, but short, cyclical downturn. The region's principal banking systems, which entered the downturn in solid shape, are emerging from the downturn slowed, but not significantly weakened, and appear reasonably well prepared to play their natural role in the upturn of the economic cycle.

Looking ahead, how do we expect 2010 to play out for the region's banking systems? The global crisis reined in the sustained and often rapid loan growth that drove bank results through the years preceding the crisis. Loan portfolios of most private sector banks grew modestly, if at all, through the first three quarters of 2009; as alluded to earlier, strong growth from state-owned banks was largely responsible for growth in systemic loans. 2010 should see loan growth return and reach double-digit levels in most of the region's more important economies. In some instances, this return to stronger growth was already evident in 4Q09. With interest rates generally near historical lows, the growth will be important to offset margins, which will be under pressure from low rates and, increasingly, competition among banks looking to boost revenues. With capital markets, both domestic and international, increasingly receptive, corporate borrowers will depend less on local banking systems and have the bargaining power necessary to pressure down spreads, which had been fattened by slack credit availability. This, in turn, will add to pressure to boost volumes.

The difference maker in banks' relative profitability will continue to be credit costs. While asset quality deterioration in retail portfolios generally seems to have peaked and begun to recede, the picture in corporate portfolios is less clear. Middle-market exposure in corporate portfolios will likely remain under pressure. Rapid, often unsecured, loan growth in this sector before the crisis meant exposures here were often less seasoned than in retail portfolios, and the middle market is often the last sector of the economy to feel the benefit of a return to macroeconomic growth. Exposures under pressure in the corporate sector are also more likely to be restructured, potentially masking future problems. Provision expenses have grown well ahead of revenues for the past year; reversing this trend, while maintaining sound reserve coverage, may well be the most important key to sustainable bottom-line growth moving forward.

The region's funding profile — largely based on domestic deposit bases and, to a much lesser extent, local capital markets — proved an important strength through the global crisis but will also pose a challenge going forward. Solid deposit bases and broad access to local markets allowed loan portfolios to grow well ahead of deposit growth; this formula will prove tougher to achieve going forward. A return to sustained strong loan growth will force banks to broaden funding sources; while international markets offer a tempting source of relatively cheap and long-tenor funding, they have proven to be fickle in times of stress. Broader funding sources will put a premium on sound liquidity management, which will prove of prime importance, particularly for banks that depend on wholesale funding. While recent experience has shown that, in times of systemic risk, authorities can and will often take pre-emptive measures to aid the flow of liquidity among banks, idiosyncratic risk during more "normal" times will demand close attention to strong liquidity management at the individual bank level.

Slow, if any, balance sheet growth in 2009 translated to little pressure on capitalization indicators in 2009. With banks aiming to once again expand balance sheets at a double-

digit pace in the year ahead, some downward pressure on capital ratios is to be expected going forward. Some of the region's largest banks have tapped more receptive capital markets by issuing hybrid capital instruments ahead of a return to growth. These instruments have generally contained some loss-absorption characteristics, usually receiving substantial equity credit under Fitch Ratings' methodologies, as well as recognition by local regulators as regulatory capital. With many developed-world banks having received capital assistance, a downward trend in capital ratios among banks in the region would mean less flattering international comparisons than in the past.

IDRs were generally steady in 2009. Support-driven ratings were tied to parent ratings. Individual ratings have remained steady through the cycle.

Key Rating Drivers

Issuer default ratings (IDRs) of internationally rated private sector banks in Fitch's Latin American coverage are driven by either the banks' intrinsic performance or the support they could be expected to receive from higher rated parent banks based in developed countries.

Most notably in Mexico, but with important examples in Brazil, Chile, and throughout Central America, many of the leading banks in the region are controlled by global banks looking to Latin America as a strategically important region, where consumer lending prospects could help them diversify balance sheets and revenue streams away from stagnating home markets. Although the performance of their Latin subsidiaries has reflected the downturn in the region's economies, these entities have been and will continue to be important contributors to their parents' balance sheets and earnings prospects; this should assure continued support, with rating prospects tied to those of the parent banks. Most of the largest investors in the region — Spain's Santander and BBVA, HSBC, and Bank of Nova Scotia chief among them — have fared relatively well with little or no need to date for infusions of capital from their home governments. Even when banks receive government support, deposit funded, and, therefore, become self-supporting, consumer finance-driven banks are usually among the core businesses that the parent banks look to maintain as they address asset valuation issues elsewhere on their balance sheets. While these operations could prove to be valuable assets as banks look to raise capital, the likelihood that these would bring at best "fire sale" prices in current circumstances makes forced sales less likely, providing an incentive for parent banks to protect the long-term value of these assets — Citibank's Banamex is a prime example of such operations.

The other support-driven ratings in the rated portfolio are those of state-owned banks, principally those in Brazil and Mexico. Their importance as buffers in counter-cyclical times was reemphasized in the past year, and their shareholders' willingness to use these banks actively in this role supports the view that these banks' ratings are closely correlated to those of their owners; indeed, at current rating levels, their support floors are generally close to or equal to those of their government owners.

