

EXECUTIVE SUMMARY: The local banking industry has done a formidable job managing its operations in a historically challenging environment, posting positive levels of profitability since 2014, and registering a Pre-Tax ROE of 8.7% during the first half of 2017. While it has been able to weather the economic and fiscal headwinds which have been fiercely and relentlessly blowing through the Island since more than a decade ago, local banks are now faced with the catastrophic aftermath brought about by the passage of Hurricanes Irma (Sep. 6) and María (Sep. 20). Moody's has estimated economic losses could amount to \$95 billion. Large capital buffers of local banks will help mitigate the potential losses due to the myriad disruptions engendered by the hurricanes. Although banks have been able to gradually improve their asset quality, registering a 90+ days past due–non accruing ratio of 5.9%, loan quality issues could reemerge due to the negative impact on business and household income and expenses. The next issue will focus further on the macro-impacts of the 2017 hurricanes, leveraging what was learned from the effects of Hurricane Katrina on the U.S. Gulf Coast's banking sector.

PROFITABILITY: "Due to the 2017 Hurricane season effects, the steady improvement in the industry ROE may be stalled"

The local banking sector continues to demonstrate resilience despite a challenging operating environment fraught with downside risks, registering an industry level Pre-Tax ROE of 8.7% in the first half of 2017 on an annualized basis, the highest level since 2006 (see Figure 1). While the banking sector has learned to weather the economic storm that has ravaged the Island since 2006, consecutively registering modest, yet positive levels of profitability, it is now faced with the aftermath of possibly the worst month for Atlantic hurricanes in recorded history which decimated the power and telecommunications grid. The passage of Hurricanes Irma and María through the Caribbean and its resulting catastrophic effects on Puerto Rico will further complicate economic recovery efforts. Moody's Analytics has estimated economic losses (i.e. physical damages and lost productivity) might amount to \$45-\$95 billion, a disconcerting estimate for Puerto Rico which is struggling to come out of a historic economic and debt crises.

This dire context has prompted local banks to raise funds for recovery efforts, directly assist their employees who have suffered losses and provide respite to their clients by establishing temporary moratoriums on loan payments.(2) The federally-appointed Fiscal Oversight and Management Board has also taken steps to help recovery efforts by reallocating \$1 billion from the budget for disaster response, requesting maximum federal assistance, cost-sharing waivers, and lifting of funding caps, postponing furlough discussions, a readiness to activate Title V of PROMESA, among other measures.

Popular and Oriental led the way with the highest Pre-Tax ROEs, 12.1% and 9.6%, respectively (see Figure 3). Popular registered a higher Pre-Tax ROE vis-à-vis the industry due to higher financial leverage, higher fee income, and a lower provision expense, partially offset by lower interest income. Oriental fared better than the industry due to higher interest income which was partially offset by higher provision expenses. FirstBank registered the third highest profitability, with a Pre-Tax ROE of 5.7%. Although it obtained a higher interest income when compared to the industry as a whole, lower fee income more than offset the gains. Santander and Scotia reported the lowest levels of profitability, with Pre-Tax ROEs of 4.7% and 4.4%, respectively. Higher provision expenses with respect to the industry's performance in the case of Santander and higher operating expenses in the case of Scotia, negatively impacted their respective levels of profitability (see Figure 3).

Figure 1: Industry Pre-Tax ROE Trend (2006-2017*)(1)

