Puerto Rico Banking Industry Report

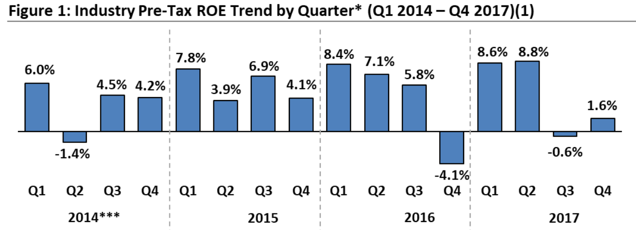
Issue XXXV | **January to December 2017**

EXECUTIVE SUMMARY: The local banking industry's profitability stayed in positive territory in year-end 2017, reaching an industry-wide Pre-Tax ROE of 4.6%, notwithstanding the challenging operating market conditions, characterized by an economy mired in a prolonged and deep contraction, a bankrupt government under Puerto Rico Oversight, Management and Economic Stability Act Title III court proceedings, and more recently, the devastation and ensuing cascading effects of Hurricanes Irma and María which severely disrupted the island's normal social and economic life. During the first half of 2017 local banks on a consolidated level posted Pre-Tax ROEs above 8.5%, dipping to -0.6% in Q3 2017 and 1.6% in Q4 2017. All banks, with the exception of Scotia which took the hit in Q4, incurred in high provision expenses in Q3 2017 due to anticipated hurricane-related losses, materially decreasing in Q4 2017. Despite this panorama, bank executives remain optimistic of the short-term outlook, pointing to the influx of funds from the federal government, insurance claims, and other sources propping up deposits, favorable trends in loan payment moratoriums, and construction sector lending opportunities when rebuilding efforts pick up. Nevertheless, downside risks to economic and bank activity still loom large.

PROFITABILITY: "Hurricanes took a toll on banks' profitability in Q3 and Q4 of 2017, after a strong first half of the year"

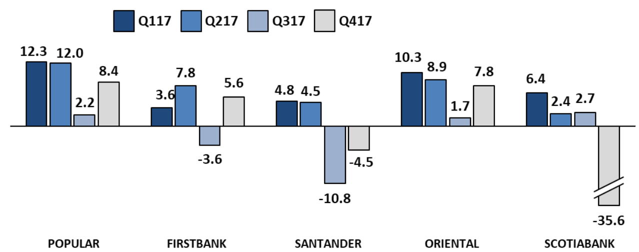
The banking industry, in Q4 2017, the first full quarter of data following Hurricanes Irma and María, registered a Pre-Tax ROE of 1.6% on a consolidated level (see Figure 1). This follows strong returns posted in the first half of the year (Pre tax ROE above 8.5%) and a negative Pre-Tax ROE of 0.6% in Q3 2017. The industry-wide 2017 year-end Pre-Tax ROE reached 4.6%, marginally higher than 2016 (4.3%) (see Annex 4). Considering the catastrophic cascading effects of the superstorms, and the broader economic and fiscal challenges being faced by Puerto Rico even prior to the storms, the 2017 year-end results are better than expected, speaking to the resilience of the sector.

Figure 1: Industry Pre-Tax ROE Trend by Quarter* (Q1 2014 – Q4 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.