Where IDRs are driven primarily by banks' individual ratings, these ratings have historically been compressed by their operating environments. Rare are cases where individual ratings are above 'C', and, as these ratings look "through the cycle," they generally reflect the risks inherent in the downturn the region faced in 2009 — a sharp, but relatively short, down cycle. With the outlook ahead improved from the same time a year ago, the stability of individual ratings through the past year seems justified. The indigenous banks with individual ratings at 'C' or better all boast solid, domestic franchises, a proven history of managing through the region's volatility, and balance sheets, which generally are an accurate reflection of the risks faced, that are adequately capitalized. With deposit bases that benefit from flight to quality during times of stress, they also proved well placed to face liquidity pressures. It is interesting to note the shrinking gap between the ratings of the best rated banks in Latin America

and the developed world's most solid banks. A decade ago, the region's highest ratings, excluding Chile's, were generally in the 'BB' range, relative to the 'AA' range of the developed-world's banks; today, stand-alone ratings of the developed-world banks are primarily in the 'A' range, compared with ratings at the high end of the 'BBB' range for the region's most solid banks (again, excluding Chile, whose best banks have held steady in the 'A' range).

Looking ahead, changes to the banks' individual ratings will likely depend on how well they manage what seems sure to be another spurt of loan growth. Fitch expects growth in 2010 to be generally quite aggressive, reflective of the optimism that currently pervades the region. Should growth prove sustained, the banks should generally reap good results; should the current recovery prove shorter, banks may be tested by the effects of another downturn on portfolios, which will likely have seen aggressive growth. Balance sheets of most systemically important banks today are generally strong, with adequate capital levels bolstered by generally solid loan loss reserves. It is possible that some of these banks could see these buffers shrink because of overly aggressive growth, putting downward pressure on individual ratings.

An important part of Fitch's ratings coverage in the region includes institutions that carry only national ratings. These ratings express relative creditworthiness within the entities' home markets, allowing Fitch to provide greater differentiation than is often the case with international ratings, which can be compressed by sovereign considerations. As Fitch's national ratings generally make use of a broad range of the respective local rating scales, they can be expected to be more volatile than international ratings. In general, national ratings remained steady through 2009; exceptions were generally driven by pressures on asset quality, which dragged performance well below local comparisons, and funding pressures. Looking forward, the region's largest countries are already seeing a return to growth, and national ratings for these countries should remain generally steady. Performance in the smaller countries is more varied; however, Chile, Colombia, and Panama also seem to be recovering, and prospects for national ratings mirror those of the well-performing larger economies. Growth prospects in Central America appear more challenging, and, in Venezuela, Argentina, and Bolivia, growth may well be held back principally because of political uncertainties that hang over the local economies. With a return to growth in these countries less certain, the downturn in the region may be more prolonged, and this could drag down national ratings, as some institutions are more affected than others.

The balance of this report contains brief country summaries of the principal themes that defined 2009 performance, as well as those that Fitch believes will drive performance and ratings over the year ahead. More detailed discussions of country specifics will be forthcoming in Fitch's country-specific review and outlook research, to be published over the weeks ahead.

Argentina

After five years of strong GDP growth (average annual rate of roughly 8.4%), economic activity in Argentina contracted sharply in 2009, in line with the international crisis. Although the official figure is roughly 3% GDP growth, private sector estimates are close to a 3% decline. In spite of this, the financial system continued to grow in 2009, albeit at a much slower pace than in past years, and maintained adequate levels of liquidity and capitalization.

Total assets of the consolidated financial system expanded 8.7% in nominal terms through November 2009, with lending to the private sector growing 5.6%. The latter took place mainly in the second half of the year and was fueled largely by consumer lending. In spite of the economic slowdown, asset quality remained much better than

expected. Non-performing loans (NPLs) rose to 3.6% (from a historically low 2.3% at December 2008), with loan loss reserve coverage of 123%. Along with this, profitability improved, although at a rate slightly below inflation (estimated by private sector economists at about 17% in 2009), mainly due to gains from the banks' securities portfolios (largely driven by the yield of central bank bills and notes) and a wider net interest margin, which benefited from high rates due to elevated inflation levels. Net fee income, administrative expenses, and loan loss provisions remained relatively stable in 2009. Driven by retained earnings, the financial system's equity rose roughly 20%, and capitalization levels remained high, which was expected given the volatile environment. At Nov. 30, 2009, the consolidated equity-to-assets ratio was 12.6%, and the total capital-to-risk weighted assets was a high 18.6%; total regulatory capital was almost double the minimum required by local regulations.

Liquidity remained ample, driven by the banks' conservative approach (cash, interbank deposits, and central bank securities represented 42.4% of deposits at the financial system level), reduced demand for credit from the private sector, and continued deposit growth. Total deposits increased 10% in 2009, boosted by sight deposits, although time deposits started to grow in the last quarter of the year.

In 2010, Fitch expects the Argentine GDP to grow 2%, while local private sector estimates are close to 5%. However, the operating environment will likely remain highly volatile due to the political instability, which was the main factor behind the various crises in the recent past. Together with the economic recovery, inflation is expected to rise again to levels close to 20%–25%, as the government is not expected to reduce fiscal spending. On the positive side, an important flow of foreign currency is expected from a record high soya harvest, which should benefit private consumption and help maintain the foreign exchange rate under control, although some further devaluation of the Argentine peso is expected.

