Venezuelan banks battle to rise above inflation and FX woes

Sky-high inflation, a spiralling economy and a bleak foreign exchange environment in which the black market is thriving are presenting Venezuela's banks with one of the toughest tasks in global financial circles just to stay in business. Jason Mitchell looks at how those still standing are managing to cope.

Venezuela’s banks are facing a daily struggle to support their customers in the face of astronomical inflation and an economy caught in a rapid spiral.

The South American country – with a population of 31.4 million people – is suffering from the most bleak economic circumstances on the planet, outside a warzone. This year’s catastrophic slump in gross domestic product (GDP) follows a 5.7% decline in 2015 and 3.9% in 2014, according to the International Monetary Fund.

Capital Economics, a London-based economic consultancy, estimates the country’s primary fiscal deficit is running at 25% of GDP. Total imports have nosedived by 49% in the past year. At $11.8bn, Venezuela’s dollar reserves are at a 13-year low.

Inflation up and up

According to estimates, inflation in the country has been rising at 30% a month for the past 27 months and professor Ricardo Hausmann, a Venezuelan who is director of Harvard's Center for International Development, estimates its inflation rate now stands at more than 1000% a year.

The minimum wage is 22,576.60 bolivars a month: $2271 a month at the official exchange rate of 9.94 bolivars per dollar as of mid-September 2016 but a measly $22 a month at the black market rate, which is much more widely used. These extraordinary economic circumstances, coupled with intense political and social uncertainty and extreme violence, pose immense challenges for the country's banks.

"The banking system is characterised by a massive tax on financial assets owing to inflation," says Mr Hausmann. "The public is losing a huge chunk of its savings every year and banks are paying highly negative interest rates. The system is highly repressed and highly regulated."

Reversal in fortune

Until a few years ago, Venezuela's banks were among the most profitable in Latin America. In July, return on assets (ROA) stood on average at 3.6% and return on equity (ROE) at 54.8%, according to the country's Superintendent of Financial Institutions (Sudeban, by its Spanish initials).

ROA ratios are only slightly lower, for example, than those found in Argentina – a country whose major macroeconomic problems are nowhere near on the scale of those in Venezuela – and ROE ratios are almost double those found in Argentina.

However, the big difference between Argentina and Venezuela is that although the former has high inflation (running at about 48% annualised, according to figures from Buenos Aires province, seen as representative of the country), the latter is in an inflation league of its own. Venezuela's ROA and ROE ratios are, in fact, highly negative in real terms.

Furthermore, the country's figures are clearly down on 2015. In May last year, for example, the official ROA was 3.9% and ROE was 61.5%.

Diminishing returns

The banking system cannot cope with inflation because most of its assets are monetary, and lending rates are kept well below inflation (29% annually is the maximum allowed rate for credit card loans and these types of loans have the best percentage returns in the country). In this way, the banks' asset base is being deeply eroded by inflation. ROA is also diminishing because ROE is declining, especially among small banks.

Experts also point out that the ROA ratio is being determined (at least partly) on the basis of 'non-monetary assets', including real-estate property (offices and branches), whose value is not being adjusted to reflect inflation (the banks' financial statements are produced on the basis of historic real-estate values). Moreover, the foreign exchange rate that is being used is 9.95 bolivars to the US dollar official rate, but banks do not have access to dollars at this rate.

"Inflation is having a huge impact," says José Antonio Muci Borjas, a banking specialist and partner at Muci-Abraham & Asociados, a Caracas-based law firm. "Banks are not able to protect their assets by investing in real estate generally. They cannot fund new residential developments, for example. They are also excluded from the foreign exchange market. All the banks are allowed to hold is local money, which is being consumed by inflation."

Rise in NPLs

In May 2015, the ratio of non-performing loans (NPLs) in Venezuela was very low, at 0.4%. In July this year, the ratio of loan loss reserves to NPLs seemed more than adequate at 387%, according to Sudeban. Loan loss provisions amounted to 25% of pre-provision income.

However, in June, the banks had surplus liquidity of only 7% of total deposits, raising concerns of a liquidity crunch in the event of an external shock.

“The profitability of the banks looks reasonably good but it is not stellar in light of all the risks,” says Georges Hatcherian, a Latin America banks analyst at rating agency Moody’s. “We expect the NPLs to increase over the foreseeable future in light of the deteriorating operating environment for banks. All the banks must be prepared for a sudden economic adjustment, which could come with a change of government or a move to free up the foreign exchange rate.”

Inflation is also driving up banks’ cost base. Today, operating expenses against average assets stand at 10%, up from only 5% in December, according to Moody’s. Mr Hausmann says that operating costs are increasing by multiples of 10 but banks’ deposits are growing at only a multiple of two times, so banks are being rapidly decapitalised.

Complex FX mechanisms

Venezuela’s foreign currency exchange mechanisms are among the country's most complicated economic issues. The Dicom rate (formerly called Simadi) stood at 649 bolivars to the US dollar in mid-September and is used for transactions such as credit-card purchases, non-essential imports and ATM withdrawals on foreign cards. It is a partially freely floating rate. Some priority food and medicines are exchanged at the stronger Dipro rate, which is fixed at 10 bolivars to the dollar. However, most Venezuelans have no access to these preferential rates and must turn to the black market, where a dollar currently buys 1025 bolivars, according to website DolarToday.

A lack of dollars affects all Venezuelans. For example, it is hard to obtain spare parts for vehicles. Meanwhile, banks do not have access to foreign exchange even at the Dicom rate. They cannot buy new computer equipment so their network systems are becoming out of date, and they have to pay royalties on software in dollars.