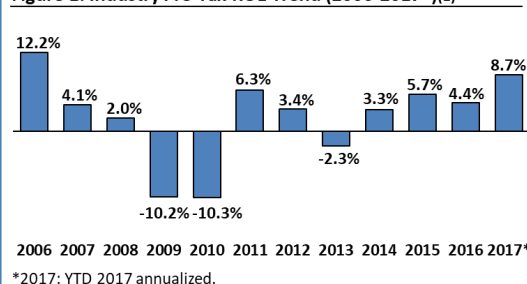


Figure 2: Pre-Tax ROE by Bank

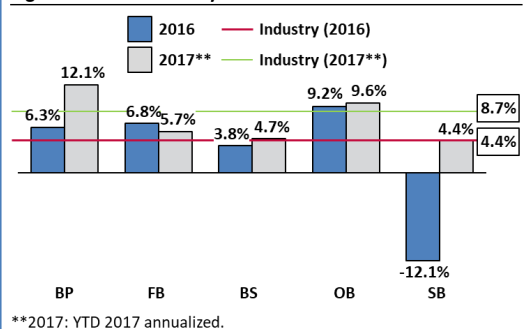
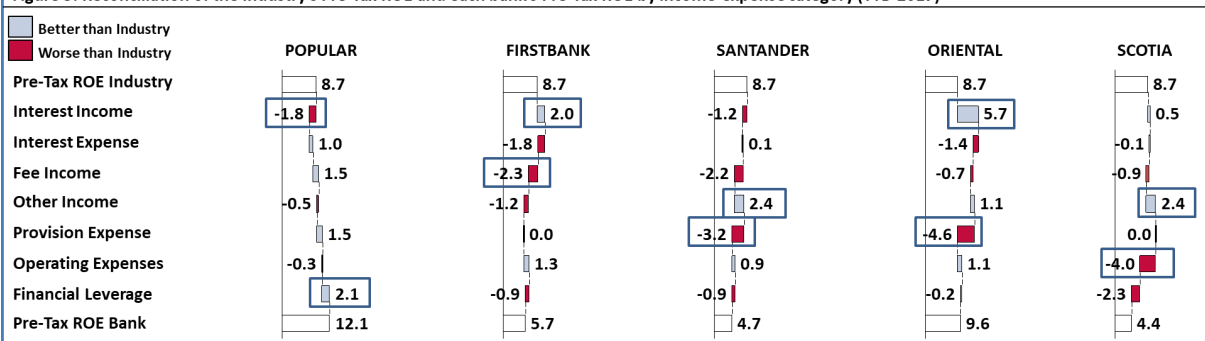


Figure 3: Reconciliation of the Industry's Pre-Tax ROE and each bank's Pre-Tax ROE by income-expense category (YTD 2017)



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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) While several banks have voluntarily provided loan payment moratoriums to their clients post-Hurricane María, a bill will be presented in the House of Representatives requiring banks to provide a 90 day moratorium on payments of consumer, auto, mortgage, and credit card loans following a natural disaster.



Puerto Rico Banking Industry Report

PRODUCTIVITY: "The disruptions of María will put upward pressure on costs and downward pressure on income"

Productivity of the local banking industry as a whole, as measured by the cost to income ratio, has continued to improve, reaching 60.5% in the first half of 2017 (see Figure 4), the highest level of productivity since 2006 when it reached 57.6%. When analyzing productivity by bank, Oriental leads the way with a cost to income ratio of 53.1%. Santander, FirstBank, and Popular registered comparable productivity levels, with cost to income ratios of 59.8%, 60.7%, and 61.1%, respectively. Scotia posted the lowest level of productivity among its peers, with a cost to income ratio of 68.4%.

Managing the aftermath of Hurricane María will likely adversely impact both components of the cost to income ratio of banks. The income generating capacity of banks will be severely suppressed given the widespread disruption of economic and banking activity due to the destruction of the electricity and telecommunication grid, and the transport system. The largely inoperative electronic payment system has created a cash economy, severely limiting commercial and economic activity. Given the likely upward pressure on costs and the downward pressure on income, the cost to income ratio will likely rise in the short-term.

Large capital buffers will be critical in the event of future losses due to a further deterioration of the economy. The Tier 1 Risk-Based Capital Ratio of the banking industry as a whole reached 20.9% at the end of the first half of 2017 (see Fig. 5). However, the long-road ahead of recovery may lead to some capital erosion.

ASSET QUALITY: "The 2017 hurricane season's far-reaching impacts will hamper progress made with delinquency"

The asset quality of the local banking industry continues to improve, with a 90+ days past due–non accruing ratio reaching 5.9% at the end of the first half of 2017, the lowest level since 2006. Local banks have aggressively de-risked and de-leveraged their balance sheets since the peak of the economic and fiscal crisis.