Fitch expects the financial system to continue to grow in 2010 and accelerate the expansion seen in the second half of 2009. This should benefit banks' net interest margins, although in real terms, they could be under pressure due to the higher inflation expected. Profitability is expected to remain adequate, similar to that shown in 2009 (ROA of 2.4%), or somewhat lower in real terms, depending on the level of inflation. However, banks' profits could be affected by the volatility inherent in the results of their securities portfolios, especially in times of political instability. NPLs started to decline after their peak reached in Q309, and this trend is expected to continue in 2010 due to the economic recovery and expected loan growth. In line with this, loan loss provisions should remain under control, as banks are relatively well reserved. While long-term funding remains a challenge for Argentine banks, greater access to such funds could be achieved should the government reach an agreement with the hold outs, and this could grant local private sector players access to the international capital markets, although Fitch does not consider this very likely. Finally, the comfortable capitalization and liquidity levels should support the expected growth, with no need for fresh capital.

Brazil

Brazilian banks showed great resilience during the downturn and resulting period of liquidity stress in late 2008/early 2009, thanks in large part to prompt and effective actions by regulators to ease liquidity pressures and the counter-cyclical stimulus package offered by the government to key economic sectors. Those measures have helped to partially offset the sharp and significant downturn of the economy at YE08 and helped in the recovery of systemic loan growth, in large part the result of a more aggressive performance on the part of state-owned banks, whose combined portfolios grew approximately 40% in 2008 and 30% in 2009.

Brazilian bank profits slowed, dragged down by credit costs, but still compared well regionally and globally.
Systemic loan growth was driven by state-owned banks, but loan growth is returning across the system.
Asset quality pressure appears to have peaked, boding well for 2010.
Funding pressures at medium-sized banks have receded.

In 2009, Brazilian bank results reflected the effect of a sharp rise in credit costs, which spiked in 4Q08 and remained high through 2009. While bottom-line results were down, most large banks still managed to report ROAs of 1% or better (down from 1.5%–2.5% over the previous several years), a level that still compared well globally. Thanks to the strong level of provisioning, reserve coverage of NPLs remained steady, despite the rise in impaired loans; adequate (generally close to or better than 100% of NPL); and ahead of credit losses. Balance sheet growth among most private sector banks slowed significantly, as banks sharply put on the brakes in late 2008 and kept them on through 3Q09. Rising demand for corporate loans, as borrowers were shut out of international capital markets, helped boost traditionally thin spreads in this sector during 1H09 and helped offset some shrinkage in retail portfolios. While asset quality deteriorated sharply through 1H09, by 3Q09, impairment in retail portfolios began to improve; early indicators of corporate impairment, concentrated principally in middle-market loans, also reversed the trend of deterioration. With the positive turn of the local economy, loan growth has heated up, and most banks are projecting loan growth above 20% p.a. in 2010, pointing towards gradual improvement in asset quality measures. Real estate, SME loans, and consumer finance are among the niches that should continue to push loan growth during the year for most players. Investment plans of the corporate sector may also contribute to growth in demand from this area, auguring well for balanced loan growth.

Volume growth and some relief from high credit costs should bode well for bottom-line improvement in the year ahead. Lower interest rates have benefited cost of funds, which have adjusted downward more rapidly than rates in loan books, supporting wide margins; looking forward, rates should rise, particularly in 2H10, and competitive pressures and lower risk premiums as the economy improves should also lead to declines in margins from YE09 highs. Helping to offset this pressure will be easing credit costs, which should fall gradually over the course of the year, and volume growth.

Funding on a systemic level resumed a steady course during 2009 after a period from 4Q08 through early 1H09 when liquidity was largely concentrated in the large banks, resulting in severe liquidity pressures on banks that had depended primarily on institutional funding. Rapid and effective measures by regulators were effective in stabilizing the situation, and, by 3Q09, most of these banks had seen balance sheets stabilize and are now growing again. Access to funding that reasonably matches the tenor of new lending will prove one of the principle challenges for Brazilian banks. Given slower growth and high levels of less capital-intensive liquid assets, capital ratios fared well through 2009. A return to growth will likely mean that the peak in capital levels was reached at YE09; Tier I regulatory ratios will also lose the benefit of inclusion of “excess” loan loss reserves after 1Q10, generally equivalent to between 100 and 200 basis points of Tier I ratios.

Ratings during 2009 remained quite stable, which was appropriate given that most banks weathered the downturn without significant damage to their credit fundamentals, remaining in a good position to perform well as the economy improves. Looking forward, containing credit costs will be the key to a return to income growth; the test of this is more likely to come later in 2010 or in early 2011, as the medium-term outlook for growth becomes clearer and renewed loan growth begins to season. Fitch will watch closely the pace at which banks return to loan growth and how they manage potential gaps between funding and asset growth, which could translate to liquidity pressure if/when the cycle turns again.