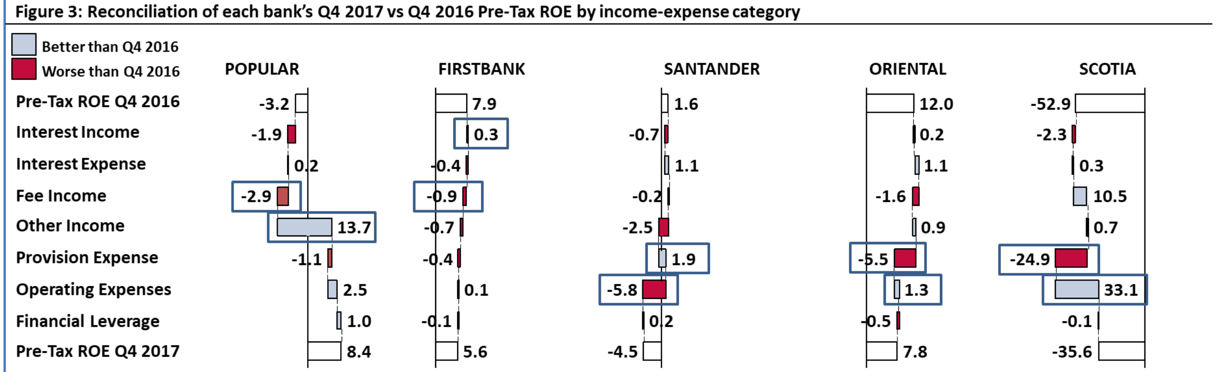
Figure 2: Pre-Tax ROE by Bank by Quarter (%) (Q1 2017 – Q4 2017)



While banking activity has made some headway during Q4 approaching normalized levels as more progress is made restoring key infrastructure systems, the FDIC data bears out that local banks' revenues and expenses in Q3 and Q4 were adversely impacted by the storms. These adverse impacts include increasing loan loss provision expenses in anticipation of interim losses, reduced commercial transaction activity negatively impacting banks' credit and debit card processing income, and a decrease in ATM fees. Furthermore, banks experienced a marked slowdown of loan originations, increased operating expenses stemming from hurricane-related outlays, additional costs due to insurance deductibles on OREOs and less revenue as a result of the waiving of certain late fees and service charges. The dramatic dip in the GDB Economic Activity Index, which decreased by -14.3%, -17.6%, and -14.0% on a YoY basis in Oct., Nov. and Dec. 2017, respectively, illustrates the acutely challenging environment local banks operated in.

Popular and Oriental posted the highest Pre-Tax ROEs, with 8.4% and 7.8%, respectively, followed by FirstBank (5.6%) (see Figs. 2 and 3). Santander and Scotia registered negative Pre-Tax ROEs in the last quarter of 2017, -4.5% and -35.6%, respectively. While most banks took the hit of a high provision expense in Q3 2017 in anticipation of hurricane-related losses, Scotia did so in Q4, reflected in the bank's deeply negative Pre-Tax ROE. When evaluating 2017 year-end results, the profitability ratios follow a similar pattern, with Popular, Oriental, and FirstBank with the highest Pre-Tax ROEs (8.7%, 7.1%, and 3.3%, respectively), and Santander and Scotia in the red with Pre-Tax ROEs of -1.5% and -5.9%, respectively (see Annex 1).

Figure 3: Reconciliation of each bank's Q4 2017 vs Q4 2016 Pre-Tax ROE by income-expense category



Inside this issue:

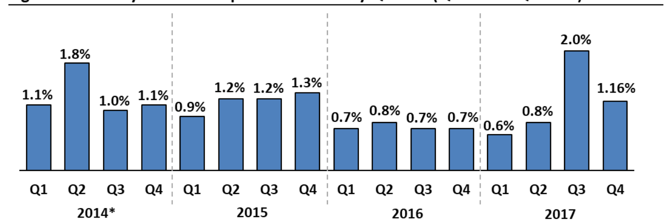
Source: Federal Deposit Insurance Corporation (FDIC), "Call Reports", 10-Q SEC filings, quarterly results calls, analysis by "Financial Institutions Practice" V2A.
(1) Citibank Puerto Rico financial data is not reported separately from Citibank US and, consequently, the bank is not included in the report analyses.

ASSET QUALITY: "The industry-wide provision expense to assets ratio spiked in Q3 2017, reaching 2.0%, dropping to 1.2% in Q4 2017"

As one might expect following a calamitous natural disaster like the one experienced in Puerto Rico, banks anticipated loan losses due to the impact and aftermath of the hurricanes, reflected in their significantly higher loan loss provision expense. The industry-wide provision expense amounted to $294 million (mn) in Q3 2017 (close to 3X the $103mn of Q3 2016), with a provision expense to assets ratio of 2.0%, as most banks chose to absorb the impact on earnings in Q3. All banks except Scotia recorded a materially higher provision expense in Q3, decreasing markedly in Q4 (see Fig. 5).

