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Special Report

2009: A Year of Reckoning for Latin American Banks

Analysts

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

Alejandro Garcia
Mexico & Central America
+5281 8399 9146
alejandro.garcia@fitchratings.com

Ana Gavuzzo
Southern Cone
+5411 5235 8133
ana.gavuzzo@fitchratings.com

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

Maria Rita Goncalves
Brazil
+5511 4503 2621
rita.goncalves@fitchratings.com

Related Research

- *Argentine Banks – Annual Review and Outlook, Sep 4, 2008*
- *Brazilian Banks – Semi-annual Review and Outlook, Oct 24, 2008*
- *Major Mexican Banks – Semi-Annual Review and Outlook, Sep 24, 2008*

Overview

After several years of riding region-wide growth to solid, growth-driven results, 2009 promises to be a year of reckoning for banks throughout Latin America. The region's banks largely escaped the adverse effects of the "first wave" of the global credit crisis-driven losses – realized and unrealized losses resulting from overvalued securities on and off the developed worlds' large banks' balance sheets. As the credit crisis continues to drive a global economic slowdown, the test facing the region's banks will be two-fold: how they deal with the "second wave" of credit challenges – old-fashioned pressure on the traditional, and largely "plain vanilla", loan products that have been the drivers of banks' results, and how they deal with the funding and liquidity challenges brought on by still-reticent capital markets at home and abroad.

Banking systems throughout the region entered the period of sustained loan growth after undergoing often significant consolidation, at times harsh systemic crises, and substantial regulatory reform. This resulted in stronger financial systems and regulators, with leading banks' franchises stronger than they had been historically, and many of these banks in the hands of 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. Strong indigenous banks, like Brazil's Bradesco and Itau, Peru's Banco de Credito, and Chile's Banco de Chile, have held their own against these global giants, at times attracting global partners as minority shareholders. With strong and growing capital bases, broad and stable deposit bases, developing local capital markets, and good prospects for a sustained period of relative political calm and balanced growth, Latin American banks were well positioned for potentially transformational growth.

The history of banking crises, however, often points to rapid loan growth as a harbinger of banking system crises. Indeed, this period of sustained growth saw Brazil (in April 2008) and Colombia (in October 2008) move from an MPI1 to MPI3 under Fitch's Banking Systemic Risk scale, and other countries advance to MPI2 and the edge of MPI3, indicating the need to examine more closely how the region's banking systems have fared through this period of sustained growth, and how well prepared they may be to face the pressures that the inevitable turn in the local economic cycles can bring. At the same time, inflation and, therefore, interest rates, spiked upwards across the region, reversing the beneficial trend of recent years; while this spectre has faded somewhat, growth expectations have been slashed in the face of the global economic slowdown.

Bank fundamentals have largely held up well through the growth cycle. Without significant questions surrounding the valuation of banks' assets, capital has not faced the need for massive adjustments seen in many developed countries. While capital has been stretched somewhat from pre-growth levels, it remains at levels that continue to compare well internationally, supported by consistently strong earnings and hybrids issuance of varying quality/equity credit. Margins have supported growing levels of provisions that have remained ahead of credit losses while continuing to backstop strong results. Loan growth was largely funded by deposits, with some contribution from local capital markets; liquidity has tightened, but proactive measures by regulators have helped support adequate levels of liquidity.

Key Rating Drivers

IDRs of internationally rated 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. Though the performance of their Latin subsidiaries will certainly reflect the downturn that the region's economies are undergoing, these entities have been and will continue to be important contributors to balance sheet and earnings prospects, and 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 have received government support, deposit funded and 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, and provides an incentive for the parent banks to protect the long-term value of these assets – Citibank's Banamex is a prime example of such operations.

Where IDRs are driven primarily by banks' Individual ratings, these ratings have historically been compressed by their operating environments. With the outlook for the year ahead almost universally negative, the likelihood of downward pressures on Individual ratings has increased. At this time, we do not expect broad, systemic downgrades, but remain alert to individual cases where institution-specific issues could pressure ratings. Rare are the cases where Individual ratings are above 'C', and, as these ratings look "through the cycle," the Individual ratings generally reflect the risks inherent in the downturn the region is facing at this time. The indigenous banks with Individual ratings above 'C' all boast solid, domestic franchises, relatively consistent profitability, a proven history of managing through the region's volatility, and balance sheets which generally are reflective of the risks faced and that are adequately capitalized. With deposit bases that benefit from flight to quality during times of stress, they are also well placed to face liquidity pressures; this is also reflected in Support floors that limit the downside to their IDRs and highlight systemic importance. Individual rating pressures would most likely come from expectations that loss absorption over the near term could result in losses that would threaten to significantly erode capital, and/or indications that historic deposit stability could be threatened, neither of which is Fitch's most-likely case view at this time.

An important part of Fitch's ratings coverage in the region includes institutions which carry only National ratings. These ratings express relative creditworthiness within their home markets, allowing Fitch to provide greater differentiation than is often the case with international ratings that can be compressed by sovereign considerations. As Fitch's National ratings generally make use of a broad range of their respective local rating scales, they can be expected to be more volatile than international ratings. While significant deterioration in local operating environments can drive system-wide downgrades of bank ratings, the primary driver of changes in National ratings would be changes in relative creditworthiness.