Central America

Banks in Central America have been exposed to an unfavorable economic environment, which to some extent will continue to pose challenges going forward. Unlike most of their Latin American peers, Central American countries (excluding Panama, see separate section)

experienced a sharper than expected economic downturn in 2009, due to the limited scope of their expansionary economic policies, comparatively low external private capital inflows, and economic concentrations. Fitch expects a decrease of 9% in overall workers' remittances from the U.S. to El Salvador and Guatemala, a key economic driver for such countries, as of November 2009. El Salvador and Costa Rica's GDP contracted in 2009 by 3.0% and 1.7%, respectively (Fitch's forecasts), while Guatemala recorded a meager GDP growth. Fitch expects modest recoveries in these countries during 2010.

In the past, Fitch had highlighted specific risks for Central American countries and their banking systems, namely their strong economic ties with the U.S., ample exposure to higher food and energy prices, high reliance on workers' remittances from the U.S. (El Salvador and Guatemala), and high level of dollarized loans to non-USD-generating customers (Guatemala and Costa Rica). While the economic downturn has affected the banks' asset quality and earnings, as was expected, other mitigating factors have prevented further deterioration of their fundamentals, particularly a prudential slowdown in loan growth, well-managed external imbalances, a sharp contraction in inflation rates in 2009, and the relative stability of their currencies vis-à-vis the U.S. dollar. Nevertheless, recent trends have been mixed throughout the region.

Costa Rica: The negative impact of the global financial crisis on Costa Rica's banking system was partially mitigated by a counter-cyclical fiscal package (Plan Escudo) that included capital injections to state-owned banks and temporary reductions in interest rates. State-owned banks provided some relief to the economy in 2009 by offering lower lending rates and more flexible refinancing conditions. Most private banks then followed with similar measures, fueling asset growth to 8% year over year (YOY) and containing nonperforming loan growth. However, net profits declined sharply by roughly 30% during 2009, mainly driven by a significant reduction in spreads and increases in credit costs. While banks' performance is expected to improve in 2010 as economic growth resumes, Costa Rica's banking system will maintain structural weaknesses arising from high levels of financial dollarization (roughly 50% of loans). At the same time, some banks will maintain ample exposure to real estate loans, which grew rapidly during the past few years and are performing poorly at present.

El Salvador: Since the vast majority of El Salvador's banking system assets are held by foreign-owned banks, risk appetite is closely linked to that of their parents. In this context, banks reduced credit origination during 2009, as requested by their headquarters, although there were a few exceptions, constraining access to credit for many businesses and consumers. While Fitch expects these conditions to somewhat ease going forward relative to 2009, financing availability will remain limited. Positively, the banks' deposit bases were not materially affected by the election period. However, delinquencies soared, underpinned by adverse macroeconomic conditions, pressuring overall profitability downward. Consequently, earnings in 2009 were considerably lower than in 2008, hampered by increasing credit costs and meager growth in net interest income. Going forward, Fitch expects that Salvadoran banks will maintain sound capitalization and an adequate loss absorption capacity. However, asset quality and profitability ratios will remain pressured as economic growth remains low.

Guatemala: The country's banking system showed some degree of resilience during the recent financial crisis, as it was the only system in the region that exhibited earnings growth in 2009. In addition, nonperforming loans grew moderately in 2009, at a much slower pace than for its neighboring peers. Fitch believes that asset quality among Guatemalan banks will remain under control. Although the country has one of the weakest regulatory frameworks in Latin America, there have been some improvements in recent years. Positively, the Guatemalan financial system has very strong growth potential, since it exhibits one of the lowest levels of financial intermediation in the region relative to GDP.

Likewise, due to the many players in the financial sector, mergers and acquisitions could eventually speed up. In Fitch's view, one of the major challenges for Guatemalan banks is their low, although increasing, capitalization levels. In turn, profitability should remain favorable during 2010, depending on the evolution of economic conditions.

Honduras and Nicaragua: For Honduras and Nicaragua, Fitch also highlights additional challenges arising from sovereign and political issues. The financial performance of microfinance institutions has been notably affected in Nicaragua since mid-2008, following the president's public declarations exhorting such institutions' debtors to breach the service of their debts, leading to the creation of the "No Payment Movement." Consequently, nonperforming loans and loan loss reserves have significantly increased, putting downward pressures on earnings and jeopardizing their ability to meet financial obligations. Moreover, interest rate caps at unprofitable levels are currently being discussed by the Congress. Honduras' banking system performance has been affected by both the adverse economic environment and political unrest experienced in 2H09. Delinquency has significantly increased, and Fitch expects the trend to continue into the near future. An imminent devaluation may put additional pressure on asset quality. Nevertheless, it is worth noting that deposits have remained relatively stable amid the political crisis, while Banprovi, a state-owned second-tier bank, has played a key role as the local funds provider. Favorably, the Honduran political situation shows signs of gradual improvement, as a new president and cabinet have been sworn in, largely putting to rest the political uncertainty that had dampened prospects for the local economy.

Chile

The Chilean banking system saw net income drop 11% in 2009, due principally to a rise in loan loss provisions (a sharp 30%, but below what was seen in most of the region) and a loan contraction (2% YOY), both were reactions to the sharp slowdown in the local economy, which saw GDP fall an estimated 1.9%. Despite the fall in net income, ROAA and ROAE remained at levels (1.2% and 15.8% YOY, respectively) that compared well both regionally and globally.

