Puerto Rico Banking Industry Report

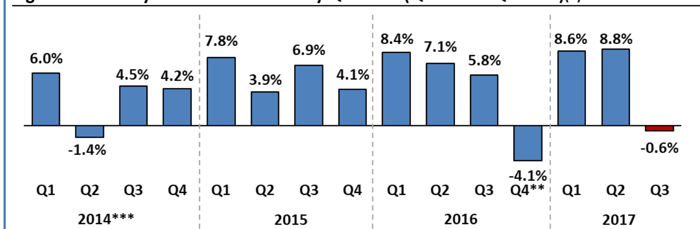
Issue XXXIV — January to September 2017

EXECUTIVE SUMMARY: The local banking industry's profitability dove into negative territory in Q3 2017, posting a Pre-Tax ROE of -0.6%, after a modestly strong first half of the year. Most local banks, anticipating asset quality deterioration and loan losses in the aftermath of the historic 2017 Atlantic hurricane season, materially increased their loan loss provisions. Industry-wide credit provision expenses reached close to $300 million in Q3 2017, a roughly three-fold increase with respect to Q3 2016. Pre-hurricane asset quality had been showing improvement, but after Superstorms Irma and María, it is under threat given the adverse impact on economic activity, borrower's financial standing, and labor market conditions. Since the hurricanes hit in the latter part of Q3 2017, the quarter's cost to income ratio was not materially impacted. However, in Q4 2017, with the expected decrease in loan originations, missed loan payments, and subdued "Point of Sale" activity, income generating capacity will be restrained. On the upside, the exceedingly strong capital levels of local banks will help absorb potential post-disaster losses. This issue reviews the potential macro-impacts of the hyperactive 2017 hurricane season, as well as examines bank performance and financial condition in impacted areas post-Hurricane Katrina.

PROFITABILITY: "The industry's Q3 2017 Pre-Tax ROE dove into negative territory, driven by higher provision expenses"

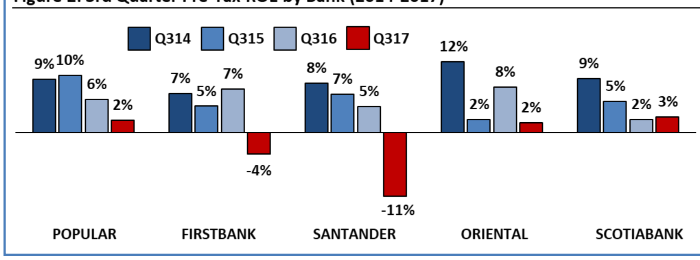
The banking industry's profitability dipped into negative territory in Q3 2017, registering a Pre-Tax ROE of -0.6% on a consolidated basis, following two quarters of Pre-Tax ROEs exceeding 8.5% (see Figure 1)(2). Evidently, the historic 2017 Atlantic hurricane season (Hurricanes Irma and María, Sep. 6 and Sep. 20, respectively) and its aftermath took a toll on the banking sector, as it has in all sectors of the economy. A local economic consulting firm has estimated that real economic growth in FY2018 could range from a minimum -8% to a pessimistic -15%(3). The widespread destruction of critical infrastructure systems, including electricity and telecommunications, severely disrupted economic and banking activity in the last month of Q3 2017 and beyond, creating a "cash only" environment. The Oct. 2017 jobs data already shows the impact the storms had on the economy, with nonfarm employment decreasing by 31,600 or 4% when compared to the previous month and 50,800 or 6% vis-à-vis Oct. 2016.

Figure 1: Industry Pre-Tax ROE Trend by Quarter* (Q1 2014 – Q3 2017)(1)



- Annualized quarterly Pre-Tax ROEs. **Excluding Scotia's $145 million goodwill impairment losses would raise the Q4 2016 Pre-Tax ROE by close to 7 percentage points to 2.8%.
- ***Includes Doral which had a Pre-Tax ROE of -58.2% in 2014.

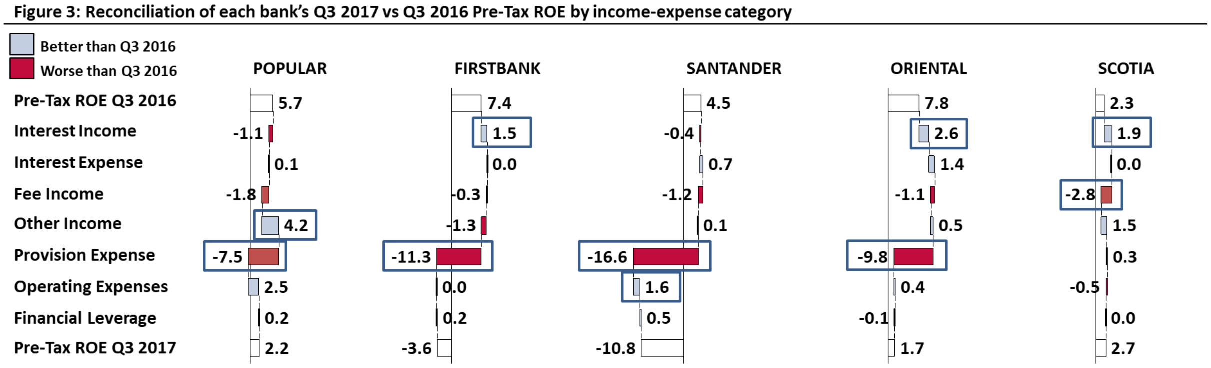
Figure 2: 3rd Quarter Pre-Tax ROE by Bank (2014-2017)