Key Performance Factors for 2009

Fitch expects that 2009 will see the sharp macro-economic slowdown reflected in bank results across the region. After several years of ROAs generally north of 2% and ROEs near or above 20%, returns should fall back, perhaps substantially, although earnings should remain positive. Tighter funding costs may not be fully passed through to borrowers, especially as some of the major central banks in the region have recently reduced policy rates underpinned by downside risks to growth and some relief from inflationary pressures, putting pressure on margins at a time when the volume growth which had helped offset margin pressures should slow substantially. Non-interest income, whose growth had already slowed for many across the region, will feel the negative effect of the slower growth in the form of stagnant or falling fees and commissions as business volumes decline. Adding to the pressure on the top line will be growing credit costs, and these will be the principal driver of relative differences among bank performance. Asset quality indicators will feel a potential "double-whammy": the loss of the beneficial effects on NPL ratios of a growing portfolio, as well as pressure from slowing economies and growing unemployment. Unemployment should prove an important leading indicator for the future performance of consumer portfolios. Corporate credit quality, increasingly important as borrowers turn to local banks to replace international borrowing, will feel pressure from slowing domestic and international economies, as well as from refinancing requirements in today's tougher markets; action by governments focused on these refinancing requirements, often channeled through state-owned commercial and development banks, may provide some cushion against these pressures.

On the funding side, the region's banking systems have fared better than most emerging markets. As mentioned earlier, funding is largely domestic and customer-driven. Foreign currency exposure to non-dollar generators, especially in consumer portfolios, is limited. The sustained loan growth of recent years did drive loan to deposit ratios upwards, however, leading to varying but growing dependence on local capital markets, most notable in Brazil, Chile and Mexico. With the corporate sector still shut out of international markets and local markets still risk-averse, corporates are turning to their domestic banks and/or competing with these banks for access to local markets. To this point in the crisis, there has been little evidence of systemic deposit flight in the principal markets, though growing risk aversion has led to flight to quality within systems, with indigenous private and public sector banks the primary beneficiaries. Foreign owned banks, often seen as safe harbors in the past, have benefited less from this flight to quality given the uncertainties surrounding their parents.

In the sections that follow, we will take a brief look at the outlook in the regions' principal markets, and the principal rating drivers in each of those markets. Our country-specific Review and Outlook Special Reports will examine year-end results and the credit outlook for the regions' markets in key markets over the coming months.

Argentina

Argentina's banking system has witnessed much of the same trend as seen around the region, and the benefits of five years of sustained loan growth have allowed many of the banks to generate the profitability to absorb much of the lingering legacies of the deep crisis that followed the "pesofication" of the economy in 2000. With revenues growth boosted by loan growth, the leading private sector banks, in particular, have largely absorbed the deferred losses of the "amparos" and marked the value of their public sector exposures to their local market values, and the system has slowly seen its ROE creep back to close to double digits, still well below regional levels. Exposure to the public sector, which stood at more than 50% at its peak, has been substantially reduced, and its mix is now dominated by the largely short term paper issued by the Central bank that have traditionally been the primary liquidity instruments of the banking system. Similar to the rest of the region, the loan growth has been driven principally by consumer loans, which have risen from under 20% of loans in 2005 to 25% at year-end 2007 and almost 40% at 1H08, with growth averaging over 60% p.a. since 2004. The consumer loan growth has been somewhat balanced, though, with commercial loans, which have also grown strongly, averaging nearly 40% since the end of 2004, adding to the diversification of the loan portfolio.

The result of this growth has been much needed balance sheet and loan portfolio diversification; loans accounted for roughly 45% of assets (vs. 30% at end-2003), and these are extended largely to the private sector. At end-September 2008, private sector lending (including individuals) made up 84% of loans, lending to the public sector 12%, and interbank lending 4%. Though automobile finance and mortgage lending saw over 41% growth in twelve months to September 2008, consumer loan growth has been driven first by unsecured personal loans and credit cards, As a result, only 37% of exposure to individuals at the end of 1Q08 was secured by real assets (primarily mortgages and autos); in the commercial portfolio, 41% of lending. Many of the leading banks have ramped up their lending to this sector, which is also largely unsecured lending. Loan growth has slowed in 2008 (growth through November was 22.1%, well lower than a year earlier), and should slow further into 2009.

