Puerto Rico Banking Industry Report

Issue XXXI January to December 2016

EXECUTIVE SUMMARY: Although local banks are operating against a backdrop of a deep economic malaise, an unrelenting fiscal and debt crisis, and a persistent population decline, they have been able to maintain, on a consolidated basis, positive levels of profitability for three consecutive years. The local banking industry posted a Pre-Tax ROE of 4.3% in 2016, 5.7% in 2015, and 3.3% in 2014. Revised forecasts of economic growth point to a prolonged economic contraction which will keep local banks' profitability levels subdued. In this issue we will highlight the difference in performance and financial condition of banks that are highly geographically diversified and the banks that are Puerto Rico-centric. Broadly speaking, Popular, FirstBank and Oriental have experienced increases in their market share in assets, deposits and loans & leases from the end of 2011 to the end of 2016. On the other hand, Santander and Scotia, which operate locally as affiliates of large multinational financial entities, have either maintained their market share or lost market share. With few possibilities of local growth, banks might be eyeing the market share of savings and credit cooperatives and nondepository entities.

PROFITABILITY: "Oriental had the highest Pre-Tax ROE in 2016 (9.2%), followed by FirstBank (6.8%) and Popular (6.3%)"

Against the backdrop of a protracted economic downturn dating back to 2006, a lingering fiscal and debt crisis which will likely lead to steep austerity measures, and net migration levels reaching historical highs, Puerto Rico's local banking industry has been able to maintain moderate levels of profitability, reaching a Pre-Tax ROE of 4.3% in 2016 (see Figure 1). Weak prospects for growth, uncertainty regarding the effects of forthcoming tax increases and spending cuts, and unrelenting demographic pressures, will constrain local banks' ability to grow their earning potential, report higher levels of profitability, and strengthen their balance sheets in the foreseeable future. The base projections of the Planning Board point to a 1.7% decrease in real economic growth in FY2017 and 1.5% decrease in FY2018. The Planning Board has also forecasted the population of Puerto Rico to reach its 1980 level of 3.2 million in 2027, a decrease of 8% or 272K with respect to 2016 (3.4 million). Robust financial buffers, sound credit risk management, increased dependence on core funding, a steadfast commitment to cost optimization, and investments in banks' digital capabilities will certainly mitigate any possible future losses if potential seismic shifts in the economy and government were to materialize.

Figure 1: Industry Pre-Tax ROE Trend (2005-2016)(1)

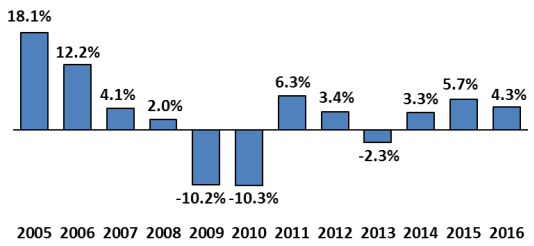
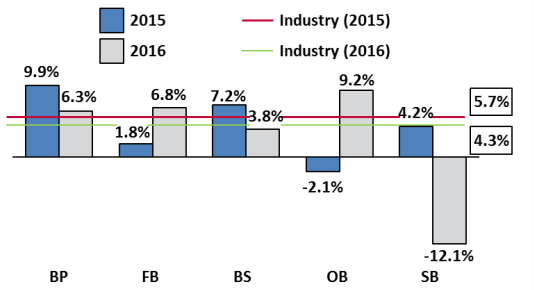
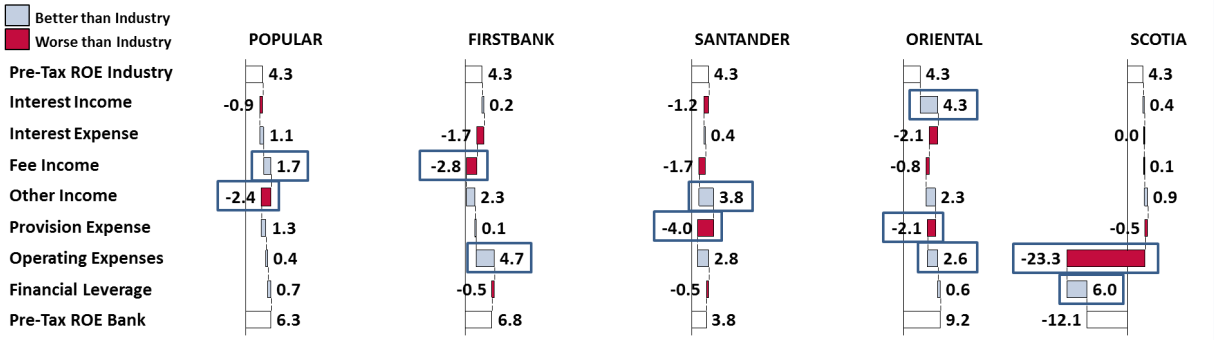


Figure 2: Pre-Tax ROE by Bank



Oriental registered the highest level of profitability with a Pre-Tax ROE of 9.2% (see Figure 3), after being in the red in 2015 due to an unusually high loan loss provision expense(2). Oriental's higher profitability in 2016 vis-à-vis the industry was driven by higher interest income and lower operating expenses. FirstBank had the second highest profitability with a Pre-Tax ROE of 6.8%, followed by Popular with a Pre-Tax ROE of 6.3%. FirstBank's higher profitability with respect to the industry level was driven by significantly lower operating expenses. Popular's non-interest income took a hit in 2016 after it lost a dispute with the FDIC related to the commercial loss shared agreement it entered in 2010, recording a $117 million loss ($87 million net of tax). Santander and Scotia, both subsidiaries of multinational financial institutions whose Puerto Rico operations constitute a razor thin portion of their global business, obtained the lowest level of profitability among their peers in 2016, with a Pre-Tax ROE of 3.8% and -12.1%, respectively. Santander's lower profitability, as compared with the industry level, was driven by higher provision expenses which were partially offset by higher other income. Scotia's unusually high operating expense, driven by high goodwill impairment losses, dragged its profitability deep into negative territory (see Figure 3).

Figure 3: Reconciliation of the Industry's Pre-Tax ROE and each bank's Pre-Tax ROE by income-expense category (YTD 2016)



Inside this issue:

Source: Federal Deposit Insurance Corporation (FDIC), "Call Reports", 10-Q SEC filings, quarterly results calls, analysis by "Financial Institutions Practice" V2A.