While in the midst of dealing with a historic economic and fiscal crisis, and a sluggish post-disaster response and recovery process, Puerto Rico is now challenged with another exogenous shock that may further destabilize the Island's economy and financial sector. Some have warned that the enactment of the U.S. Federal Tax Reform, which imposes a 12.5% excise tax on products manufactured in subsidiaries of American companies in Puerto Rico when shipped to the mainland, could lead to massive job losses, jeopardize one third of general fund revenues, and exacerbate out-migration to the mainland(3).

When analyzing profitability by bank, Santander suffered the greatest loss in Q3, registering a Pre-Tax ROE of -11% followed by FirstBank (-4%) (see Figure 2). A dramatic spike in credit provision expenses is largely to blame for this plunge in profitability when comparing Q3 2017 with Q3 2016 (see Figure 3). Popular, which reported $80 million in pre-tax hurricane expenses ($70 million provision for loan losses) registered a Pre-Tax ROE 2.2% while Oriental, which also increased its loan loss provisions anticipating asset quality deterioration, posted a Pre-Tax ROE of 1.7%. The only bank to not experience a marked increase in its credit provision expense was Scotia, reporting the highest, albeit low, Pre-Tax ROE of 2.7%.

Figure 3: Reconciliation of each bank's Q3 2017 vs Q3 2016 Pre-Tax ROE by income-expense category



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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) The 2017 YTD Pre-Tax ROE reached 5.6%, dragged down by the poor performance in Q3 (see Annexes 1 and 4).

(3) https://juntasupervision.pr.gov/wp-content/uploads/wpfd/50/5a214536b2185.pdf

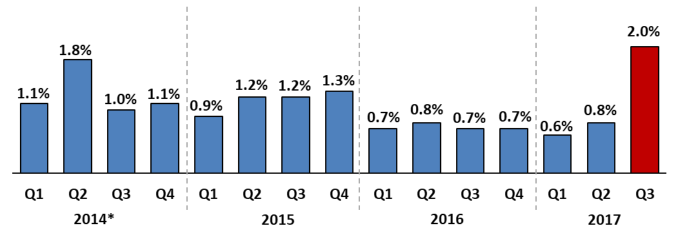
ASSET QUALITY: "Anticipating a deterioration of asset quality, the local banking industry increased provision expenses by threefold"

Foreseeing loan quality issues in the coming quarters following the destructive passage of Hurricanes Irma and María in September 6 and 20, respectively, most banks have significantly raised their credit provision expenses. On a consolidated basis, provision expense increased roughly threefold to close to $300 million. The local banking industry's provision expense to assets ratio reached 2.0% in Q3 2017 (see Fig. 4), the highest since Q2 2013. Business failures, disruptions in the income streams of borrowers, unexpected increases in the operating costs, and the further weakening of the labor market caused by the hurricanes and their cascading effects, will likely impact the credit quality of the banks' borrowers. An increase in credit provision is therefore warranted.

Prior to this natural exogenous shock, the banking sector has seen a consistent decline in its delinquency ratio. The YTD 2017 unadjusted nonperforming loans ratio(4) reached 7.2% in YTD 2017, from 12.2% in 2012 (see Annex 4).

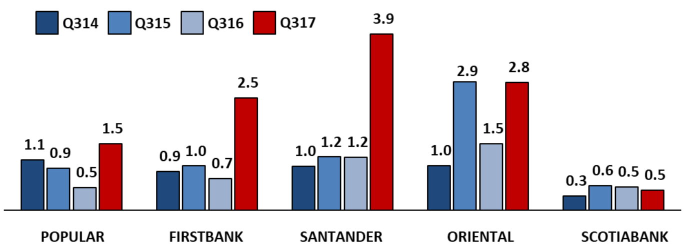
All the banks experienced a significant increase in loan loss provision relative to assets except Scotia. Scotia, however, does have a highly robust capital buffer. Santander registered the highest provision expense to assets ratio (3.9%), followed by Oriental (2.8%), FirstBank (2.5%), and Popular (1.5%) (see Figure 5).

Figure 4: Industry Provision Expense to Assets by Quarter (Q1 2014 – Q3 2017)



*Includes Doral which had a Provision Expense to Assets of 3.1% in 2014.