Asset quality measures have had the benefit of the robust expansion the local economy saw through the end of 2007 as well as the dilutive effect of rapid loan growth of an unseasoned portfolio. Impaired loans have fallen precipitously from their post-crisis peaks an historical, and unsustainable, low point: from 18% of loans at the end of 2002, they stood at 2.5% of loans at y/e 2007. The seasoning of the new portfolios, and rising inflation coupled with a slowing economy, has seen this trend reverse as, despite continued strong loan growth, impaired loans had risen to 2.9% at end-November 08, while coverage by loan loss reserves has been relatively steady, at 123.5% at the end of 2007 and 131% at end 2008. The effects of slower economic growth and the erosion of earnings power that flows from surging inflation point towards further pressure on asset quality. Indeed, impaired loans in the consumer portfolio already show early signs of pressure, as they rose from 3% of consumer outstandings at the end of 2006 to 3.6% at the end of 2007, even as this portfolio expanded 57% in 2007; this trend continued in 1H08 as impaired loans rose close to 4% through November 2008. With the bulk of lending unsecured, healthy loan loss reserve coverage will remain key to loss absorption capacity, and some pressure on profitability will make the maintenance of strong reserves, especially under stress scenarios, more challenging.

The loan growth and shifting mix of the loan portfolio has helped improve margins that had been weighed down by substantial public sector exposure. The operating costs of re-investing in loan and product expansion have weighed on results. With little pressure on asset quality, loan loss provisions consumed about 14% of pre-tax income, a level that will rise going forward. Looking ahead, the pressures the banking system has seen on its deposit base, together will still high real inflation, may combine to put important pressure on banks' funding costs and, therefore, margins. With the economy slowing and political uncertainty helping to depress loan demand, loan growth should slow, perhaps sharply. As stated earlier, the combination of the natural seasoning of a relatively young loan portfolio, a slowing economy, and potential pressures on margins could hamper banks' capacity to absorb an important increase in loan loss provisions, should these become necessary. This pressure on profitability will be somewhat offset by the fact that banks have almost finished with the amortization of the "amparos", which was a heavy burden on some income statements until 2008. Also helping offset some of this concern is a relatively healthy level of capital in the system, with equity equal to 12.4% and 11.6% of assets at y/e 2007 and Q308, respectively.

Brazil

Brazil was one of two countries in the region to move into the MPI3 category in 2008 (Please refer to the Special Report "Banks Systemic Risk", April 7 2008). While its banking system seems well positioned to face the pressures of a downturn, the reckoning may come sooner, and perhaps more sharply, than has been expected. The rapid deceleration of industrial production, which in turn has prompted a growing number of private sector companies to cut labor costs through job cuts and production slowdowns, led to a significant, and higher than expected, jump in unemployment numbers in December 2008. With credit growth expected to slow sharply, the employment outlook should translate to significant pressure on the performance of the loans to individuals and small businesses that were the principal drivers of the sustained loan growth since 2003. In Fitch's view, how the banks deal with asset quality in these segments will be the principal determinant of their performance through 2009. While asset quality pressures will not be limited to these segments, the government's growing effort to address the financing and refinancing needs of the corporate sector will provide a cushion for this segment that is of yet not available to the other principal segments of the system's borrowers, making it likely that banks will favor lending to the corporate sector over lending to individuals.

Liquidity in the banking system remains adequate, though there have been pressures on foreign funding (roughly 10% of the system's total liabilities) and on individual institutions as local capital markets and institutional investors became increasingly risk averse, reflecting the uncertainties of global capital markets. The external uncertainties were exacerbated by the significant losses suffered from derivatives operations undertaken by several of the country's most visible corporate names. Brazil's Central bank has been quite proactive in putting in place measures and facilities aimed at facilitating liquidity in the banking system. The country's still ample hard currency reserves are being made available to help cushion the loss of external lines, and a series of measures aimed at allowing the use of banks' historically significant reserve requirements (already held at the Central Bank, and often criticized as too high), as well as the institution of rediscount facilities at the Central Bank and the deposit guaranty fund, have helped stabilize liquidity pressures within the banking system. The government has also indicated its willingness to incent the federally owned banks to take measures aimed at assuring a flow of credit to the corporate sector, and has indicated its intention to provide facilities aimed at easing the external refinancing requirements of the private sector corporate segment; though this should favor corporate liquidity, it may lead some of the federally owned banks into activities they have little experience in. While segments of the banking system were hard hit by the growing risk aversion of institutional investors– in particular banks principally dependent on wholesale funding – Fitch's monitoring of liquidity in the banking system indicates that the measures taken to date have stabilized the funding movements within the system, with the large indigenous banks, both private and public sector, having been the prime beneficiaries of the concentration of liquidity. Indeed, Central bank numbers for the period from June through December indicate that total deposits in the banking system for large banks grew at a much faster rate than the reduction of deposits for the smaller banks, indicating an increase in deposits at a systemic level.

While tighter domestic markets have meant a rise in funding costs across the system, systemic figures indicate a widening of bank margins in lending to both individuals and corporate borrowers, as demand for credit in tight markets has helped offset the pressure on banks' funding costs. This will prove important to offset what should be a significant drop in overall credit growth, which had been the primary driver of bank results for the past 4-5 years. While the local market still expects low double digit credit growth, GDP growth projections are falling (Fitch recently lowered its projected growth figure to 1.6%), making slower than expected loan growth increasingly likely. With loan loss provisions expected to rise significantly in 2009, banks whose earnings are primarily generated by their interest margins will see the greatest pressure on their earnings. The universal banks that comprise the group of systemically important large banks have consistently covered an important part of their operating costs from largely recurring and reasonably diversified non-interest income. This should continue to be the case, but Fitch expects that lower levels of commercial activities that will affect both banking and insurance, a fall in assets under management, and much slower capital markets activities should all contribute to lower fees and commissions.