(1) Citibank Puerto Rico financial data is not reported separately from Citibank US and, consequently, the bank is not included in the report analyses.

(2) The high loan loss provision expense of Oriental in 2015 was due to its participation in a Puerto Rico Electric Power Authority (PRPEA) fuel line of credit which it sold during the second half of 2016, eliminating $183 million of non-performing assets .

MARKET DYNAMICS: "Popular, FirstBank and Oriental have taken bold steps to secure their position in the local market "

Although the entire financial sector has felt the ramifications of a decade-long economic downturn and has undergone a historic consolidation process, our analysis, which looks at the financial condition and performance of banks from the end of 2011 to the end of 2016, suggests that banks whose main jurisdiction of operation is Puerto Rico have adopted and implemented aggressive strategies to further consolidate their presence in the Island. On the other hand, local banks that are part of global, multinational financial institutions and are therefore more geographically diversified (i.e. Santander and Scotia) have been comparatively less bold in seizing opportunities to solidify their position in Puerto Rico. Local banks whose operations are focused in Puerto Rico (i.e. Popular, FirstBank and Oriental) have been generally more proactive in dealing with a contracting economy, have been more aggressive in cleaning their balance sheets of delinquent loans, and have more readily seized local merger and acquisition opportunities, further consolidating their positions in the Island. It must be noted that savings and credit cooperatives, which are entirely dependent on the local economy, have experienced, on a consolidated basis, growth from 2011 to 2016 in assets, deposits and gross loans and leases, in both relative terms and absolute terms (see Figures 4, 5, and 6).

The local industry's largest bank, Popular, is an excellent case in point. Banco Popular is the principal banking subsidiary of Popular Inc., a publicly-owned financial holding company with consolidated assets of $38.7 billion and $30.5 billion in total deposits as of Dec. 31, 2016. Its Puerto Rico business represents 77% of its total assets and 81% of total deposits, making its local operations critical for its success and longevity. Despite a shrinking economy and declining population, it has been able to increase its total assets by $1.8 billion or 6.3% from the end of 2011 to the end of 2016. Its market share of total assets, when including the assets of savings and credit cooperatives, increased from 34% at the end of 2011 to 45% at the end of 2016 (see Figure 4) (52% excl. COSSEC). Its market share of deposits increased from 39% in Dec. 31, 2011 to 48% in Dec. 31, 2016 (see Figure 5) (54% excl. COSSEC) while its market share of gross loans and leases increased from 35% to 42% during said time period (see Figure 6) (47% excl. COSSEC). It has been able to achieve this by acquiring Westernbank in April 2010 in the FDIC-assisted transaction, acquiring a large share of assets and deposits of failed Doral which was closed on February 2015, and selling off toxic assets resulting in a less risky loan portfolio, among other efforts to secure its local presence.

Figure 4: Total Assets 2011 vs. 2016
(As of Dec. 31, $US Billions)

	2011-2016 (CAGR)	2011 vs. 2016 (% change)	2011 vs. 2016 (abs. change)
BPPR	1.2%	6.3%	1.76
FB	-1.9%	-9.2%	-1.20
DB	N/A	N/A	-7.24
BS	-4.1%	-18.9%	-1.25
OB	-0.6%	-2.8%	-0.18
BBVA	N/A	N/A	-5.02
SB	-8.9%	-37.2%	-2.51
COSSEC	1.7%	8.6%	0.68
TOTAL	-4.0%	-18.4%	-14.96

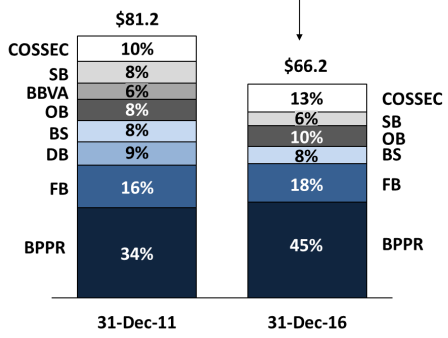


Figure 5: Total Deposits 2011 vs. 2016
(As of Dec. 31, $US Billions)

	2011-2016 (CAGR)	2011 vs. 2016 (% change)	2011 vs. 2016 (abs. change)
BPPR	2.5%	13.4%	2.93
FB	-2.3%	-10.9%	-1.08
DB	N/A	N/A	-4.44
BS	-3.8%	-17.6%	-0.92
OB	14.2%	94.6%	2.27
BBVA	N/A	N/A	-2.97
SB	-2.1%	-10.3%	-0.36
COSSEC	1.2%	6.3%	0.34
TOTAL	-1.6%	-7.6%	-4.24

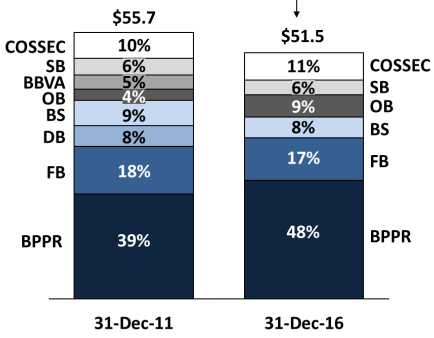
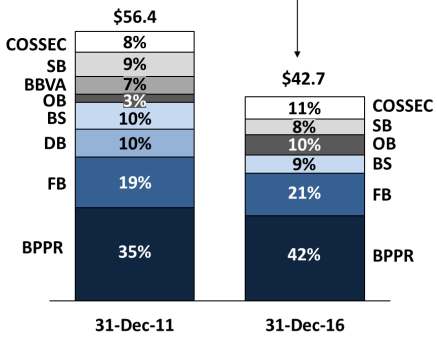


Figure 6: Gross Loans and Leases 2011 vs. 2016
(As of Dec. 31, $US Billions)

	2011-2016 (CAGR)	2011 vs. 2016 (% change)	2011 vs. 2016 (abs. change)
BPPR	-1.8%	-8.7%	-1.70
FB	-3.3%	-15.4%	-1.63
DB	N/A	N/A	-5.82
BS	-7.7%	-33.2%	-1.86
OB	19.6%	144.4%	2.52
BBVA	N/A	N/A	-3.70
SB	-8.5%	-36.0%	-1.84
COSSEC	1.7%	8.9%	0.38
TOTAL	-5.4%	-24.2%	-13.66



FirstBank, which operates as a subsidiary of First BanCorp., has been able to safeguard its market position as the Island's second largest bank in terms of assets, managing $11.9 billion in assets as of Dec. 31, 2016 or 18% of total assets (21% excl. COSSEC). It has been able to solidify its local presence through the acquisition of 10 branches of Doral in 2015, the de-risking of its balance sheet through the sale of nonperforming loans, and reducing its dependence on brokered deposits. While it does have other operations in the Caribbean and in Florida, both of these regions combined represent a minority share of its business. The actions it has taken have increased its market share of total assets from 16% at the end of 2011 to 18% at the end of 2016, and its gross loans and leases market share from 19% to 21%.