Figure 5: 3rd Quarter Provision Expense to Assets (%) by Bank (2014-2017)

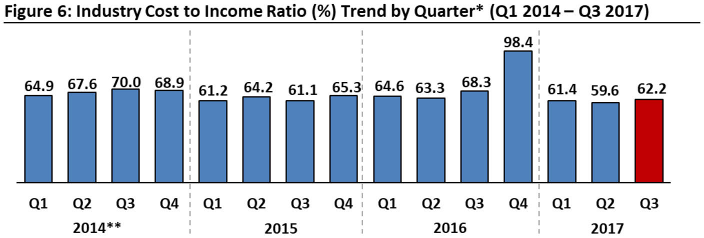


PRODUCTIVITY: "Cost to income ratio rose slightly in Q3 2017"

Productivity levels of local banks rose slightly in Q3 2017. The industry's cost to income ratio reached 62.2%, somewhat higher than Q2 2017 and lower vis-à-vis Q3 2016 (see Fig. 6). Given that the hurricanes impacted the Island in the latter part of the quarter, September 7 and 20, the cost nor the income of banks were greatly affected, at least not yet. While banks did report additional hurricane-related operating expenses, these were not substantial enough to materially impact the efficiency ratio.

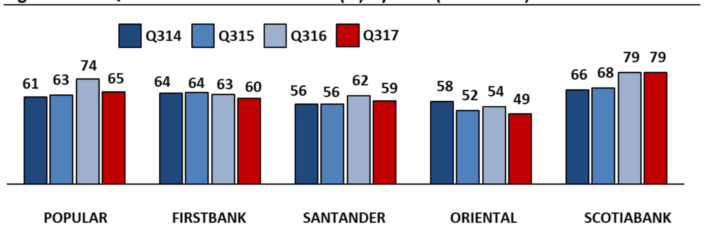
In Q4 2017 we will likely see a drop in productivity, particularly a decrease on the income side. The sweeping disruptions of economic activity in the wake of the natural events will likely lead to fewer loan originations, missed loan payments, and subdued "Point of Sale" activity, all impacting the income generating capacity of local banks. The pace of the restoration of the electric power grid and telecommunications systems is key to minimizing the economic pain endured by households, businesses, and the third sector. Once these systems are reliably up and running, energies and resources can be focused towards financing reconstruction.

Figure 6: Industry Cost to Income Ratio (%) Trend by Quarter* (Q1 2014 – Q3 2017)



**Includes Doral which had a Cost-to-Income Ratio of 145.1% in 2014.

Figure 7: 3rd Quarter Cost to Income Ratio (%) by Bank (2014-2017)

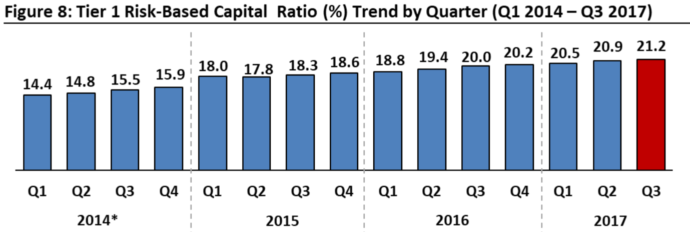


CAPITAL ADEQUACY: "Banks are exceedingly well-capitalized"

To adequately respond to severe economic distress, banks need a strong capital cushion to absorb losses. Fortunately, the local banking sector's capital levels have continued to strengthen, reaching an industry-wide Tier 1 Risk-Based Capital Ratio of 21.2% in Q3 2017, amply exceeding the well-capitalized level of 8% (see Figure 8). Local banks subjected to the Dodd-Frank Act Stress Test (DFAST), those with consolidated total assets greater than $10 billion, have reported strong results in the latest round of supervisory stress tests. Even in a "severely adverse" scenario, local banks, given their historically high capital ratios, could adequately meet the financing needs of households and businesses.

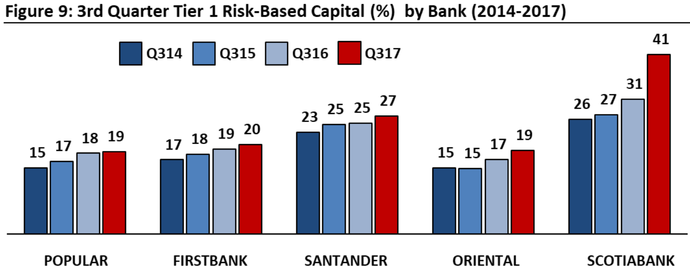
When analyzing capital levels by banks, measured by the Tier 1 Risk-Based Capital Ratio, Scotia boasts the highest ratio with 41% (see Fig. 9). Santander's Tier 1 Risk-Based Capital Ratio is the 2nd highest, with 27%, followed by FirstBank with 20% and Popular and Oriental, both with 19%. In sum, a robust, well-capitalized banking sector will be critical to absorb potential losses from impaired economic activity and meet post-disaster financing needs.

Figure 8: Tier 1 Risk-Based Capital Ratio (%) Trend by Quarter (Q1 2014 – Q3 2017)



*Includes Doral which had a Tier 1 Risk-Based Capital of 2.7% in 2014.

Figure 9: 3rd Quarter Tier 1 Risk-Based Capital (%) by Bank (2014-2017)



Source: FDIC, OCIF, 10-Q SEC filings, quarterly results calls, analysis by "Financial Institutions Practice" V2A. www.v-2-a.com / Tel. V2A (787) 919 7303

(4) Does not exclude FDIC covered portfolios, held for sale portfolios and guaranteed portion of portfolios insured by the U.S. Government.