Systemic capital, which suffered over the past two years with the rapid credit growth (combined BIS ratio for the top 50 banks: 17.9% at end-2006, 17.8% at end-2007, and 15.9% at Sept. 2008), still compares well internationally; slower loan growth will ease these pressures, though lower earnings will also mean slower growth of the capital base. Quality of capital varies among the banks. Among the large banks, capital growth was achieved in part through issuance of high equity content hybrid debt, raising Tier II elements in the capital structure; in addition, levels of deferred tax assets, which had been declining through 2007, rose in 2008 as loan loss provisioning accelerated, and easing of regulatory restrictions on these assets, together with still rising loan loss provisions will translate to still higher levels of intangible assets in 2009. Among the small and medium sized banks, capital varies but remains generally adequate; ten banks in this segment of the system raised capital in IPOs in 2007, and the asset shrinkage brought about by the funding pressures on these banks will also relieve pressure on regulatory capital ratios. The foreign owned banks have traditionally worked with tight capital levels, preferring to centralize capital management and inject capital as needed; capital requirements at the parent level may lead higher dividends or the sale of certain assets in Brazil.

Ratings on Brazilian banks vary widely – when considering the portfolio of national ratings, they range from 'AAA(bra)' to 'BB(bra)'. As noted in the Key Ratings Drivers section of this report, support driven ratings of banks with still relatively well rated parents will remain correlated with the ratings of their parents. Similarly the ratings of government owned banks will continue to depend on the rating of their controlling shareholder – the Brazilian government; their role growing roll as agents of government stimulus actions solidifies this correlation. For indigenous private sector banks, the ratings gap between the strongest and the weakest is already pronounced, and it is natural to expect more ratings volatility at the lower end of the range. While we expect bank performance to suffer across the system in 2009, the highest rated indigenous banks have a demonstrated history of successfully managing through Brazil's turbulent economy; rating of these banks would be negatively affected if the downturn proves to be of a sharpness or length that translates to performance that puts in danger their still solid financial fundamentals. The lower rated indigenous banks have been the most affected to date by the crisis. With national ratings from A-(bra) to BBB-(bra)), these banks have faced a severe liquidity crisis since mid-September 2008 (please refer to "Fitch Comments on Liquidity Among Brazilian Banks", October 14, 2008). They have faced these pressures to date without default, but most will also emerge from the liquidity crunch smaller, more concentrated in their lending activities, and still dependent on interbank and wholesale funding. Their performance in managing asset quality, both on their balance sheets and in portfolios sold and/or securitized, will determine if the already wide gap between their ratings and those at the top of the scale widens further.

For further details of the issues facing the Brazilian banking system, please refer to Special Reports "Brazil's MPI – 3: Traffic Light Flashes Yellow..." 7 April 2008, "Fitch comments on Liquidity Among Brazilian Banks, October 14 2008" available at www.fitchratings.com.)

Chile

As was the case across the region, the Chilean banking system's performance through 2007 was driven mainly by the strong growth of retail banking, as banks focused their commercial efforts on the retail segment, increasing lending to middle and low income individuals, aiming to protect margins and diversify their portfolios across a broader spectrum of the local economy. This led to strong growth in lending to individuals through 2007 (+15% in 2007, +24% in 2006 and +25% in 2005). Growing indebtedness of individuals, rapidly rising inflation, and increased demand from the corporate sector led to a welcome tightening of credit standards, resulting in steady growth (15.4% in 2008) of lending to individuals, concentrated principally on mortgage lending, while loans to corporate borrowers saw much stronger growth, growing 23%. The outlook for 2009 is a continuation of this trend. The prospects for slower growth and higher unemployment should see lending to individuals slow further, while loan demand from corporate borrowers, who continue to have at best limited access to international capital markets, should mean that the portfolio shift towards these will continue. At YE08, the loan portfolio was distributed as follows: 65% commercial loans, 23% mortgage loans and 12% consumer loans (73%, 18% and 9%, respectively in 1999).