Oriental has also actively sought out M&A opportunities to secure its position in a highly competitive market. In April 2010 it acquired Eurobank and before the end of 2012 acquired Banco Bilbao Vizcaya Argentaria's (BBVA) Puerto Rico subsidiary in a $500 million cash deal. These acquisitions expanded Oriental's branch network, grew and further diversified its loan portfolio, strengthened its core deposit funding profile, and increased its customer base. From the end of 2011 to the end of 2016 its market share of total assets increased from 8% to 10%, its deposits market share from 4% to 9% and its gross loans and leases market share from 3% to 10% (see Figures 4, 5, and 6).

Santander and Scotia, banks that are part of large global financial institutions, have ostensibly adopted a different strategy with respect to their Puerto Rico business. When analyzing assets, deposits and loans and leases we see that these banks have either maintained their market shares or have experienced a decline (see Figures 4, 5, and 6). While Santander did not partake in the waves of consolidation since 2010, Scotia seems to not have fully exploited the opportunity it had after acquiring R-G Premier Bank in April 2010 to sell other products to its new clients and strengthen its position in Puerto Rico. It seems that its large mortgage loan portfolio will be amortized through time and will not create much new business. In the following page, we will provide more detail on the loan portfolio segments of the local industry.

Sources: Federal Deposit Insurance Corporation (FDIC), "Call Reports", 10-Q SEC filings, quarterly results calls, Public Corporation for the Supervision of Insurance of Cooperatives (COSSEC by its Spanish acronym), analysis by "Financial Institutions Practice" V2A.

MARKET DYNAMICS: "Mortgage and commercial portfolios have dropped significantly; consumer loans have remained stable"

In this portion of the report we analyze the loans and leases market by portfolio segment. As depicted in Figure 6, loans and leases portfolios have taken a hard hit due to the protracted economic downturn, housing market crash and other macro factors, decreasing by $13.7 billion or 24% from the end of 2011 to the end of 2016. This dramatic decline is due to banks aggressively selling nonperforming loans to clean their balance sheets, combined with a sharp slowdown of credit flows. Despite this decrease in absolute terms, we see that some banks have been able to grow their market share in the last 5 years, while others have lost market share. While residential mortgages and commercial loans portfolios have experienced material declines during said time period (see Figures 7 and 8), consumer loans and auto loans portfolios have remained stable, showing a slight increase during the time period under study (see Figures 9 and 10).

Figure 7: Mortgage (Residential) 2011 vs. 2016
(As of Dec. 31, $US Billions)

	2011-2016 CAGR	2011 vs. 2016 % change	2011 vs. 2016 abs. change
BPPR Domestic	14.0%	92.2%	$3.24
FB Domestic	3.2%	17.2%	$0.49
DB	N/A	N/A	-$3.50
BS	-11.0%	-44.2%	-$0.98
OB	7.6%	44.3%	$0.43
BBVA	N/A	N/A	-$0.96
SB	-6.8%	-29.5%	-$0.77
COSSEC	-1.6%	-7.7%	-$0.11
TOTAL	-2.5%	-12.0%	-$2.16

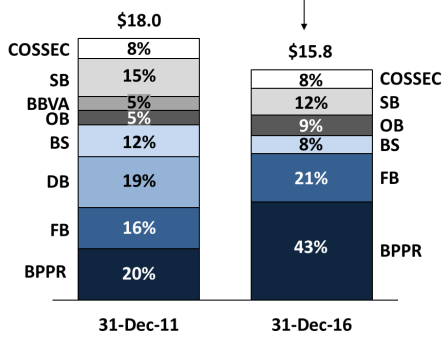
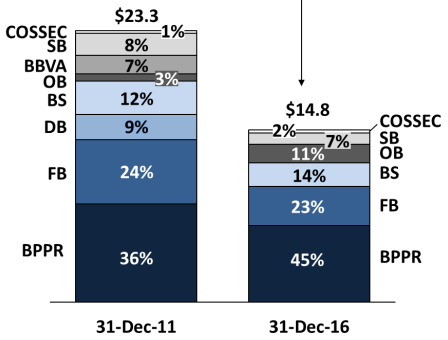


Figure 8: Commercial 2011 vs. 2016
(As of Dec. 31, $US Billions)

	2011-2016 (CAGR)	2011 vs. 2016 (% change)	2011 vs. 2016 (abs. change)
BPPR Domestic	-4.8%	-21.9%	-$1.85
FB Domestic	-9.7%	-39.9%	-$2.21
DB	N/A	N/A	-$2.15
BS	-6.6%	-29.0%	-$0.83
OB	20.6%	154.8%	$0.98
BBVA	N/A	N/A	-$1.59
SB	-12.5%	-48.6%	-$0.92
COSSEC	3.1%	16.5%	$0.04
TOTAL	-8.7%	-36.6%	-$8.53



As was seen in the previous analysis, generally speaking, the banks that are more dependent on their Puerto Rico business experienced an increase in market share. Popular's market share in the residential mortgage market increased from 20% to 43% from the end of 2011 to the end of 2016, FirstBank's market share in this segment increased from 16% to 21%, while Oriental's increased from 5% to 9%. Savings and credit cooperatives were able to maintain an 8% market share during the aforementioned time period (see Figure 7). On the other hand, Santander experienced a decrease from 12% to 8%, while Scotia registered a decline from 15% to 12%. Commercial loans, which includes construction loans, loans secured by farm and commercial real estate, commercial and industrial loans, and public sector loans, have decreased by close to 37% or $8.5 billion from 2011 to 2016 (see Figure 8). Oriental and savings and credit cooperatives on a consolidated basis were alone in experiencing an increase in absolute terms in said time period. Popular's market share increased from 36% to 45%, FirstBank's and Scotia's market share remained relatively stable, Oriental experienced a significant increase from 3% to 11%, and Santander experienced a slight increase from 12% to 14% (see Figure 8).