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MACRO-IMPACTS OF MARÍA: "Contracting economic output in the short-term followed by a boost in growth"

The devastation brought about by Hurricanes Irma and María to Puerto Rico is truly historic, utterly disrupting the Island's life and economy. These superstorms, with sustained wind speeds exceeding 150 mph, have had far reaching consequences including causing fatalities, destroying already weak infrastructure systems, triggering a humanitarian crisis, and materially weakening overall economic performance, which in turn generate innumerable cascading and spillover effects. While in the short-term there will be severe negative economic impacts due to widespread business disruption and concomitant losses in income and production, a boost in growth will surely follow fueled by the influx of new monies from the federal government, private insurance outlays, central government budget reallocations and investments, and nongovernmental organizations like the American Red Cross. The proper functioning of financial intermediation institutions will be critical to address the post-disaster financing needs of individuals and businesses.

Moody's(3) analyzed the impact of natural disasters, identifying the following commonly experienced macroeconomic consequences, which in turn have a direct or indirect impact in the affected jurisdiction's banking and broader financial sector. In the case of Puerto Rico, most of these key indicators were already in a severely weak state.

⇒ ECONOMIC OUTPUT: Constricting of economic activity and production in the short-run, usually followed by a boost in growth thanks to reconstruction investments and insurance proceeds. Puerto Rico's economic output has already shrunk by more than 16% from the onset of the economic downturn in FY 2006 up to FY 2016.

⇒ TRADE BALANCE: Reconstruction efforts cause an upsurge in imports and exports generally decline. Puerto Rico's high-tech manufacturing sector, responsible for most of the Island's trade, has experienced a slowdown in production due to the unavailability of critical infrastructure systems. The 2017 U.S. tax reform poses an additional threat to the sector, raising concerns among local stakeholders and mobilizing efforts to lobby Congress.

⇒ FISCAL HEALTH: Worsening of the fiscal health, as government revenues decrease due to less economic activity while expenditures rise to address emergency and reconstruction activities. During the 1st post-María meeting held by the Fiscal Oversight and Management Board, it was elucidated that collections of taxes and fees have dropped by 50%, cash income dropped by $1.7 billion, while collections for electric and water service suffered a reduction of $1.3 billion. Furthermore, $1 billion were reallocated to address emergency needs and relief efforts. Given this new post-María reality, the draft of a new 5-year fiscal plan will need to be submitted by Dec. 22.

⇒ DEBT SUSTAINABILITY: Rising debt/GDP ratio, i.e. downward pressure on economic output and upward pressure on borrowing. Moody's downgraded Puerto Rico's General Obligation bonds further, pointing to "protracted economic and revenue disruptions caused by Hurricane María" and a diminished debt servicing capacity. On the upside, a more favorable debt restructuring may materialize due to weaker economic prospects.

EVIDENCE FROM KATRINA: "Higher OPEX and provision expenses in coming Qs; deposit & loan growth may ensue"

Examining the post-hurricane performance and financial condition of banks impacted by Hurricane Katrina in the U.S. Gulf Coast Region can shine some light on what to expect in the local banking industry post-Hurricane María.(4,5)

⇒ HIGHER CREDIT RISKS & WEAKENED ASSET QUALITY: A large part of the damages suffered by borrowers is not insured, increasing banks' credit risks. Moody's highlighted low insurance penetration as a downside risk.

⇒ HIGHER CHARGE-OFFS & PROVISIONS: The material damages to property caused an increase in charge-offs and loan loss provisions for those banks impacted by Katrina. Moody's estimated that loss provisions might increase materially for local banks following María but remains confident that strong capital buffers can mitigate losses.