In the face of the global contraction of liquidity seen in late 2008 and early 2009, banks tightened credit standards and prioritized liquidity, actions that affected the composition of the balance sheet, margins and, therefore, bottom-line results. Margin contraction resulted principally from negative inflation, given that a significant part of the banks' asset base is denominated in inflation-linked UF (51% of loans and 36% of total assets); the higher level of liquid assets in the balance sheet mix; and significant dollar devaluation (10% of loans were denominated in dollars). The resulting pressure on margins, combined with loan contraction and higher credit costs, was the principal factor behind the fall in net income. Strong trading results in the face of the pronounced and rapid drop in local interest rates and surprisingly strong performance from fees and commissions drove the improvement in non-interest income, which helped offset pressures on margins and loan volumes.

This greater bank liquidity, along with prompt action from the central bank in expanding liquidity facilities and the counter-cyclical growth in lending by Banco del Estado, helped the banking system and its corporate borrowers weather the months of heightened liquidity pressure in early 2009. As expected, asset quality suffered in the face of the slowing economy; these broad pressures were exacerbated by problems faced in the salmon farming sector, which is heavily dependent on bank funding. Nonperforming loans to total loans increased significantly in 2009 to 2,99%, while loan loss reserve coverage rose 79,8% as of December 2009, a level that easily covered credit losses but lagged coverage in the rest of the region. As in much of the region, balance sheet contraction and a higher proportion of liquid assets in the balance sheet

mix contributed to a sharp 250-basis-point improvement in the system's regulatory capital to 14.3%, a level Fitch expects will fall with the resumption of loan growth.

The outlook for 2010 is positive; Fitch expects growth of 4.8% in 2010, resulting in lower unemployment and resumed growth that should fuel loan demand, with expectations of about 10% loan growth for the system over the year ahead. Asset quality pressures are already easing; however, the relief from lower loan provisions will be somewhat limited by tightening regulatory provisioning requirements, currently expected to come into force in 2H10. Margins should benefit from higher interest rates and a reversal of the effect of negative inflation on UF-indexed assets and liabilities.

Ratings have remained steady through the cycle, as most institutions proved able to weather the sharp, but short, cycle of economic contraction without lasting damage to their credit fundamentals. Looking forward, while Fitch expects relative ratings stability, ratings changes could be driven by the evolution of credit quality, the ability to build capital through earnings retention, and economic prospects for Chile. Among national ratings, changes could be driven by the same factors mentioned above and eventual changes in the international credit ratings of the parents banks, which support those of subsidiaries and branches in Chile, mainly small entities that operate in niche segments.

Colombia

The global crisis was more severe for Colombia than for some of its regional peers, but economic growth should resume in 2010, albeit at a slower pace than in 2007, hence impacting loan demand and asset quality ratios. During 2009, loan growth almost stalled (+0.8%), showing the lowest growth level since the end of the last financial crisis (1998–2001). Loan growth declined mainly in the unsecured consumer loans segment (since 2008) and for commercial loans. However, secured loans, such as mortgage loans, continued growing during 2009 but have yet to achieve the volumes reached before the 1999 financial crisis. Bank assets continued to grow at a nominal rate of 10%, thanks to a 41% increase in their securities portfolios due to their desire to maintain an additional liquidity cushion in response to the international turmoil. Banks also took advantage of the expected reduction of interest rates and aforementioned lower loan demand.

Loan quality as measured by past-due ratios (loans past due 30 days to gross loans) continued to deteriorate until mid-2009 and have since stabilized at about 5%. A faster deterioration was observed on commercial loans, while past-due consumer loans remained almost stable, thanks to a conservative charge-off policy and proactive collection efforts, in 2009; the consumer loan portfolio stagnated during the year. Even as loan demand is expected to speed up in 2010, the level of past-due loans should remain steady or even grow given the usual lag of the economic recovery and meager expected rebound in economic activity. Despite the decline of asset quality, loan loss reserves consistently covered 100% of 30-day past-due loans during 2009. Accordingly, loan loss provisions continued to consume a significant part of net interest revenues (71%), limiting the room to endure a further deterioration of the loan portfolio. Loan deterioration has apparently faded, but a worse than expected economic recovery during 2010 or unfavorable trading conditions could more easily have an impact on bank profits, particularly due to larger trading portfolios. Profitability levels have remained relatively stable (ROA 2.3%; ROE 19.3% for the system), mostly thanks to the positive effect of lower interest rates on the banks' securities portfolios and net interest margins, despite increasing provisioning. Capital ratios benefited from cautious cash dividend payouts, resulting in an improvement to regulatory capital. However, regulatory capital is still affected by "plain vanilla" subordinated debt instruments, which have zero equity credit, according to Fitch's methodology for determining the equity content of hybrid instruments. The quality of capital is also affected by high

The Colombian economy was less hard hit than expected, but recovery prospects appear modest.

Loan quality slipped but appears to have stabilized, with adequate reserve coverage.