Consumer loans and auto loans, on a consolidated basis, have experienced a more positive trend during the last five years. Consumer loans, excluding auto loans, have increased by 6% from 2011 to 2016 while auto loans have increased by 12%. Popular's, Santander's and Scotia's market share in this segment has remained stable, while FirstBank and Oriental have experienced a material increase (see Figure 9).

The auto loans market has also shown some growth when comparing the end of 2011 with the end of 2016, increasing by roughly $700 million or 12% (see Figure 10). Popular's market share increased from 9% to 13%, FirstBank's decreased from 17% to 13%, and Oriental became an important player in the auto loans market after the purchase of BBVA, with a 14% market as of Dec. 31, 2016. Santander is not a player in the auto loans market while Scotia's market share experienced a slight decline (see Figure 10).

The considerable market share of savings and credit cooperatives in the consumer and auto loan segments and the large market share of nondepository financial institutions in the auto market (e.g. Reliable, the largest auto finance company, will possibly be sold), represent opportunities for banks to solidify their position in the local market and obtain loans that have been performing well compared to others.

Figure 9: Consumer (excl. auto) 2011 vs. 2016
(As of Dec. 31, $US Billions)

	2011-2016 CAGR	2011 vs. 2016 (% change)	2011 vs. 2016 (abs. change)
BPPR	0.0%	0.0%	$0.00
FB	12.4%	79.2%	$0.27
DB	N/A	N/A	-$0.04
BS	1.2%	6.2%	$0.03
OB	46.7%	579.3%	$0.28
BBVA	N/A	N/A	-$0.19
SB	-10.7%	-43.2%	-$0.07
COSSEC	0.6%	3.3%	$0.07
TOTAL	1.2%	6.1%	$0.36

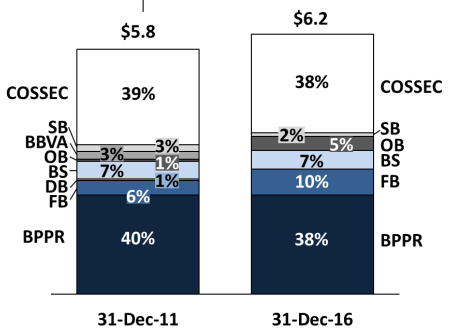
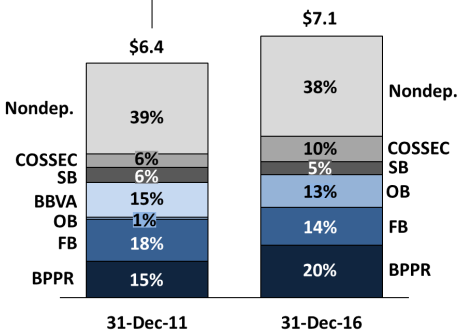


Figure 10: Auto Loans & Leases 2011 vs. 2016
(As of Dec. 31, $US Billions)

	2011-2016 CAGR	2011 vs. 2016 (% change)	2011 vs. 2016 (abs. change)
BPPR	7.8%	45.7%	$0.45
FB	-2.3%	-10.8%	-$0.12
OB	71.3%	1376.0%	$0.84
BBVA	N/A	N/A	-$0.96
SB	-2.9%	-13.7%	-$0.06
COSSEC	13.7%	89.7%	$0.33
Nondepository	2.1%	10.8%	$0.27
TOTAL	2.2%	11.7%	$0.75



Sources: Federal Deposit Insurance Corporation (FDIC), "Call Reports", 10-Q SEC filings, quarterly results calls, Public Corporation for the Supervision of Insurance of Cooperatives (COSSEC by its Spanish acronym), Office of the Commissioner of Financial Institutions (OCIF by its Spanish acronym), analysis by "Financial Institutions Practice" V2A.

LOAN MIX: "Banks manage less risky loan mixes, except for Scotia, which is heavily concentrated in mortgages"

Despite the myriad challenges faced by local banks and other financial institutions and the significant contraction of the financial system, there have been some positive developments that are worthy of noting. The capital position of banks is very strong which would help them weather a potential future deterioration of economic conditions, in the aggregate banks have been able to maintain positive profitability levels for several years and they have resolutely cleaned their balance sheets of toxic loans, resulting in less risky loan mixes. Residential mortgages represent between 33% and 39% of their total loans and leases, with the exception of Scotia with 56% (see Figure 11). Having residential mortgages represent such a large part of Scotia's loan mix has proven difficult to manage given the island's economic woes. Commercial, construction and public sector loans fluctuated between 30% and 54%. In terms of consumer and auto loans combined, among the local banks this segment represents between 12% and 29%. For savings and credit cooperatives on a consolidated consumer loans and auto loans represent 65% of the mix.

Furthermore, total loan originations during the last five years have also experienced a steep decline, decreasing by 42% or $5.2 billion (see Fig. 12). Commercial and industrial loans represented 24% of total originations in 2016 compared to 32% in 2012. Personal loans experienced an increase from 26% to 34%. When it comes to mortgages, depository institutions have taken market share from nondepository institutions. In 2012, 27% of loan originations was mortgage loans issued by nondepository institutions, decreasing to 11% in 2016.

In conclusion, local banks have generally taken the necessary measures to effectively confront a challenging economic panorama and will likely do so going forward. Although there are few opportunities to purchase additional portfolios, the market share of savings and credit cooperatives and nondepository institutions (e.g. Reliable) represent an opportunity for banks. Savings and credit cooperatives are in a vulnerable position because they have not cleaned out their portfolios and are undercapitalized. This could accelerate take over transactions.

Finally, the Planning Board revised its economic forecasts showing continued contraction in FY2017 and FY2018 (see Figure 13). Under this economic environment, banks' strategies are not likely to change a lot. As a result, we will keep on monitoring whether recent trends analyzed in this report continue to materialize in 2017 and 2018.