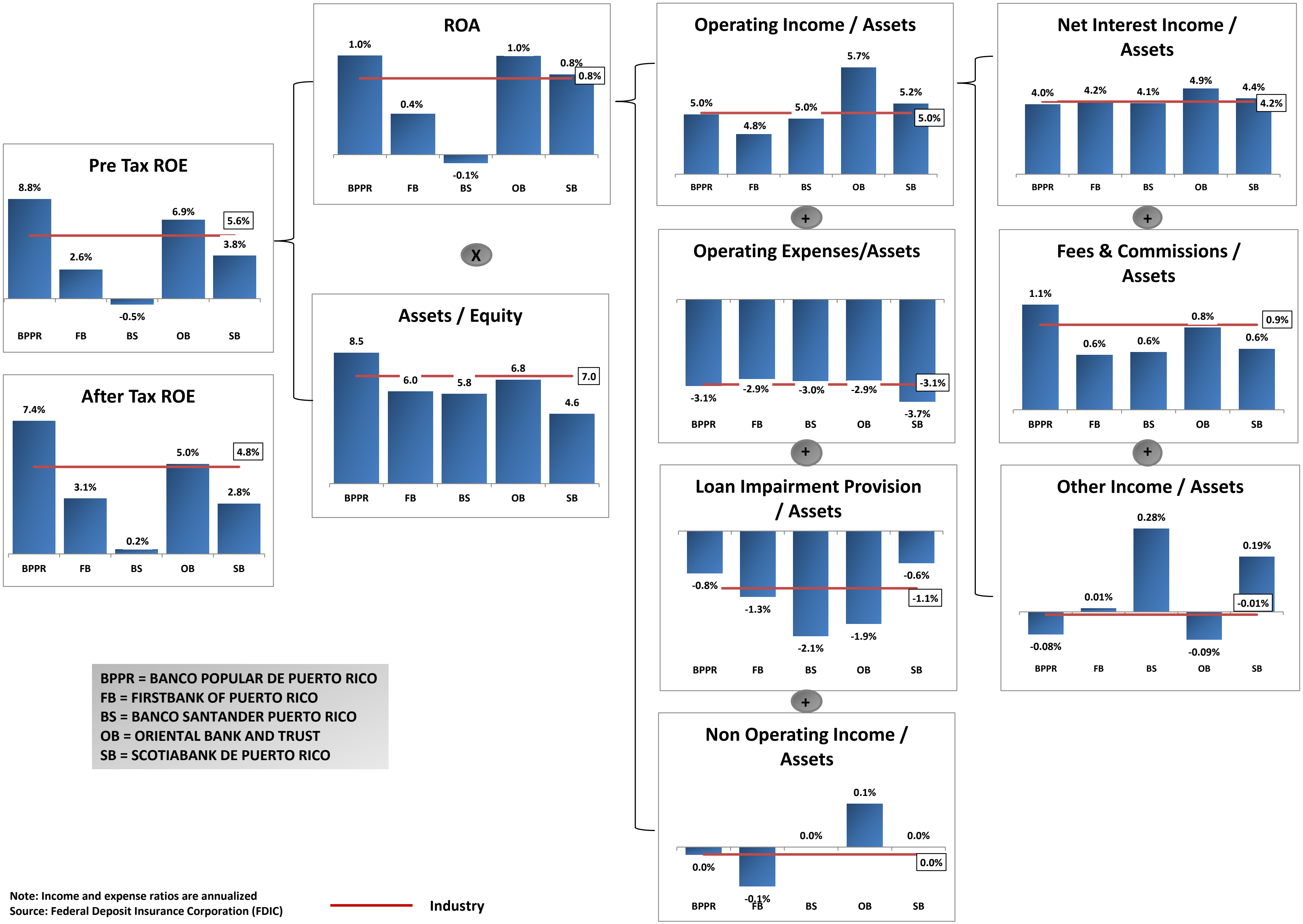
⇒ CLOSE MONITORING BY CREDIT AGENCIES: The major credit agencies announced that they would be vigilant of the capitalization and the risk-management processes of banks impacted by Katrina.

⇒ ELEVATED EXPENSES FOLLOWED BY BOOST IN BANKING ACTIVITY: Higher expenses due to hurricane-related disruptions and damages are expected, but federal aid and insurance proceeds will boost banking activity.

In summary, Puerto Rico's economy and banking sector have a long-road ahead of recovery. The destruction caused by Irma and María and the subsequent slow progress to repair damaged infrastructure, has significantly disrupted economic and banking activity. Following María, banks will likely be adversely impacted by somewhat higher OPEX, slowdown of new loan originations, higher loan loss provisions, and lower income. It should be noted that the continued increase in the federal funds rate will in turn raise borrowing costs for consumers and businesses already dealing with a new post-disaster reality. On the upside, once the monies from insurance disbursements, disaster assistance and other rebuilding and reconstruction investments start trickling in, deposit and loan growth may ensue.

(3) Moody's (2016) Understanding the Impact of Natural Disasters. Available at https://www.eenews.net/assets/2016/11/30/document_cw_01.pdf.
(4) Lambert, C., Noth, F., & Schüwer, U. (2015). How do banks react to catastrophic events? Evidence from Hurricane Katrina. SAFE Working Paper No. 94.
(5) Noth, F. & Schüwer, U. (2017) Natural disaster and bank stability: Evidence from the U.S. financial system. SAFE Working Paper No. 167.

ANNEX 1: BANKING INDUSTRY PROFITABILITY 2017

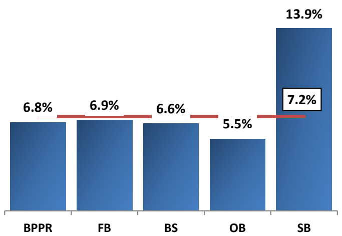


Note: Income and expense ratios are annualized
Source: Federal Deposit Insurance Corporation (FDIC)

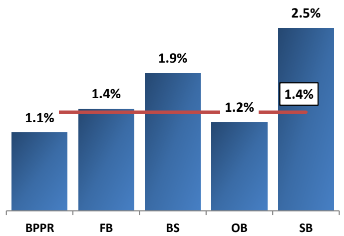
ANNEX 2: BANKING INDUSTRY PERFORMANCE RATIOS 2017

ASSET QUALITY

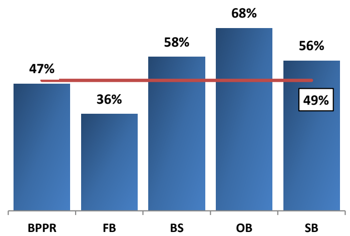
Noncurrent Loans Ratio



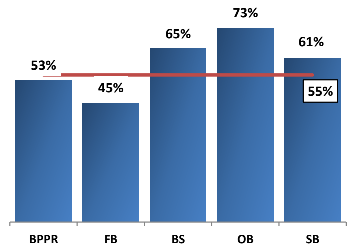
Charge-Off (Loss) Ratio



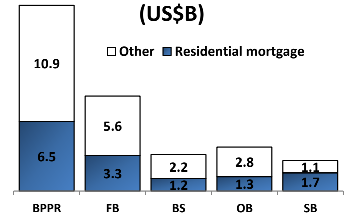
Reserve / NPL



(Reserve+NCO)/(NPL+NCO)