Asset quality has been strength of the Chilean banks; through the period of strong loan growth, impaired lending measures reached historic lows, benefiting from growth and a relative lack of seasoning of the growing consumer portfolio. As would be expected from the shift in loan mix, signs of some pressure on the quality of the new loans appeared in 2007, though overall asset quality remained strong as the absolute level of impaired loans grew more slowly than overall growth. This pressure translated to a rise in loan loss provisions from very low levels, as they grew to represent roughly 33% and 43% of pre-tax income in 2007 and 2008, respectively; this increase is notable, and a trend we expect to continue in 2009, dampening the prospects for bank results. It is interesting to note that loan loss provisions after the Asian crisis in 1999, the most recent period of significant asset quality pressures, peaked at a level of 67% of pre-tax income, while bank results were positive (ROA of 0.7% and ROE of 5%) though well below those achieved before and after that crisis (1997: 1.0% y 13.7%; 2001: 1.3% y 17.7%). As provisions increased (up over 70% in 2008, vs. loan growth of 22%), reserve coverage of loans has risen to a still low 1.76% of loans (1.58% FY2007). Local regulatory oversight focuses on banks' reserving policies and practices and how well these match individual credit exposures, and this has historically resulted in reserve coverage which has been adequate to absorb losses. Loan loss reserves stood at 180% of reported overdue loans at year-end 2008 (210% YE 2007). While this level provides adequate coverage relative to recent historical losses, reserves relative to the total loan portfolio are well under 2% and will need to rise as asset quality continues under pressure. Unexpected stress which might push losses well above recent historical levels would mean that such a shock would need to be absorbed largely through the income statement; with the increasing leverage seen in the system, this is a potential point of concern.

As was the case across the globe, liquidity in the banking system and in local markets saw its nadir around the end of 3Q08 and into early 4Q08. Cuts in foreign trade lines for banks and corporates, and the effective closure of local markets to new debt issues through mid to late November were the principal symptoms of the uncertainty that dominated the near term outlook. Actions by the authorities, initially in the form of dollar swaps made available by the Central Bank, and the repatriation of tax proceeds that had been held abroad helped address the liquidity crunch. As it became clear to the local markets that the Chilean banks were generally free of the "toxic assets" behind the global crisis in confidence, local markets began to ease. Further action by the government, culminating most notably with the recent fiscal stimulus package announced in January, contributed to significant easing of local capital markets, and local corporate issuers have issued over $ 800 million in new debt through late January 2009.

Ratings on Chilean banks are among the highest ratings in the region, befitting the highest rated sovereign. Fitch recently revised Chile's rating to a Stable Outlook. Ratings of Financial Institutions in Chile, in particular in its national ratings portfolio, range widely. At the high end of the scale stand the country's largest banks, whose broad domestic franchises have proved solid through economic cycles, and these banks appear to be well positioned to face a slower economy in 2009. The lower end of the rating scale is largely dominated by non-bank financial institutions, whose ratings could be expected to see more volatility. The current situation may prove particularly challenging for entities dependent on wholesale funding, since, as is the case throughout global markets, funding has become scarcer and/or more expensive, and a slower economy will test asset quality in the consumer segment, where most of these entities focus their lending activities.

Colombia

Vigorous economic growth, the recovery from the past financial crisis and the intention of banks to expand their loan portfolio have resulted in a significant increase in loans since 2004, with nominal loan growth rates of 10% (2004), 20% (2005), 36% (2006), 24% (2007), slowing to 19% in the twelve months through November 2008, significantly above the average inflation rate for the period. Similar to regional trends, this expansion has been sustained and balanced across most economic sectors, and also, by a vigorous activity in the consumer loans market, a market quite active before the 1997-1999 financial crises and a market with above average customer information compared to the regional median.

The expansion in consumer loans has been driven principally by unsecured lending; while auto loans and mortgages are sizable, their participation is still less than 15% of total household exposure (consumer debt plus mortgages). At end-2007 consumer and mortgage loans represented roughly 30% of total loans, while in 2003 these were just 19%; both those levels are still below the level achieved during the 1997-1999 financial crisis. Mortgage lending returned to growth since 2006, and have been granted using fixed rates programs instead of the past practice of floating rate facilities (31% of outstanding loans at end 2007 were fixed rate loans, compared to almost 0% five years ago); this has been made possible in part by an increasingly active mortgage securitization market, but the practice can also add market risks, and banks often continue to hold first-loss tranches of their securitized mortgage portfolios. Loan to value figures, albeit increasing, are still within adequate levels (on average, below 50% at end-2007), which could limit the loss given default of the system for this exposures, contrary to the situation observed during the last financial crisis. Household debt levels well lower than those posted during the last crisis, with a total financial debt to individuals' financial assets ratio of around 25% in 2006 (but increasing) while the same ratio stood around 60% in 1997.

As should be expected, indications of asset quality since the most recent lending boom have shown some deterioration in the quality of consumer lending from the relatively low levels exhibited in 2002-3. Loan seasoning, and vintage analysis of Central Bank information for 2005, 2006 and 2007 vintages of consumer loans are posting increased impairment figures as high as almost double of the impairment ratio showed by previous vintages (risky loans representing 12% of total loans for the 2005-2006 vintages compared to no more than 7% for 2002-2004 vintages); which suggest the possibility of an even worse performance going forward for that kind of exposures. At end-2007, the total past due loan ratio climbed to 3.7%, with an increase of almost 43% in past due loans; this trend continued during the first three quarters 2008, with the past due ratio increasing again up to 4.5%, while the consumer loans past due ratio went up to 7.3%. Accordingly, reserves have provided decreasing coverage of rising impaired loans, just 100% at end-2008. Loan loss provisions are increasing rapidly (in part affected by a change in the regulation related to loan loss reserves during year 2007) to more than 65% of net interest revenue in 2008, pointing towards limited room for absorbing significant further provisioning in an environment characterized by increasing funding costs and a less predictable trading income, and the pressure on asset quality implied by the trends in recent vintages mentioned above. The commercial loan portfolio has also seen pressure from its strong levels of asset quality, given the rapid deceleration of the economy. Commercial past due loans rose 60% in 2008, to 2.4% of the commercial portfolio, but remain below historic averages and pre-crisis levels. Further deterioration of corporate loans should be expected during 2009 as growth prospects remain dimmed. Despite the deterioration seen to date, profitability levels have remained relatively constant, but further deterioration of loans could have a significant impact on returns. Profit growth still remains above 20%.