Figure 11: Loan Mix by Bank As of Dec. 31, 2016
($US Billions)

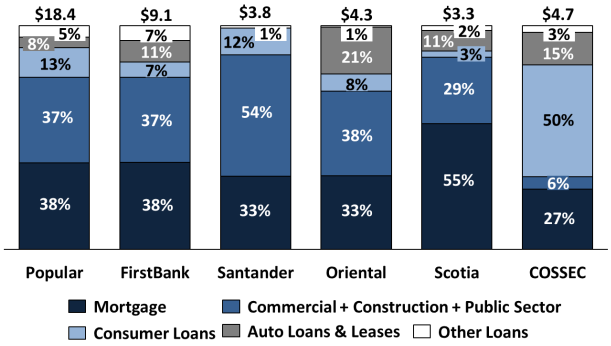


Figure 12: Loan Originations 2012-2016 ($US Billions)

	2012-2016 CAGR	2012 vs. 2016 (% change)	2012 vs. 2016 (abs. change)
Commercial & Industrial	-19%	-57%	-2.30
Personal	-7%	-24%	-0.77
Mortgage - Depository	5%	20%	0.38
Mortgage - Nondepository	-30%	-76%	-2.51
TOTAL	-13%	-42%	-5.21

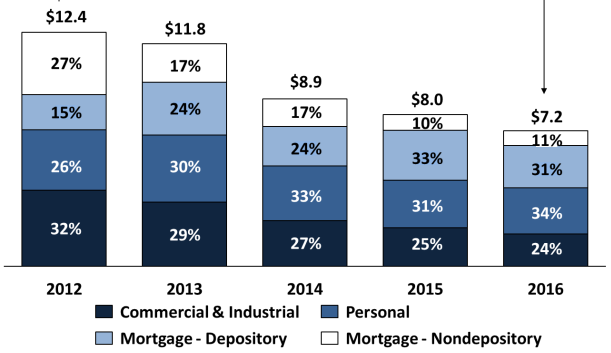
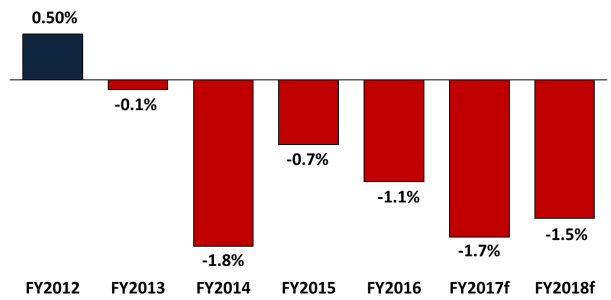


Figure 13: Real GNP Growth FY2012-FY2018 (%)



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Source: Federal Deposit Insurance Corporation (FDIC), Puerto Rico Planning Board, Office of the Commissioner of Financial Institutions (OCIF by its Spanish acronym), analysis by "Financial Institutions Practice" V2A.

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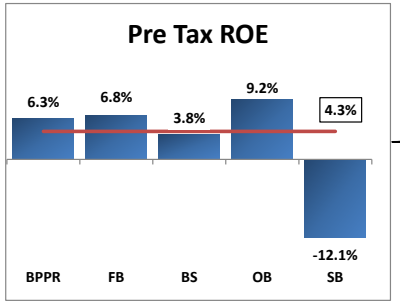
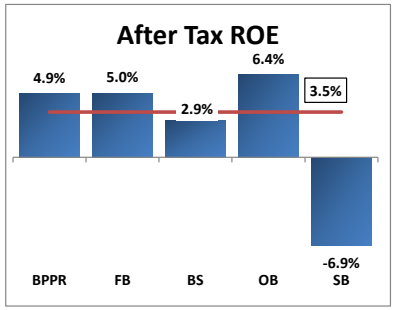
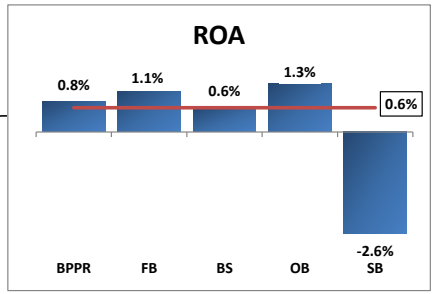
ANNEX 1: BANKING INDUSTRY PROFITABILITY 2016







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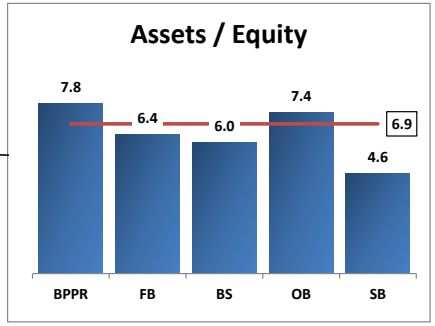

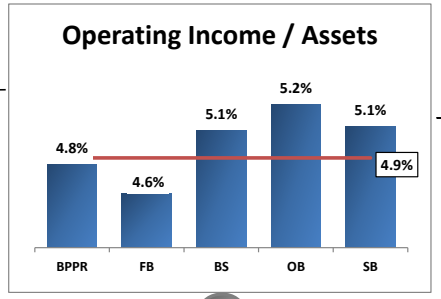

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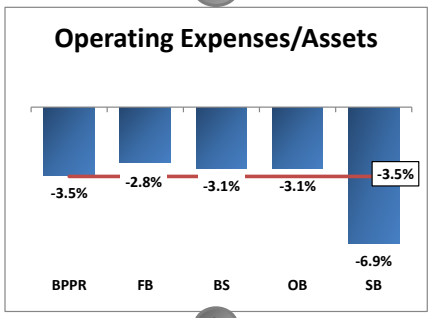

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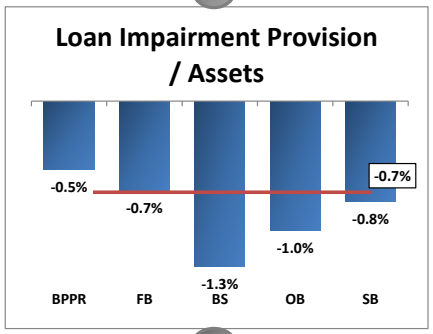

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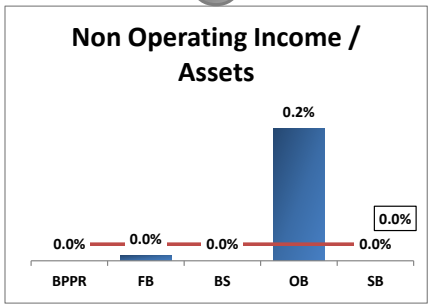