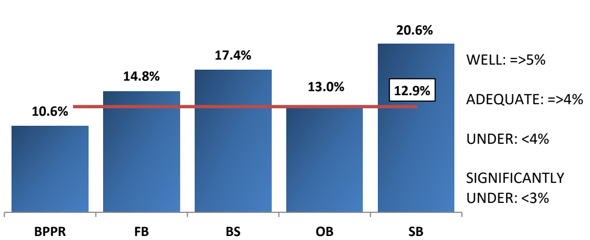


Total L&Ls & Residential Mortgage Participation (US$B)

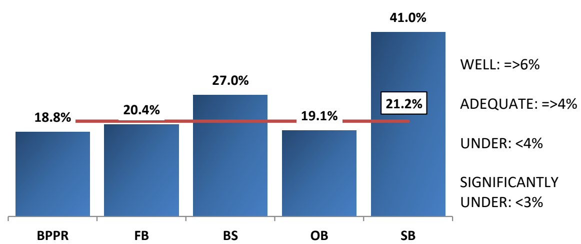


CAPITAL ADEQUACY

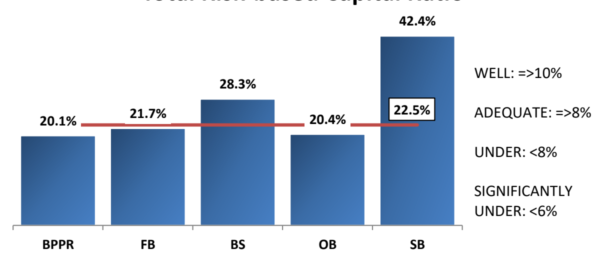
Tier 1 Leverage Ratio*



Tier 1 Risk-based Capital Ratio

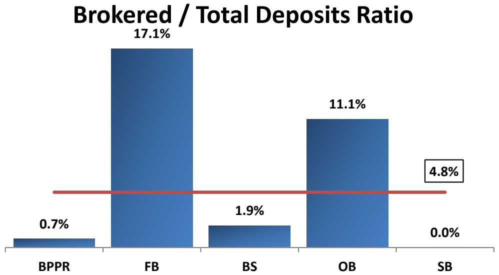


Total Risk-based Capital Ratio

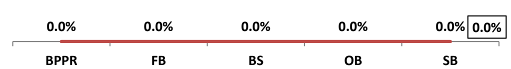


LIQUIDITY

Brokered / Total Deposits Ratio

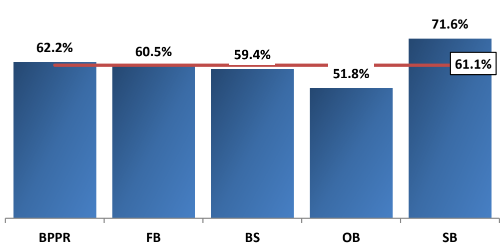


Broker Dep Mat < 1Y / Broker Dep.

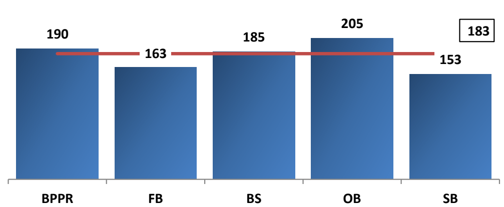


PRODUCTIVITY

Efficiency Ratio (Cost / Income)



Net Margin per Employee (USD Thousand)