When analyzing asset quality by bank, Popular boasts the lowest delinquency ratio with a 90+ days past due–non accruing ratio of 4.3%. FirstBank, Santander, and Oriental have comparable 90+ days past due–non accruing ratios, 5.4%, 5.4%, and 5.5%, respectively. Oriental has also continued to reduce its exposure to government-related assets selling a \$38 million municipal loan which resulted in a \$4.3 million pre-tax loss. Furthermore, Oriental also unwound a \$100 million repurchase agreement and sold \$166 million of mortgage backed securities, further de-risking its balance sheet.

Local banks, in response to the devastation caused by Hurricane María, have offered or given 90 day moratoriums on loans and credit card payments to their clients. Given the high level of uncertainty in the aftermath of this natural disaster, it is difficult to predict the impact on asset quality but should be closely monitored.

In summary, the resilience of the local banking industry will be further put to the test following the passage of Hurricanes Irma and María. In subsequent quarters, local banks will likely be adversely impacted by higher operating expenditures, the practical cessation of new loan originations, higher loan loss provisions, and lower income. On the upside, once the monies from insurance disbursements, federal disaster assistance and other rebuilding and reconstruction investments start trickling in, deposit and loan growth may ensue, positively impacting banks.

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Figure 4: Cost to Income by Bank (%)

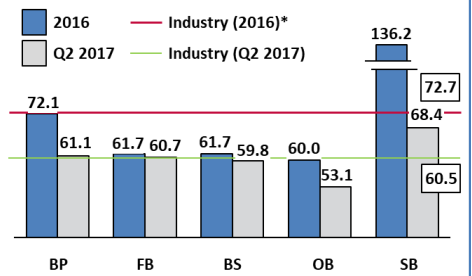


Figure 5: Tier 1 Risk-Based Capital Ratio by Bank (%)

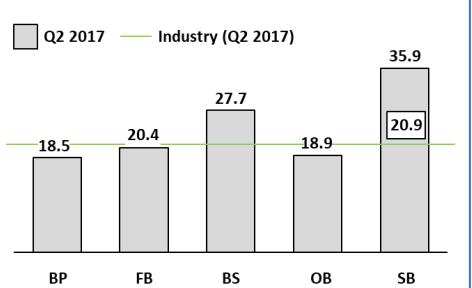
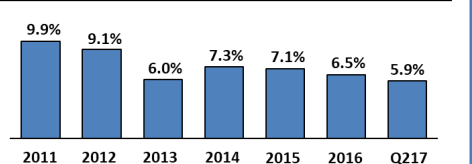
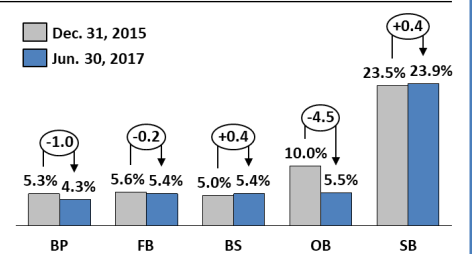