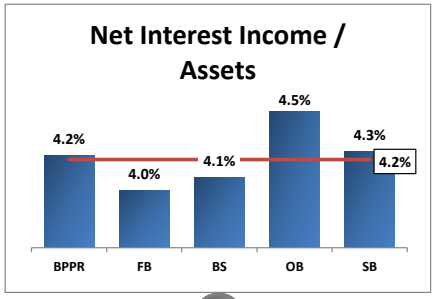

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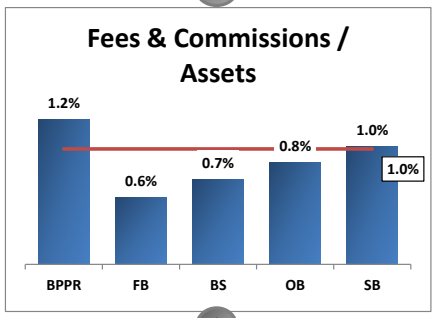

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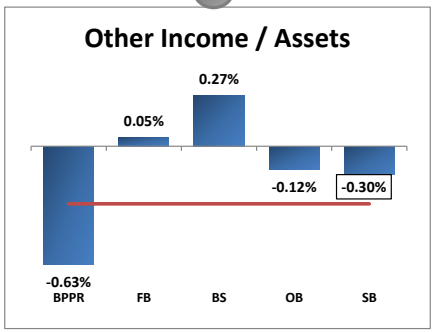


BPPR = BANCO POPULAR DE PUERTO RICO
FB = FIRSTBANK OF PUERTO RICO
BS = BANCO SANTANDER PUERTO RICO
OB = ORIENTAL BANK AND TRUST
SB = SCOTIABANK DE PUERTO RICO

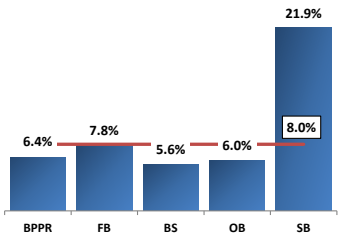
Note: Income and expense ratios are annualized
Source: Federal Deposit Insurance Corporation (FDIC)

Industry

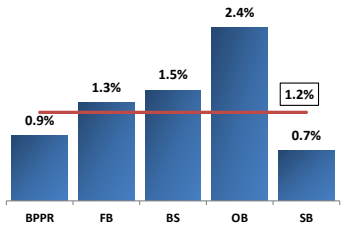
ANNEX 2: BANKING INDUSTRY PERFORMANCE RATIOS 2016

ASSET QUALITY

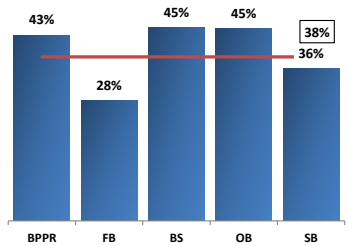
Noncurrent Loans Ratio



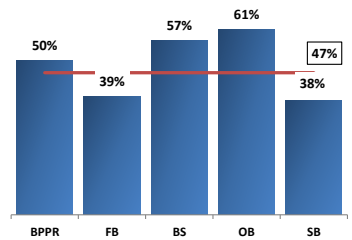
Charge-Off (Loss) Ratio



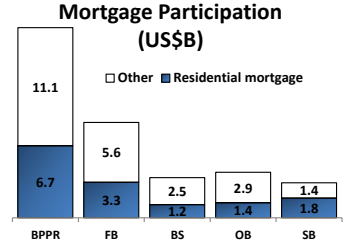
Reserve / NPL



(Reserve+NCO)/(NPL+NCO)

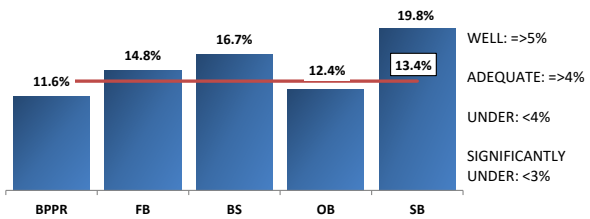


Total L&Ls & Residential Mortgage Participation (US$B)



CAPITAL ADEQUACY

Tier 1 Leverage Ratio*



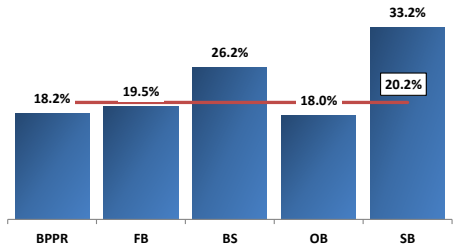
WELL: =>5%

ADEQUATE: =>4%

UNDER: <4%

SIGNIFICANTLY UNDER: <3%

Tier 1 Risk-based Capital Ratio



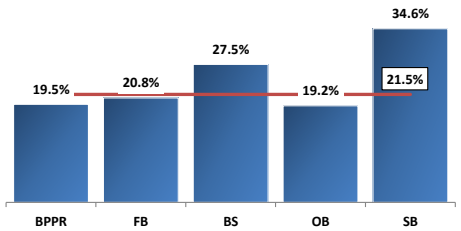
WELL: =>6%

ADEQUATE: =>4%

UNDER: <4%

SIGNIFICANTLY UNDER: <3%

Total Risk-based Capital Ratio



WELL: =>10%

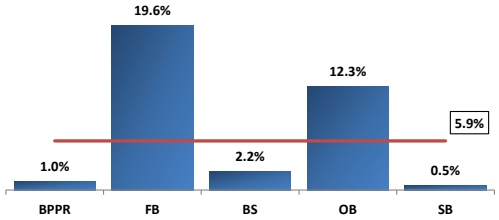
ADEQUATE: =>8%

UNDER: <8%

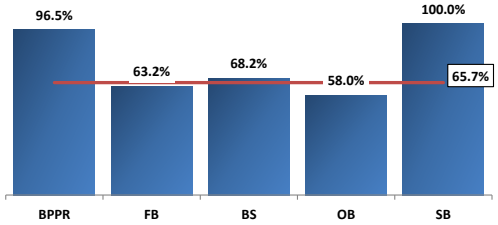
SIGNIFICANTLY UNDER: <6%

LIQUIDITY

Brokered / Total Deposits Ratio

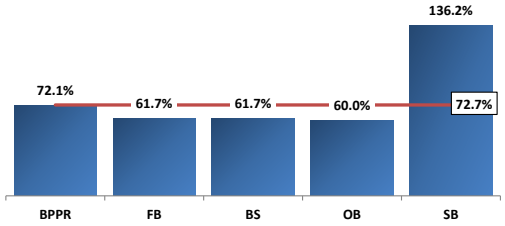


Broker Dep Mat < 1Y / Broker Dep.