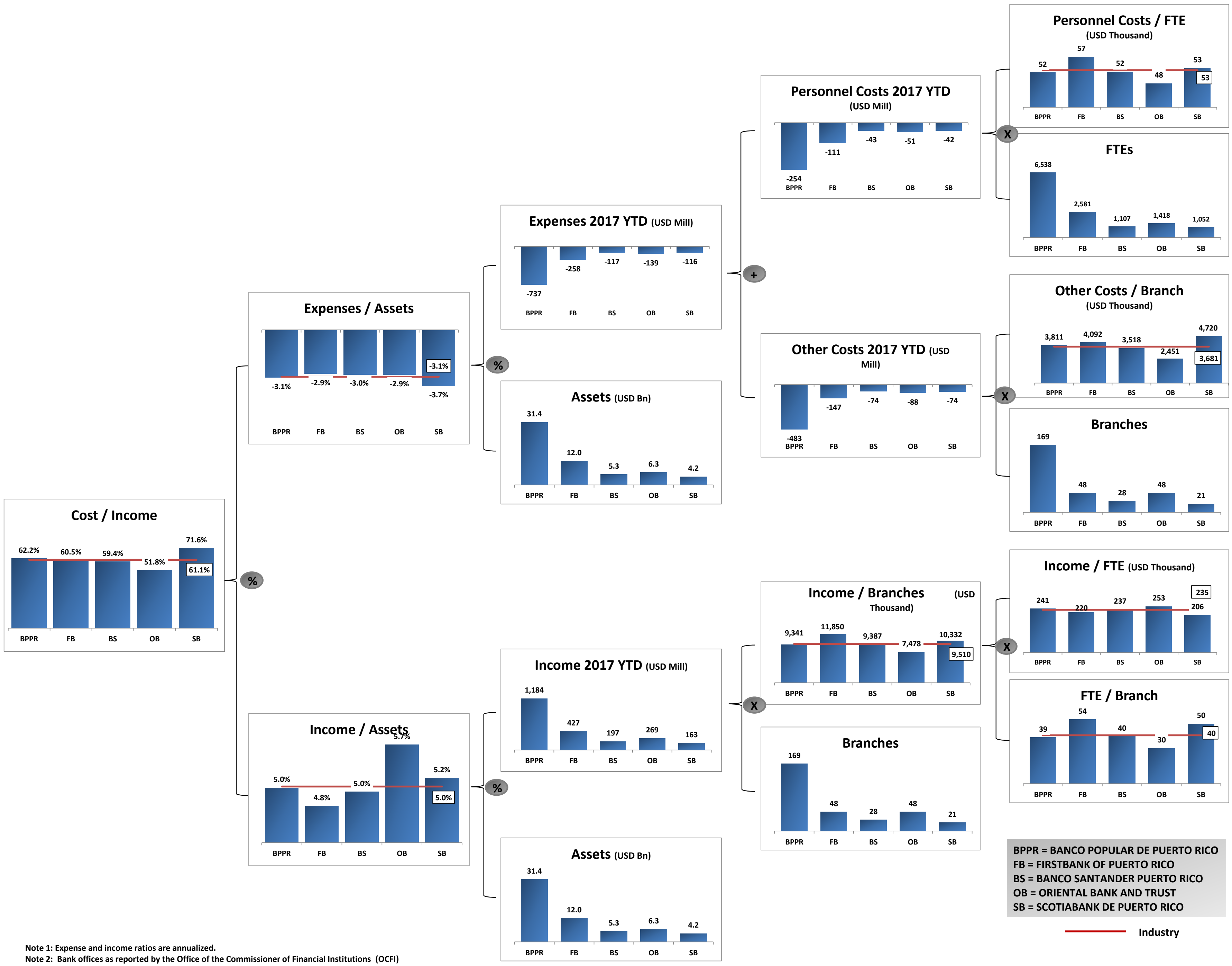
BPPR = BANCO POPULAR DE PUERTO RICO
FB = FIRSTBANK OF PUERTO RICO
BS = BANCO SANTANDER PUERTO RICO
OB = ORIENTAL BANK AND TRUST
SB = SCOTIABANK DE PUERTO RICO

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)

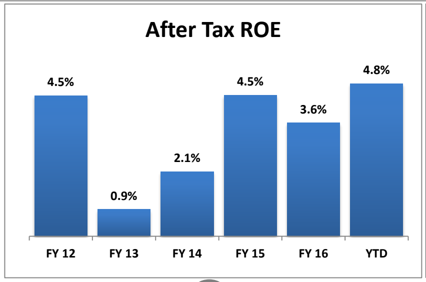
ANNEX 3: BANKING INDUSTRY PRODUCTIVITY 2017

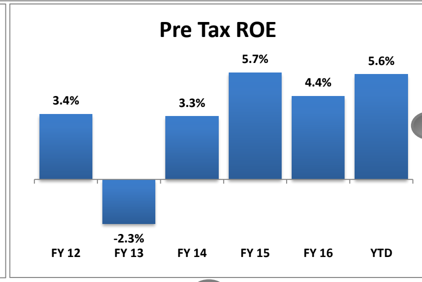


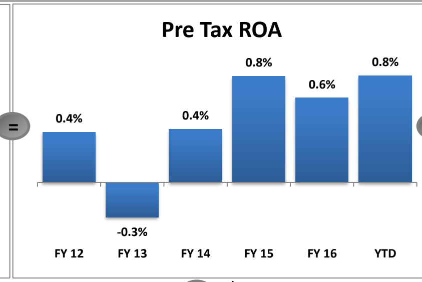
Note 1: Expense and income ratios are annualized.
Note 2: Bank offices as reported by the Office of the Commissioner of Financial Institutions (OCFI) of Puerto Rico as of June 2017.