Figure 6: 90+DPD & non accrual <90DPD to Total Loans*



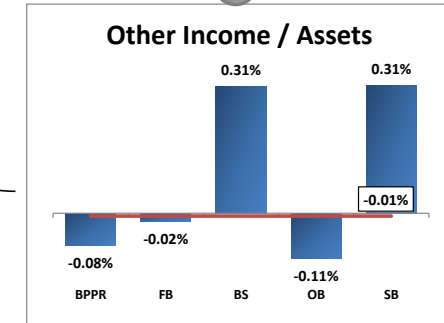
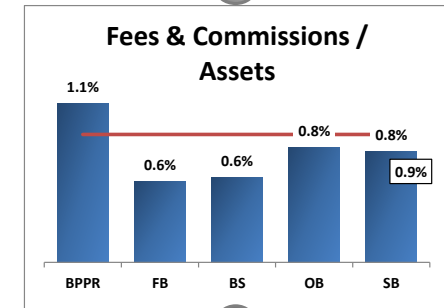
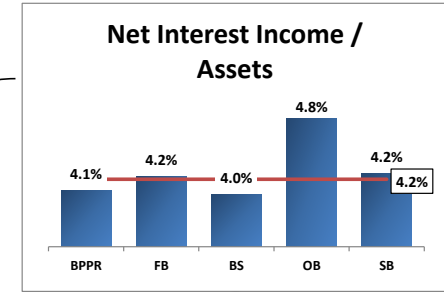
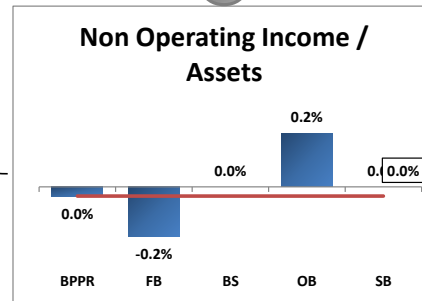
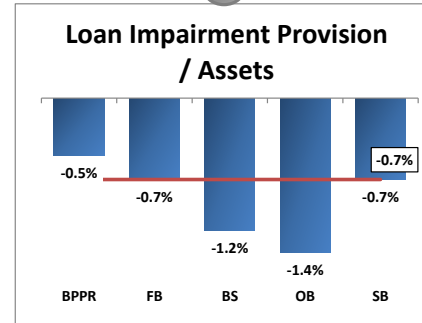
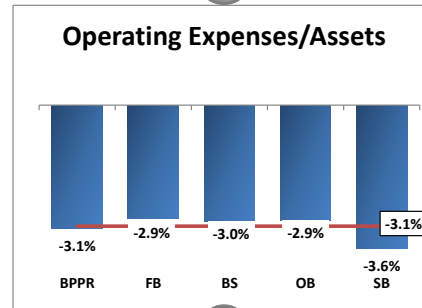
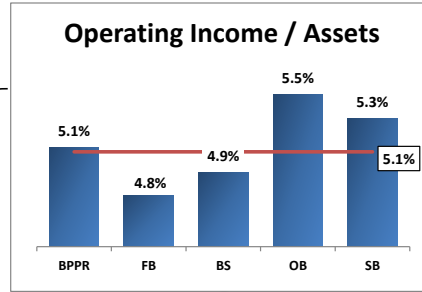
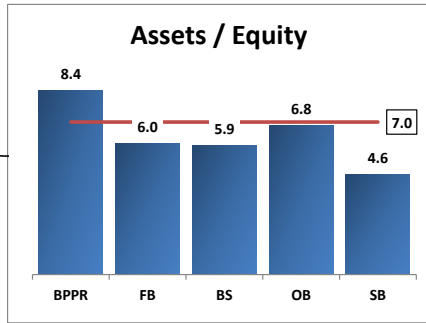
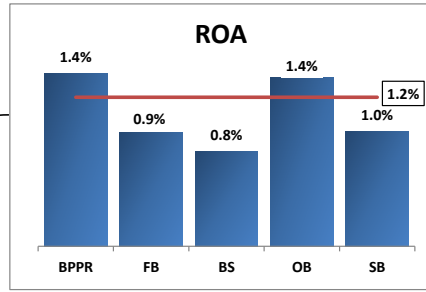
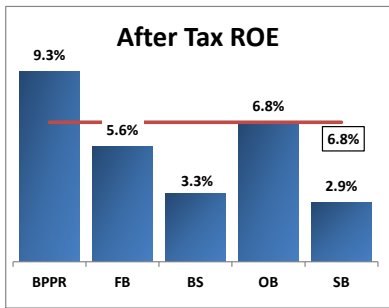
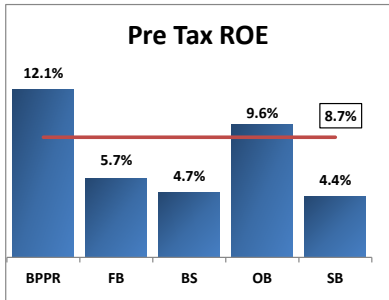
*Excludes FDIC covered portfolios, held for sale portfolios and guaranteed portion of portfolios insured by the U.S. Government.