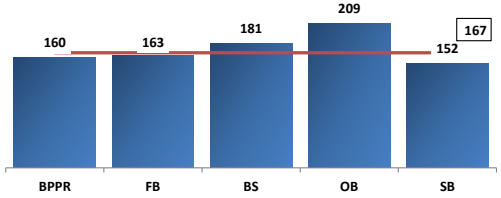


PRODUCTIVITY

Efficiency Ratio (Cost / Income)



Net Margin per Employee (USD Thousand)



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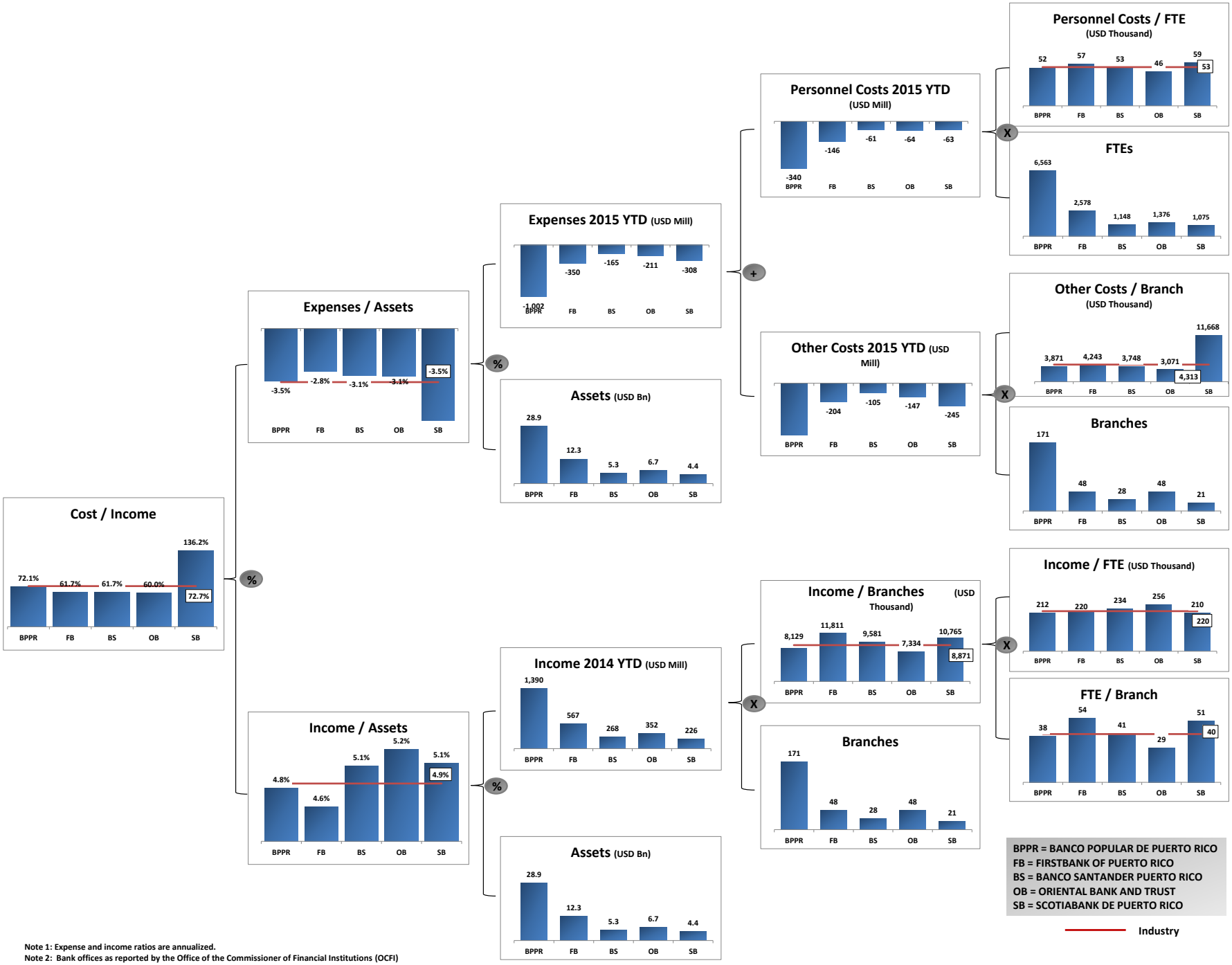
Industry

* Also referred to as Core Capital (leverage) Ratio by the FDIC

Notes:
Asset quality ratios are not adjusted for FDIC covered and available for sale portfolios
Income and expense ratios are annualized

Source: Federal Deposit Insurance Corporation (FDIC)

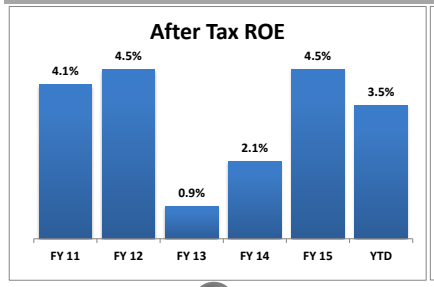
ANNEX 3: BANKING INDUSTRY PRODUCTIVITY 2016

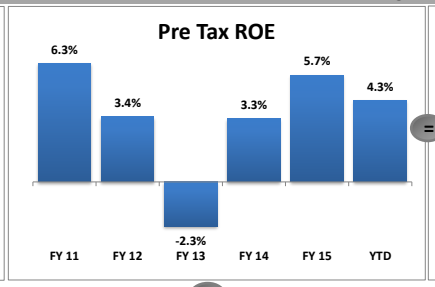


Note 1: Expense and income ratios are annualized.
Note 2: Bank offices as reported by the Office of the Commissioner of Financial Institutions (OCFI) of Puerto Rico as of December 2016.