Due to inflationary concerns the central bank had increased reference interest rates during almost three consecutive years until December 2008. However, systemic liquidity was ample during the same period, because of domestic and international conditions, and only tightened for banks more recently. Since 2007 the average growth of bank deposits has been 15%, slightly above historic averages, but term deposits during the past year have increased at more than double the rate (37%) with negligible impact on interest margins. Stability of deposits has remained high, but funding costs have turned more onerous as term deposits represent a larger portion of banks' funding.

Much of the recent growth in regulatory capital has come in the form of "plain-vanilla" subordinated debt which, under Fitch's methodology for determining the equity content of hybrid debt, has little loss absorption capacity. The quality of capital is also affected by often significant levels of goodwill which, under local practice, is not deducted from regulatory capital. As a result, and given the downward trend in reserve coverage, Fitch views the loss absorption capacity of Colombian banks as tight relative to regional peers, leaving the banks more exposed to potential pressure on asset quality. While the Colombian banks have performed well since the end of the crisis of the lat 1990's, the aforementioned issues revolving around quality of capital, especially in light of growing asset quality pressures, continue to constrain Individual and IDR ratings.

Central America

The three largest economies in the region (Guatemala, Costa Rica and El Salvador) have mirrored other countries in terms of rapid lending growth in recent years. Since end-2003, total loans have grown at a compounded annual growth rate (CAGR) of 22%, 24% and a relatively moderate 10%, respectively. In most cases, consumer and mortgage loans have been the fastest-growing segments and together accounted for roughly half of total lending in each of these three countries. Central American countries share some common challenges and risks going forward to sustain asset quality, namely strong economic ties with the US and ample exposure to high food and energy prices. However, other indigenous features also pose additional risks to the outlook for retail lending. In the case of El Salvador and Guatemala, high reliance on worker's remittances from the US somewhat constrains borrowers' disposable income under an economic downturn in the US. In Costa Rica and Guatemala, a high level of dollarized loans to non-USD generating customers is also an important source of risk. In El Salvador, a dollarized economy poses particular challenges as policy makers and bankers face an environment with slowing economic activity, decreasing foreign currency inflows and widening current account deficit. Recent trends have been mixed throughout the region.

In **Guatemala**, Fitch highlights the limited availability of system-wide information to assess the growth and quality of retail loans, among other issues. In line with the strong growth in total lending (CAGR 2005-June 08: 22%), consumer loans (excluding mortgages, which are not disclosed on a system-wide basis and are accounted for as other commercial loans and/or securities) have grown at a 35% CAGR over the same period. Therefore, consumer loans have increased their relative contribution to total lending, to roughly 30% at June 2008 from 23% at end-2005. In contrast to other countries, credit cards make a relatively modest contribution to consumer loans (15% of total at June 2008), while the vast majority is directed toward the acquisition of durable goods (80%). In Fitch's opinion, mortgages are not a source of significant risk, since most are granted through the government-sponsored agency FHA, and the guarantees provided by this entity indirectly encourage banks to maintain sound origination. At the total portfolio level, non-performing loans have declined to 2.6% of total, due to changes in accounting rules which relaxed definitions, but Fitch believes that this figure is understated relative to international comparisons due to ample growth recently. Moreover, only around 20% of the system's loans have some kind of real guarantee, and Fitch considers that this is largely concentrated in mortgages and some commercial lending. Therefore, consumer and other retail lending are predominantly unsecured. Roughly one third of total loans are USD-denominated and a portion of this is retail lending granted to non-USD generating clients. Fitch is also concerned because the low level of loan loss reserves, which accounted for 1.9% of total loans and 71% of non-performing loans at June-2008. Coupled with the tightest equity/assets ratio among Central American banking systems at 8.5% (adjusting for non-eligible subordinated debt under Fitch criteria), the system-wide ability to absorb losses is limited under a potential scenario characterized by gradually slowing loan growth, weakening economic activity and rapidly declining credit quality of a large portion of retail customers. Other risks are the narrow real interest rates (on a risk-adjusted basis), which might not provide enough earnings capacity to cushion credit losses under a downward credit cycle, given the aforementioned low levels of loan loss reserves. While loans still account for a relatively modest 82% of deposits, depositors' confidence may still be somewhat fragile due to a recent history of failed banks, among other systemic issues, which also poses additional challenges to sustaining loan growth in the future. The modest pace of growth, low banking penetration in the economy, and relative size of retail lending provides some comfort, but Fitch remains concerned by the Guatemalan banks' tight financial profile and their ability to face the headwinds that the region is foreseeing.