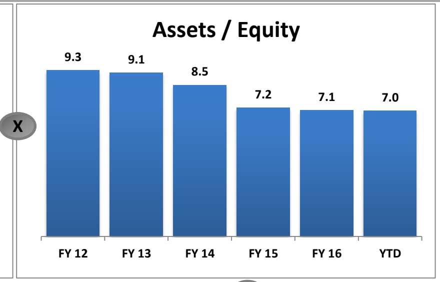
ANNEX 4: INDUSTRY TRENDS - SELECTED METRICS

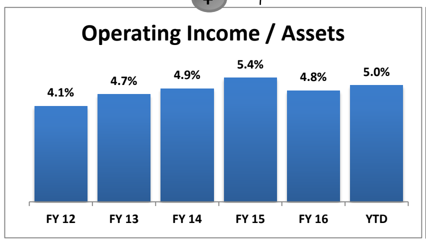
PROFITABILITY

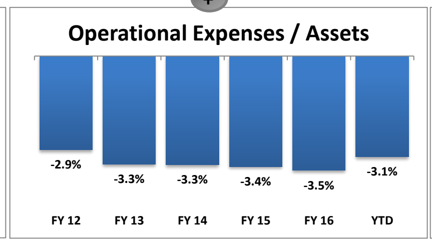


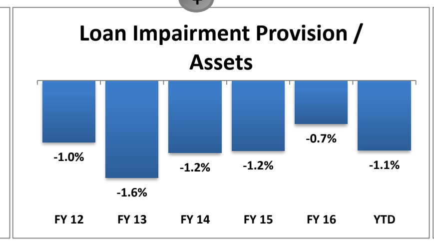


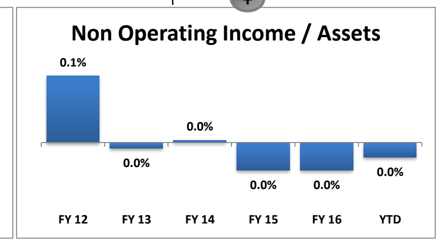




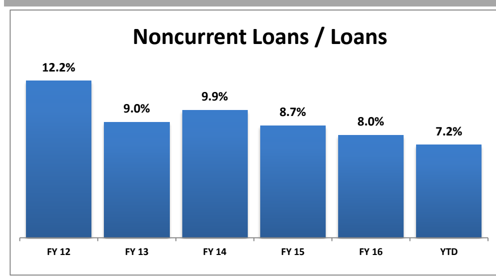


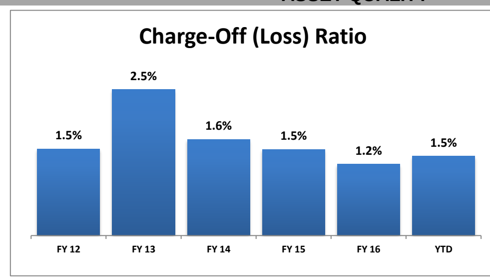


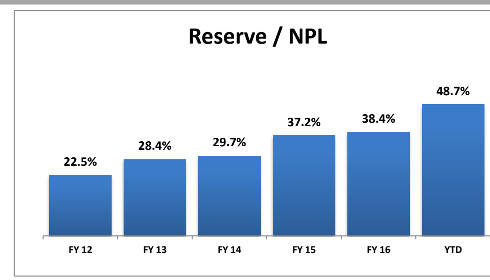


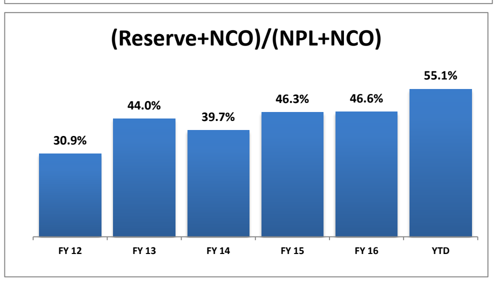


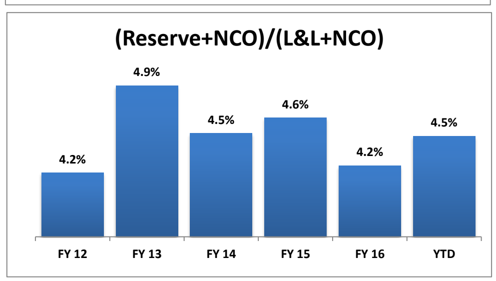
ASSET QUALITY











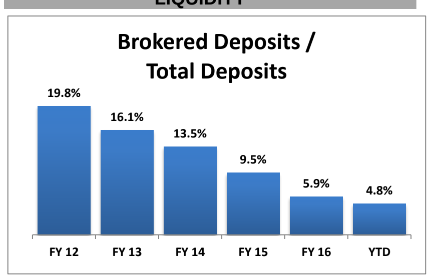
Notes:

Asset quality ratios are not adjusted for FDIC covered and available for sale portfolio.

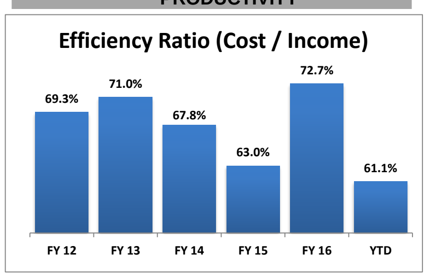
YTD numbers are annualized.

Source: Federal Deposit Insurance Corporation (FDIC)

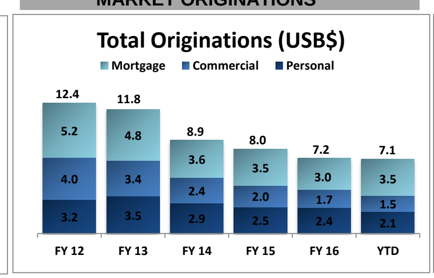
LIQUIDITY



PRODUCTIVITY



MARKET ORIGINATIONS



TOTAL ASSETS