ANNEX 4: INDUSTRY TRENDS - SELECTED METRICS

PROFITABILITY





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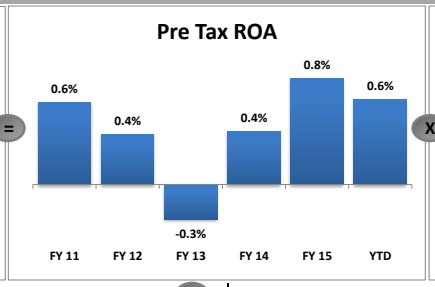

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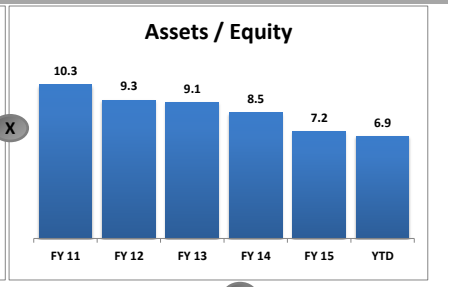

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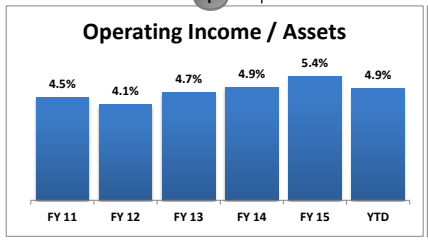
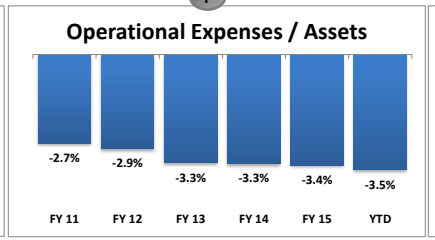
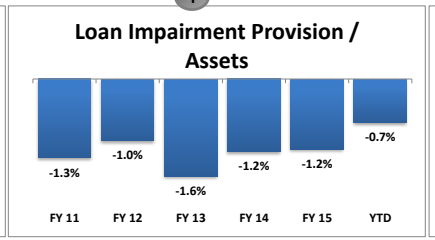
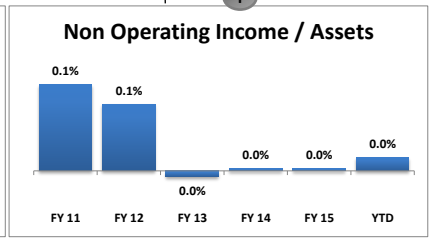
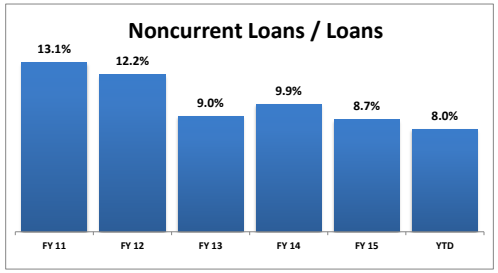


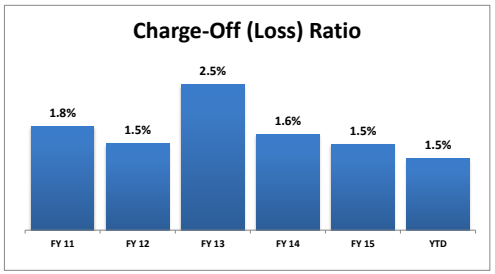


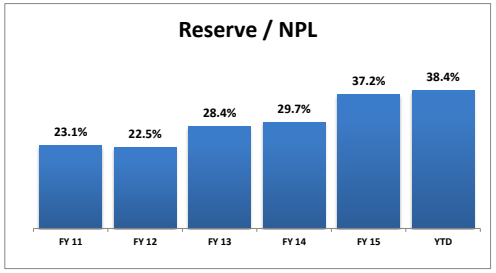


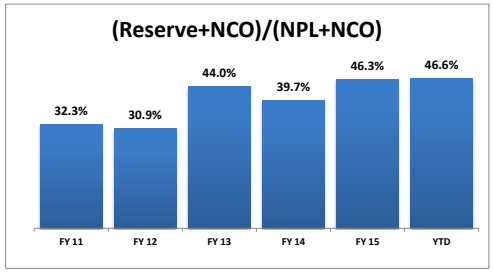


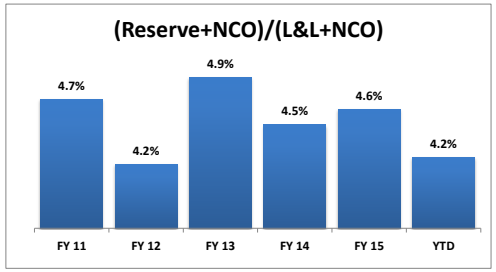
ASSET QUALITY





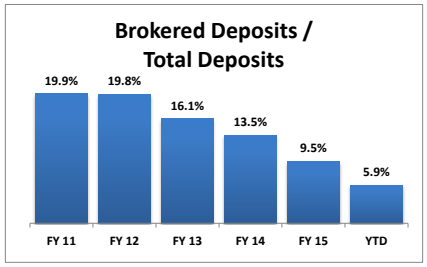




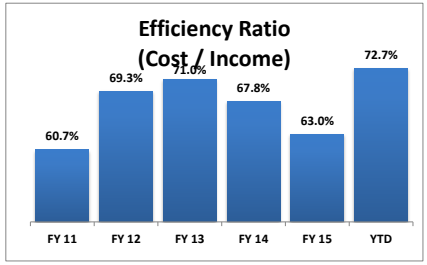


Notes:
Asset quality ratios are not adjusted for FDIC covered and available for sale portfolio.
YTD numbers are annualized.
Source: Federal Deposit Insurance Corporation (FDIC)

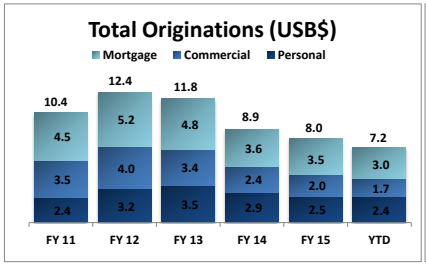
LIQUIDITY



PRODUCTIVITY



MARKET ORIGINATIONS



TOTAL ASSETS