Provisions consumed a significant portion of net interest revenues, but profitability continued to compare well.

Leverage is among the highest in the region, in part because of composition of capital.

levels of goodwill for some institutions, which, under local practice, are not deducted from regulatory capital.

In general, the ratings of Colombian banks — primarily national ratings — are deemed to be generally stable, despite the expected anemic economic recovery, due to their current sound asset quality, adequate loan loss provisioning, and profitability, even when capital ratios can be enhanced to provide enough resources to fund a healthy expansion during the years to come.

Dominican Republic

The international financial and economic crisis has resulted in sluggish economic growth, and credit growth accordingly showed slower growth in 2009, continuing the trend of previous years. In this context, delinquency rates (nonperforming loans/total loans) increased during 2009 after three years of improvement since 2006. Fitch believes that the seasoning of consumer loans and a still vulnerable economic environment could add some pressure during 2010, although past-due levels should remain at moderate levels (4.5% of total loans as of November 2009), with a still tight loan loss reserve coverage (104% as of November 2009).

Several measures were taken by monetary authorities during 2009 to prevent a further negative impact on the economy and to generate incentives to stimulate local credit demand. As a result, banks saw a lower cost of funds due to a sharp decrease of interest rates paid to deposits, which more than compensated for modest loan expansion, resulting in an increase of net interest revenue. However, higher loan loss provisions have limited any advances in systemic profitability, a trend that Fitch expects will continue into 2010, in order to allow banks to keep pace with expected past-due growth and improve reserve coverage levels. Profitability would be the key to improving current capitalization levels, which are considered tight, due to the heavy weight of fixed assets, foreclosed assets, and investments in subsidiaries on bank balance sheets.

Fitch believes that Dominican banks will continue to feel pressure on asset quality and net profits during 2010, in the context of a challenging economic environment, while capitalization and reserve levels will remain tight and potentially prove insufficient to confront eventual losses. Fitch believes that if economic vulnerability persists, some institutions will continue to see deterioration in their financial profiles, with smaller and less sophisticated entities that exhibit low capitalization and profitability levels more vulnerable to the negative economic environment. Consequently, Fitch anticipates some downward pressure on the ratings of certain institutions. Nevertheless, some upside on ratings can be expected on some institutions with an improved financial profile, despite the economic downturn, and an enhanced capital base.

Mexico

Mexico's economy was severely hit in 2009 by the three simultaneous shocks of global recession, reduced capital inflows, and a sharp correction in oil prices. Private consumption was adversely affected by the deterioration in consumer confidence, rising unemployment, negative real wage growth, and sharp contraction in consumer credit (19.9% YOY). While Mexico will continue to be exposed to the sluggish recovery in the U.S., it should return to modest economic growth in 2010 due to the favorable statistical base effect, some recovery in the manufacturing and services sectors, and improved consumer and business confidence. Fitch expects Mexico's real GDP to contract 6.7% in 2009 before recovering to growth of 3% in 2010 and 3.5% in 2011.

As Fitch previously projected (*see the special Report, "Mexican Banks Review and Outlook," dated Sept. 28, 2009 and available on Fitch's Web site at www.fitchratings.com*),

- The Mexican economy was among the hardest hit in the region; modest growth from a lower base is expected.
- Earnings are down sharply, affected by high credit costs and loan shrinkage.
- Strong margins supported by sizable market-related gains, likely nonrecurring, point towards lower margins going forward.
- Tighter margins and still high credit costs are likely to restrain profit growth.
- The system remains well capitalized.

banks' lending to the private sector recorded a slight decline of 3.5% in 2009. Banks were reluctant to lend in the face of a weakening macroeconomic outlook and worsening consumer portfolios, as well as their parents' need (in the case of foreign-owned banks) to consolidate balance sheets as part of their global strategy to deal with financial problems. The confluence of severe economic events has negatively affected asset quality for some time, draining banks' earnings, although they have remained slightly positive. In Fitch's view, impairment metrics peaked during 2Q09 and have somewhat eased since, especially in consumer portfolios, but they remain high, and the outlook is still difficult. Banks have prevented further loan deterioration through aggressive charge-offs, which have maintained credit costs at high levels. The worst of provisions and deterioration in consumer portfolios is probably in the past, but the outlook is less clear on other segments, especially for SME lending and mortgage loans, for which the economic environment is likely to continue to weigh on the still moderate proportion of problem assets and credit costs. For the overall loan portfolio, Fitch expects relative provisions and charge-offs to decline in 2010, but there is limited room for reductions relative to the high levels seen in 2008 and 2009.

Fitch expects that banks will soon report ROA and ROE for 2009 at roughly 1% and 10%–12%, respectively, but a number of factors had an upward bias on these figures, namely the ample interest margins accrued in the first part of 2009 and, more importantly, the sizable market-related gains obtained when interest rates declined aggressively in 2Q09. As of September 2009, trading gains accounted for an abnormally high 18% of net interest income and 54% of pre-tax profits. Fitch estimates that normalized ROA and ROE would have likely ranged at about 0.5% and 5%–7%, respectively. Going forward, banks will likely benefit from somewhat lower provisions, a moderate recovery in loan growth, and sound and well-contained operating costs, but these are likely to be offset by tighter margins on a full-year basis and limited room for expanding non-interest income. Therefore, Fitch expects that banks' earnings will remain low in 2010, albeit positive, with ROA and ROE probably at less than 1% and 10%, respectively.