Figure 7: 90+DPD & non accrual <90DPD to Total Loans*



*Excludes FDIC covered portfolios, held for sale portfolios and guaranteed portion of portfolios insured by the U.S. Government

ANNEX 1: BANKING INDUSTRY PROFITABILITY 2017



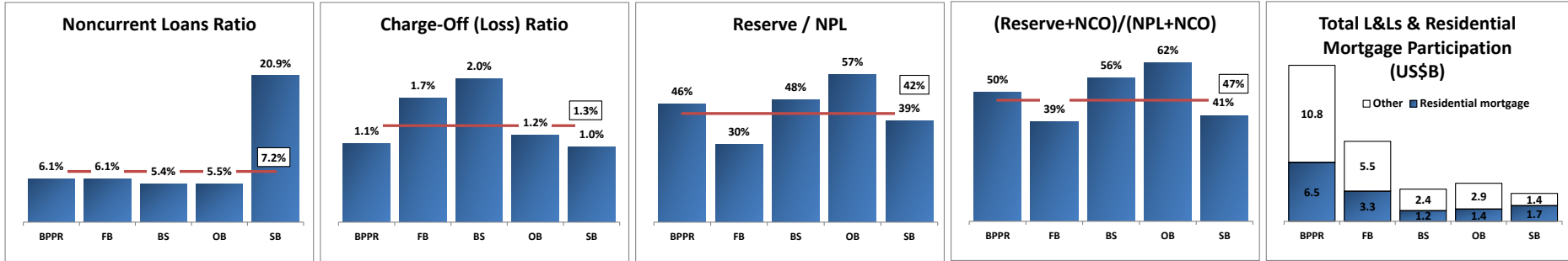
BPPR = BANCO POPULAR DE PUERTO RICO
 FB = FIRSTBANK OF PUERTO RICO
 BS = BANCO SANTANDER PUERTO RICO
 OB = ORIENTAL BANK AND TRUST
 SB = SCOTIABANK DE PUERTO RICO