The poor information technology infrastructure has become a bigger issue in Venezuela recently, however, as people increasingly use their debit and credit cards. Part of the reason for this growing use is because the public does not want to carry around bundles of notes due to the country's poor security situation (the biggest bill in the country is the 100-bolivar note – the equivalent of less than 10 US cents). The most efficient method of payment is by plastic but this means banks constantly having to handle many hundreds of thousands of transactions.

Furthermore, it has become very hard for Venezuelans to make ends meet. Junior bank clerks earn only slightly above the minimum wage, for example, at about 25,000 bolivars a month – $24 a month at the unofficial exchange rate. A professional lawyer or architect in Caracas could earn up to 150,000 bolivars a month but that is still the equivalent of only $146 at the black market exchange rate.

"Families are unable to pay their rent," says Luis Segovia, a Venezuelan entrepreneur. "All the middle class is affected. There is something that people now refer to as the 'Maduro diet': people going hungry under the [Nicolás Maduro] government's current economic policies."

Mr Muci Borjas adds: "People are having to finance their daily lives by credit cards. This is the only way they can survive. Of course, they will have to pay those loans back one day but they have no choice at the moment."

Pressure on private banks

Private banks account for about 64% of the overall financial system in Venezuela in terms of deposits. During the past two years an increase in the tax burden has been an issue that has affected all banks. Until November 2015, the maximum tax that banks could pay was 34% but now all banks pay a flat rate tax of 40%. Previously, banks were able to pay taxes that were adjusted by inflation but the government has also removed that advantage.

Private banks also have to make a number of 'semi-fiscal contributions' to the government in addition to the normal taxes. They must also contribute to the Fund for the Social Protection of Bank Deposits (Fogade by its initials in Spanish), which public banks do not have to carry out. Only private banks participate in the interbank lending system.

The extra burdens faced by private banks mean their liquidity is a lot lower than that of public banks, which have about 81% of total surplus liquidity despite having only about one-third of total deposits.

Many foreign banking groups have already quit Venezuela or have been forced to leave. In 2009, the late former president Hugo Chávez paid $1bn for Banco de Venezuela, a division of Spanish bank Grupo Santander.

In July, Citibank closed several accounts belonging to the Central Bank of Venezuela and other government arms that are used to make international payments, provoking strong criticism from Mr Maduro.

However, some foreign groups remain in the country. BBVA, the Spanish banking group, has a major subsidiary in BBVA Provincial, which was founded in the country in 1953. Scotiabank, the Canadian banking giant, has a 40% stake in local Venezuelan bank BanCaribe. The Fierro Group, the Spanish banking and industrial conglomerate, owns the Venezuelan bank Banco Exterior, which is widely considered to be one of the best-managed banks in the country.

“These banks are already in the country and see some light at the end of the tunnel,” says Mr Hatcherian. “They could be very profitable again in the future once the economy is back on track. They are betting on the opportunities that could arise.”

Violent environment

Another challenge Venezuela’s bankers face – unimaginable for most of their peers in other countries of the Western world – is physical security. The country is estimated to have more than 20,000 murders a year.

Caracas is now the most dangerous city in the world, with 120 murders per 100,000 residents, according to a report on the world's 50 most violent cities by the Mexico City-based Council for Public Security and Criminal Justice. Three other Venezuelan cities appear on the list: Maturin and Valencia, which feature at fifth and seventh place, respectively, and Ciudad Guayana, which is the 11th most violent.

In June, a gunman opened fire inside Venezuela's central bank, located in the centre of Caracas. He wounded two guards before he was shot dead by security officers. Banks try to keep as few bolivars in cash as possible at their branches because of fears of armed raids and concerns about the logistics of moving cash around.

Political tensions

Currently, Venezuela is experiencing a tense political landscape. The country's opposition is pushing for a recall referendum that provides a mechanism to remove the sitting president and is the equivalent of a popular no-confidence vote. Timing is crucial. If the vote occurs before January 10, 2017 and is successful, Mr Maduro will be removed from office and there will be fresh elections. If it takes place after that date then the vice-president, the socialist Aristóbulo Isturiz, replaces him and serves out the remaining two years of Mr Maduro's term.

Most analysts expect the recall referendum will not take place this year but believe Venezuela's current economic path is unsustainable. It has managed to remain current on its foreign debts for much longer than many expected. A default does not now seem likely this year but both the sovereign and the state-owned oil giant PDVSA have to pay many billions of dollars in debt servicing in the next few years.

There has already been a huge drop in imports to about $20bn a year and experts say it is just not sustainable for these to fall further (non-governmental organisations are reporting widespread hunger throughout the country). The agriculture industry cannot access dollars to purchase inputs, so agricultural production is likely to shrink even further over the coming 12 months. The government seems to be gambling on an increase in the price of oil (the country has the world's biggest reserves and oil makes up 95% of its exports) but there is no guarantee this will happen.

Yet analysts point out that some aspects of Venezuela's banking system will favour it in the future. For example, the banks have hardly any dollar-denominated debt, so the sector could withstand a sudden move to freely float the bolivar.

"What amazes me is that despite everything that is happening in Venezuela, the banks are still in reasonably good shape. I think that stands the country in good stead for the future," says Victor Rodríguez, a Venezuelan who is chief executive officer at LatAm Alternatives. The financial services company, based in Fort Lauderdale, Florida, is promoting a private equity fund for Venezuela, called Vene Avanza Opportunity Fund I.

Venezuela is suffering from myriad difficulties that are having a huge impact on its banks. However, the system is still just about holding up – and despite the expected deterioration in NPLs next year, international watchers and locals alike hope that it will continue to do so.