Capital adequacy and liquidity have remained strong throughout the crisis, as Fitch previously signaled to be the banks' major drivers of individual and/or stand-alone issuer ratings. As of September 2009, cash and cash equivalents accounted for 15% of deposits and wholesale funding, while the loans/deposits ratio was a reasonable 90%. In turn, the system's Tier-1 capital ratio was a comfortable 14%. Nonetheless, the confluence of some lending resumption and still moderate internal capital generation in 2010 could somewhat pressure liquidity and capital levels in the near future, although Fitch expects that the impact on these factors would be minor, if any. In Fitch's opinion, liquidity risk and capital concerns deserve special monitoring in the case of nonbank specialized lenders (particularly mortgage and consumer finance entities), as these account for an increasing portion of systemic lending and accounted for the vast majority of problem institutions during the recent financial turmoil. To a lesser extent, smaller and less diversified banks could also present more challenges in terms of capital, liquidity, and funding stability, but these are unlikely to represent a systemic risk for the Mexican banking sector. The banks' loss absorption capacity has also been enhanced by ample loan loss reserves, which remained above 160% of impaired loans throughout 2009, although this was largely explained by more stringent regulatory reserve requirements effective August 2009 for credit card portfolios. It is expected that similar changes could be approved in 2010 for mortgage and nonrevolving consumer products, as regulators also seek to emulate global standards for required reserves, based on projected credit losses.

Panama

Panama's banking system benefited from its dynamic economy, which has shown greater resilience to the global financial crisis than its regional peers. Although the

GDP's growth rate sharply declined during 2009, it still enjoys a favorable momentum that is expected to remain over Fitch's forecast horizon. Following a number of years of accelerated growth, particularly in the consumer, mortgage, and construction sectors, credit growth slowed during 2009 as a result of lower credit demand and lower risk appetite. This slowdown, combined with a greater preference for liquid assets, and higher credit costs damped banks' profitability ratios to an ROAE of about 10% and an ROAA slightly higher than 1.0%. In addition, profitability ratios were affected by lower returns of the investment portfolios and, for some smaller banks, the mark-to-market losses related to securities that exhibited high volatility. While profitability is expected to pick up during 2010 as the banking system resumes its credit expansion, it should remain moderate, given the relatively low interest rate margins and prevailing high levels of competition in the Panamanian banking system.

Nonperforming loans increased slightly during 2009; however, asset quality remains sound as a result of the relatively favorable economic environment and efficient collection mechanisms (a sizable fraction of retail loans is collected through payroll deduction). However, some banks grew rapidly in retail loans, using looser credit standards, and began showing some deterioration as such exposures mature. At the same time, a major risk that some banks face is their significant exposure to real estate loans (i.e. high-end apartment construction), and difficulties might arise should the real estate market deteriorate. Favorably, larger exposures to real estate are concentrated in larger banks, which have a better capacity to absorb potential losses; an important share of high-end construction has reportedly been funded abroad. Going forward, unless significant impairments take place in real estate exposures, asset quality ratios should remain under control throughout 2010.

One of the main challenges facing Panamanian banks will be the ability to strike the right balance between higher profitability goals and growth into riskier segments/products. To achieve such a balance is particularly important, given the high penetration of banks in Panama (roughly 100% loans to GDP) and the likely continuous flow of deposits driven by the instability of Panama's neighboring countries.

Peru

A resilient economy and cautious lending policies framed the performance of Peruvian banks during 2009. The global crisis took its toll on economic growth during the first half of the year, curbing demand for Peruvian products, thus leading to lower credit demand. On the other hand, banks adopted a cautious approach, curbing loan growth to retail borrowers and taking early corrective action on the most vulnerable segments. By midyear, economic growth resumed, and the expansive economic policy (lower interest rates and smaller deposit reserve requirements) contributed to lower interest rates and underpinned margins, while investment portfolios recovered from 2008 lows. Operating expenses grew at a slower pace as expansion plans were scaled back, but loan loss provisions increased, in line with a decline in asset quality. Overall results improved, although profitability was a bit lower than recent record levels, in part due to higher capital levels; as for return on assets, figures were fairly stable. As expected, asset quality declined, driven mostly by retail lending, but remained moderate with PDL ratios among the lowest of the region; reserve coverage declined from previous highs but remains comfortably above 100%. Slower growth and strong earnings helped bolster capital, while new regulation is increasing required capital and introducing more stringent definitions of core and supplementary capital.