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

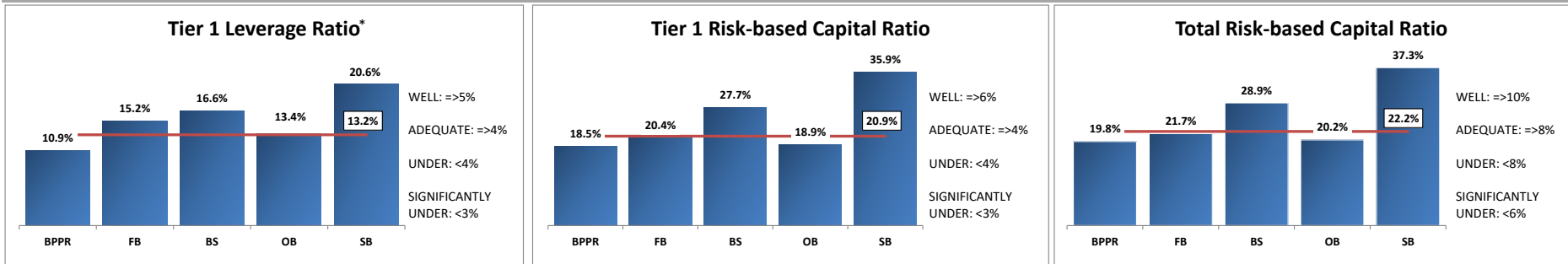
— Industry

ANNEX 2: BANKING INDUSTRY PERFORMANCE RATIOS 2017

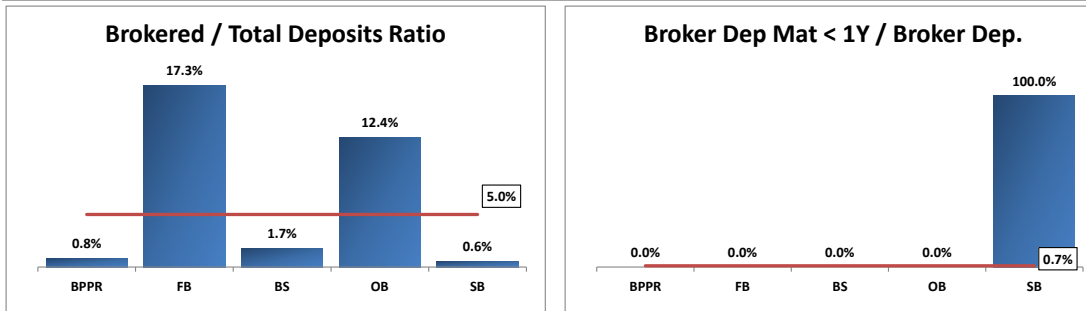
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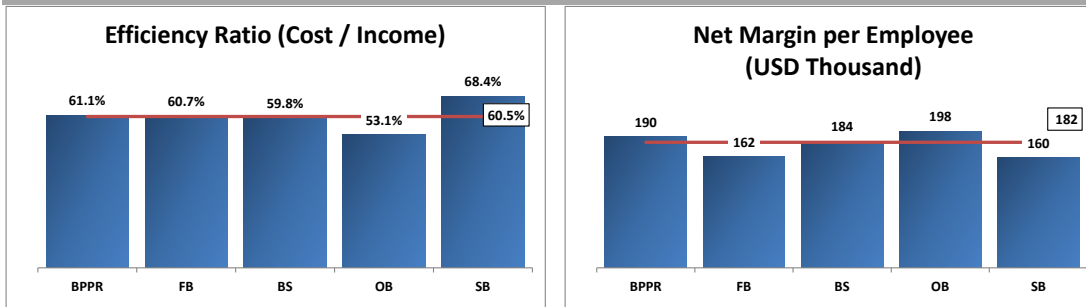