In **Costa Rica**, while economic growth remains strong, the main challenge for banks is the confluence of rising inflation and increasing interest rates, as a result of a relatively new and less predictable exchange rate regime. Total and retail lending have grown vigorously, underpinned by above-average economic dynamism. Between end-

2004 and June 2008, total and retail loans increased at a 24% and 26% annual rate, respectively. Mortgages have grown at a faster pace than consumer lending (35% versus 20%, respectively) and together accounted for 53% of total lending and 28% of Costa Rica's projected GDP at June 2008. In Fitch's opinion, the sharp increase in retail lending has not been tested in Costa Rica, since a confluence of factors has prevented asset quality deterioration. First, loan growth is still strong, which dilutes the impact of gradually seasoning loans. Second, the upward trend in interest rates is very recent, and its potential effect on asset quality and borrowers' debt service capacity, still not evident. Therefore, the level of reported non-performing assets remains at a low 1.2%, while reserve coverage stood at 160% at June 2008. However, inflation has risen to 12.8% at June 2008 from 9-10% in 2006-2007. Narrower real interest rates are constraining margins and overall profitability. While the ROA is still comfortable at 1.7% at mid-year 2008, this is somewhat exposed to potentially rising provisions, driven by weakening asset quality going forward. Provisions still accounted for a relatively low 13% of net interest income at June 2008. Fitch is particularly concerned that weakening asset quality and increasing provisions will likely occur at a time when earnings are already limited, due to the narrower margins and modest revenue diversification. Tighter real rates could also discourage bank depositors, which has contributed to the downward pressure on the loan/deposits ratio to 94% at June 2008 (2004: 68%), a trend that we expect to continue.

Unlike most peers, loan growth in **El Salvador** has been moderate over the past few years, although sustained. Moreover, growth has been flat or slightly negative in real terms during recent months. Total loans have increased at a CAGR of roughly 10% since end-2004, a rate that has been mirrored by mortgages. However, consumer lending (including mortgages) has increased at a 16% CAGR. Total retail loans accounted for 48% of total lending and roughly 22% of GDP at June 2008. Asset quality compares well regionally; despite rapidly rising non-performing loans, these accounted for 2.3% of total at June 2008, although reserve coverage is somewhat limited at 113% of NPLs. Fitch's primary concern is to what extent banks will absorb a likely upward trend in interest rates, since inflation has increased twofold in 2008 (9.0%) relative to the previous three-year's average. While provisions are still a modest 0.6% of average loans, these already absorb 35% of net interest income, since margins remain relatively limited. While the large and/or deposit-funded banks will likely benefit in the short term from higher interest rates, these could eventually slow economic growth and harm borrowers' ability to honor their financial obligations, which could further affect asset quality and earnings. The proportion of riskier loans (classified C, D or E) has increased to 7.0% in consumer and 4.6% in mortgage loans at June 2008 (2004: 4.2% and 3.6%, respectively), a trend that deserves close monitoring. System-wide liquidity is somewhat limited, since loans now account for 106% of total deposits (2004: 94%), a risk that is particularly important given the absence of lender of last resort in the dollarized economy. Deposits have marginally declined in 2008, while further challenges on this regard could arise as the 2009 presidential elections approach. Coupled with relatively modest room to absorb increasing credit costs (system-wide ROA: 1.4% at June 2008), these factors will likely constrain the pace of loan growth going forward.

Mexico

After several years of sluggish growth following the 1995 financial crisis, retail lending by Mexican banks grew vigorously over the past few years. Consumer lending resumed notably in 2002, while mortgage portfolios have grown since 2004. Total consumer and mortgage loans have increased at a compounded annual growth rate (CAGR) in excess of 30% in real terms since end-2002. As expected, both business lines have slowed more recently seeing 20% real growth in 2007 and slowing further in 2008; mortgage loans increased 11% y-o-y in real terms through September, and Fitch estimates that, on an adjusted and comparable basis, consumer lending is still growing at roughly 4-6% y-o-y in real terms as of September 2008 (certain inter-company sales of consumer portfolios in 2008 distorted absolute system-wide growth rates). In turn, commercial loans have been growing at a faster pace recently (30% in 2007; 18% over the twelve months ended in September 2008), which has partially compensated the slowdown in retail lending and has provided healthy diversification in overall loan growth.

As is the case throughout the rest of the region, the sustained loan growth, led initially by rapid growth in riskier assets, has gradually changed the mix of banks' loans. At September 2008, consumer and mortgage loans together accounted for roughly 42% of the system's total portfolio, in contrast to barely 20% in 2002. Loans to individuals (consumer and mortgages) have replaced the declining balances of public sector loans. As this trend has continued, banks have been increasingly challenged to contain credit costs of a larger, riskier and more diversified loan portfolio. It should be noted that roughly half of retail lending is unsecured (credit cards accounted for 65% of consumer loans and 41% of total retail lending at September 2008), implying potentially higher loss content in impaired loans. Secured financing to individuals is largely concentrated in mortgage and auto loans and, to a lesser extent, payroll-deductible personal loans and certain products for the acquisition of durable goods.