As the economy seems to be leaving the worst of the crisis behind, Peruvian banks are resuming growth across all segments, aiming to consolidate the substantial growth they achieved in the past few years. Peru's low banking penetration represents an important opportunity for growth, but competition may be fierce in some subsegments. Banks'

performance should be driven by loan portfolio growth and improving cross selling, while margins should be stable in the short run, although they are expected to come under some pressure by year end as interest rates have nowhere to go but up. The recent tightening of reserve requirements for short-term foreign currency funding illustrates this trend. Asset quality may see some deterioration but is expected to remain better than the regional average, although banks oriented to consumer and micro-lending could show somewhat higher delinquency levels. A combination of adequate capital, sufficient reserves, and a still strong revenue-generation capacity should allow Peruvian banks to withstand the remnants of the crisis and grow without jeopardizing solvency while maintaining a flattering level of profitability. Peru remains an attractive market with strong growth potential for global and regional players; these players should continue investing and positioning themselves to tap into the market's growth. Fitch's ratings of Peruvian banks are expected to remain stable throughout 2010.

Uruguay

In 2009, the level of activity of the Uruguayan financial system continued to expand, although at a much slower pace than in recent years given the sharp economic slowdown; the system reported a moderate rise in resident loans and deposits and maintained a historically low level of delinquency and ample reserve coverage (past-due loans were roughly 1% and loan loss reserves represented 6.6% of total lending at Sept. 30, 2009). Solvency has remained adequate (total capital-to-risk weighted assets of 17.6% at the same date), and liquidity continues to be very ample. Despite this, profitability has been strongly affected since 2008 by thinner spreads, significant variations of the Uruguayan peso, and, in 2009, the inflation adjustment; the central bank decided to reinstate this adjustment because the inflation rate was so high. Therefore, at Sept. 30, 2009, ROA and ROE were a modest 0.4% and 4.1%, respectively.

Fitch believes that the system's main weaknesses continue to be its high level of dollarization and the state-owned banks' high market share (the two public sector banks accounted for almost 50% of system assets). Although the degree of dollarization has decreased since 2002 in response to measures taken by the Uruguayan Central Bank (BCU), Fitch does not expect a substantial change in the medium term due to the characteristics of the country's economy.

In 2010, Fitch expects faster growth of lending to the private sector, which will be essential for the financial system to continue consolidating and restoring profitability. Thus, it will be vital to maintain credit standards during the expected expansion since delinquency, which is at a historical low, could increase as the portfolios season, especially consumer loans. Additionally, as seen in recent years, the banks' profitability will continue to be strongly influenced by the evolution of exchange rates and inflation.

Finally, Uruguay has significantly reduced its reliance on Argentina, and, consequently, the impact on Uruguay of an eventual crisis in that neighbor nation should not be as severe as in the past.

Venezuela

2009 was characterized by a decrease in economic activity, despite the rebound of oil prices and government spending, constant government intervention in the banking business and other private sector activities, and, during the last quarter of the year, the seizure of several small banks that had been operating, often for some time, in technical breach of regulatory requirements. Understandably, these actions led to growing negative market sentiment in 4Q09, resulting in a wider asymmetry of banks' liquidity (being mostly concentrated in large banks), deterioration of the market value of investment portfolios, and added pressure on the black market rate for foreign exchange.

Strained local economy contributed to failures of several small banks in late 2009/early 2010. Outlook is for further stress on the local economy. Devaluation of the Bolivar should add one-off gains to bank results. Recurring profitability will be pressured by growing credit costs. Sustained growth with falling profitability has weakened balance sheet integrity.

During early 2010, additional bank interventions brought the total number to 11 (about 14% of total assets at Sept. 30, 2009), and the government announced a long-expected change in the foreign exchange control regime. The latter implied the actual devaluation of the currency by at least 24%, creation of a multiple exchange rate, and active participation of the central bank in the so-called foreign exchange black market through periodic sales of Short-Term Central Bank Securities denominated in USD but payable in local currency, as a way to provide additional foreign currency to market participants.

The aforementioned devaluation will result in foreign exchange gains for most banks, a source of extraordinary income in the past, which have been significantly reduced since 2005. These extraordinary gains and a relatively stable interest spread will aid the system in coping with the sustained increase of credit costs observed since 2008 and inflationary pressures on its operating costs. The outlook for 2010 remains challenging. Fitch expects that economic activity will remain limited, while creeping government intervention in the private sector should continue, especially considering the latest developments registered early in the year (more bank intervention and more nationalization initiatives were seen in such other sectors as food retailers).

With banks operating with very thin capital bases, compared with the required minimum and regional averages, the conservative approach by banks towards lending, and limitations imposed by the elevated compulsory loan portfolio, it is expected that the loan portfolio will decrease in real terms again, as in 2009, while asset quality ratios should deteriorate further; past-due loans represented 2.7% of total loans as of September 2009, which were still far from the historical highs (21% of total loans in 1994 and about 7% of total loans during the last economic crisis of 2002–2003). While reported profitability should remain close to 2% of average assets aided by the extraordinary foreign exchange gains, recurring operating profits will remain under pressure, limited by increasing credit costs.

At the moment, a number of Venezuelan bank ratings carry Negative Rating Outlooks driven by decreasing capital bases and continuing government intervention, a situation that is not expected to change in the short term. Further government intervention and/or a significant deterioration of asset quality ratios, which would not be compensated by the expected extraordinary foreign exchange gains, could result in further deterioration of those ratings; however, notably, current ratings are already quite low, such that deterioration would have to be substantial to result in further downgrades.

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