CAPITAL ADEQUACY



LIQUIDITY



PRODUCTIVITY



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— Industry

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

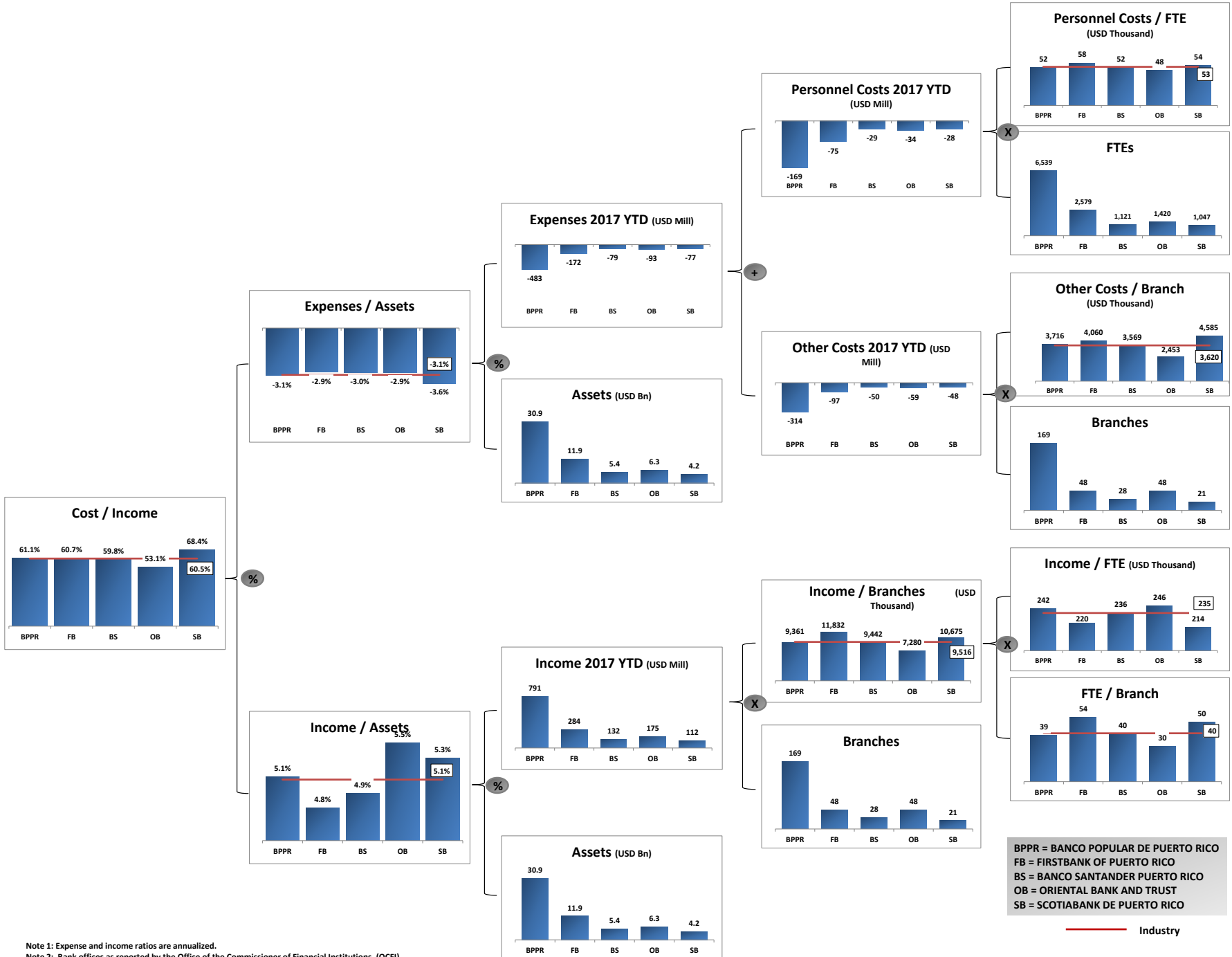
Notes:

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)

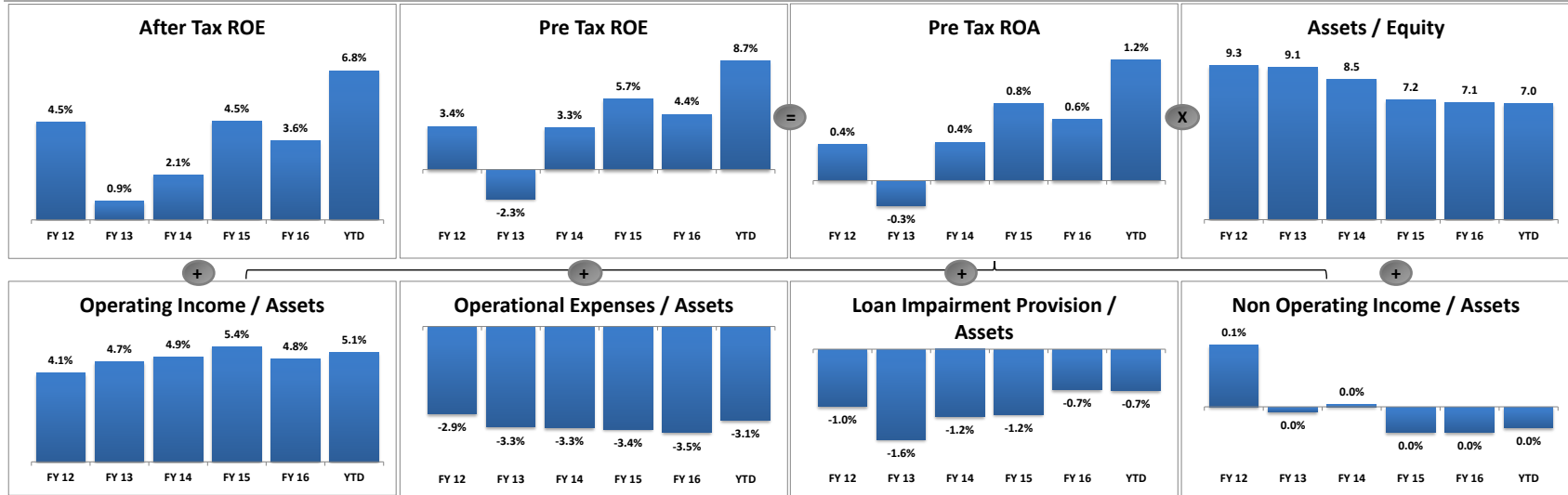
ANNEX 3: BANKING INDUSTRY PRODUCTIVITY 2017



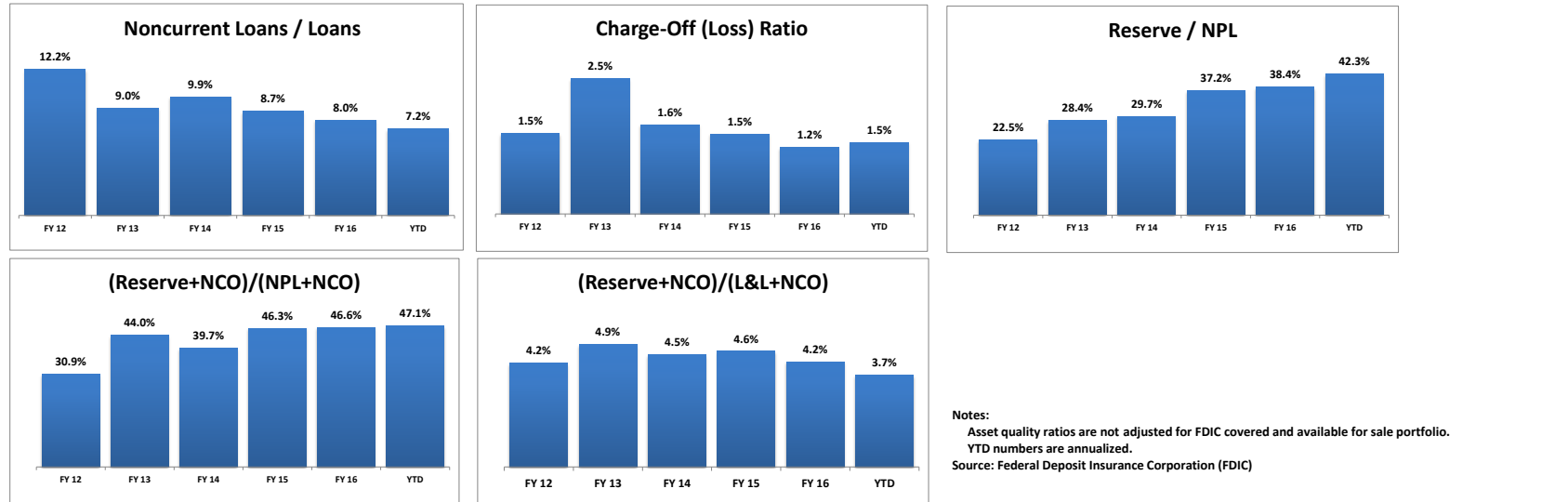
Note 1: Expense and income ratios are annualized.
 Note 2: Bank offices as reported by the Office of the Commissioner of Financial Institutions (OCFI) of Puerto Rico as of June 2017.

ANNEX 4: INDUSTRY TRENDS - SELECTED METRICS

PROFITABILITY

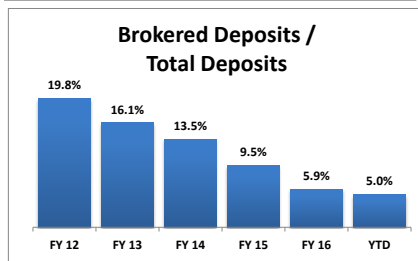


ASSET QUALITY

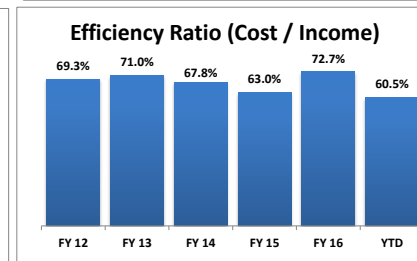


Notes:
 Asset quality ratios are not adjusted for FDIC covered and available for sale portfolio.
 YTD numbers are annualized.
 Source: Federal Deposit Insurance Corporation (FDIC)

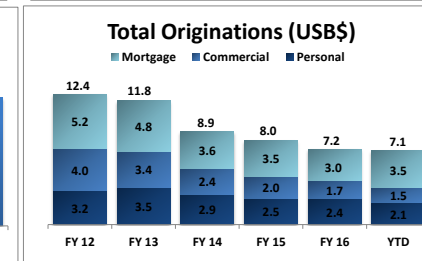
LIQUIDITY



PRODUCTIVITY



MARKET ORIGINATIONS



TOTAL ASSETS