Asset quality metrics have worsened relatively rapidly despite ample loan growth rates, as these relatively new and riskier retail loans are seasoning and pressuring asset quality, as expected. Consumer loans are the worst-performing, as a large portion of these has been granted to individuals with little or no financial track-record. Higher personal indebtedness has also weighed on loan quality. Difficult to measure because of sometimes significant debt owed to unregulated non-bank lenders, the overall level of personal indebtedness appears to be highest within some low-to-medium income brackets of population, where much of the credit card growth was concentrated. As of September 2008, delinquency ratios in total, consumer and mortgage loans on a system-wide basis had increased to 3.0%, 7.7% and 3.3%, respectively (end-2005: 1.9%, 3.1% and 2.3%). Since end-2005, delinquency in retail portfolios has soared in a period of strong loan growth, especially in consumer loans, where impairment ratios have more than doubled in all products (credit cards, financing of durable goods and personal loans). Fitch highlights that consumer portfolios in Mexico are the worst-performing among comparable Latin American banking systems in the recent past.

Sharp increases in provisions and charge-offs also deserve close monitoring. Provisions and charge-offs have climbed steadily to relatively high levels, 4.2% and 4.0% of average loans in the first half of 2008, respectively; positively, provisions continue exceeding charge-offs, preventing depletion of reserves (157% and 4.75% of impaired and total loans at September 2008, respectively), as banks have prioritized maintaining reserves over boosting net income. We expect that provisions and charge-offs will maintain an upward trend, and that problem loans will continue rising going forward, especially in credit cards, with further deterioration of asset quality and profitability metrics.

Strong margins, adequate revenue diversification from fee and service income and well-contained operating costs have been the major drivers of still sound recurring earnings at the industry level. However, sizeable and rising provisions, which in 1H08 accounted for 34% of net interest income and 57% of operating profits before provisions, are rapidly affecting the bottom line, and this pressure should accentuate as loan growth slows and the economy worsens. The worsening economic environment will continue to pressure asset quality and provisions in two ways: harming the debtors' payment capacity and further limiting loan growth over the short- to medium-term. Coupled with the upward trend in funding costs arising from constrained liquidity and increased risk aversion, pressures on the system's earnings and profitability ratios will likely exacerbate going forward. With a return on assets (ROA) at 1.95% in the first half of 2008, the banking system's profitability still provided some capacity to absorb further declines in profitability. Risk-adjusted profitability (pricing) still remains sound in most of the lending sectors, which has allowed banks to absorb normal credit losses, although this has to be tested yet under the tougher circumstances that emerging markets face going forward. In general, we expect that the performance of Mexican banks will continue weakening to some extent, until asset quality problems are fully contained. However, we do not expect the performance to be dramatically adverse, rather low, although still positive, profitability measures will likely be recorded in the foreseeable future.

Despite ample loan growth in the past few years and the worsening asset quality recently, capital adequacy and liquidity at the bank level have remained sound. At August 2008, the system's Basel II ratio stood at a strong 16.15% (Tier-1: 14.70%). In turn, liquidity is also ample, with cash accounting for 25% of total deposits at June 2008 (48% when securities are included). Rapid lending growth has not dramatically increased the loans/deposits ratio (95% at 1H08), while major banks continue being largely deposit-funded. As Fitch has stated previously, risks on the funding side might be somewhat higher in smaller and less diversified specialized banks, as well as in the case of unregulated non-bank non-deposit taking lenders, such as mortgage and consumer finance companies (Sofoles). Liquidity and refinancing risks are especially dangerous amidst the current environment driven by limited system-wide liquidity and dramatically increased risk aversion from investors. While financial institutions that are heavily reliant on wholesale funding are particularly exposed to this environment, government-led actions could sustain the financing flows in socially-important sectors, such as the housing industry –see Fitch's Comment "*SHF Support Program Sets a Rating Floor for Non-Bank Mortgage Companies*", released on October 22, 2008. In addition to loan growth and asset quality issues, a potential escalation of the currently uncertain financial environment could also affect eventually the banks' capitalization and liquidity levels.

Given asset quality pressures, most major banks have reacted by reducing lending approval rates, replacing and/or enhancing scoring systems and, more importantly, redefining the scope and target markets of their retail lending products. The regulator is also aiming to strengthen the system's loss absorption capacity; generic reserves requirement for credit cards were revised upward to 2.5% of the outstanding credit line effective August 2008, from less than 1.0% previously. These factors, coupled with less benign economic conditions, will significantly constrain loan growth in the near future. Fitch expects that retail lending growth will remain positive, though significantly lower. However, consumer and mortgage loans granted by commercial banks barely account for a mere 10% of the country's GDP (around 18-20% of GDP when non-bank retail lending is included), which highlights the challenge to properly balance short term retrenchment with the need to further financial intermediation on a longer term view throughout the economic cycle.