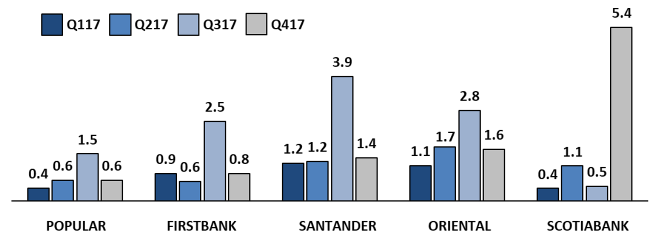
The steep decline in economic activity as evidenced by the drop in the GDB Economic Activity Index (13.3% drop when comparing Dec. vs. Aug. 2017), the swift deterioration of the already weak labor market with nonfarm employment decreasing by 30,000 or 3.4% when comparing Dec. 2017 with August(2), and hurricane-induced outmigration into the U.S. mainland exacerbating the island's demographic challenges, pose considerable downside risks to banks' credit quality in the coming quarters. Closely monitoring consumer and commercial borrower behavior once the moratoriums expire will be critical going forward, as the "new normal" sets in.

Figure 4: Industry Provision Expense to Assets by Quarter (Q1 2014 – Q4 2017)



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

Figure 5: Provision Expense to Assets (%) by Bank (Q1 2017 – Q4 2017)

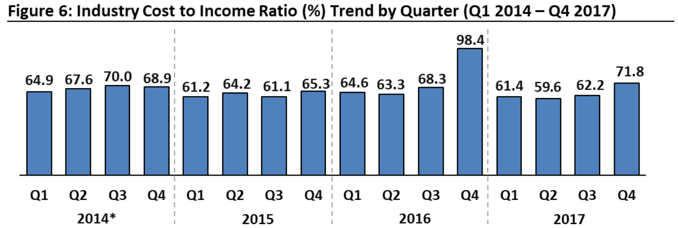


PRODUCTIVITY: "Cost-to-income ratio in Q4 2017 rose by 10 ppts., reaching 72%, due to hurricane-related impacts on income/expenses"

The industry's cost-to-income ratio, after experiencing a small uptick in Q3 2017, rose by close to 10 percentage points in Q4 2017, reaching 72% (see Figure 6). The 2017 year-end cost-to-income reached 63.8%, a significant improvement vis-à-vis 2016 and below the last 10-year average of 67% (see Annex 4). The decrease in productivity as measured by the cost-income ratio in Q4 2017 with respect to Q3 2017 is mainly attributable to the rise in operating expenses, which in turn was driven by hurricane-related expenses.

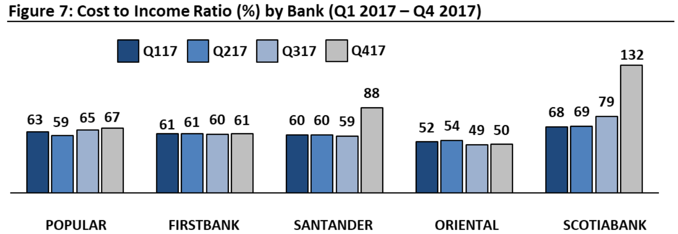
Popular disclosed $20mn in lost revenues and $7.5mn in hurricane-related expenses during Q4 2017, including $1.8mn in personnel costs, $3.0mn in building repairs, fuel and equipment expenses, and $2.3mn in donations and sponsorships. FirstBank reported $5.3mn in expenses including purchasing diesel, costs of increased security, providing employee assistance, removal of debris, among other storm-related expenses. During 2018 these effects on costs and income will taper off as infrastructure systems and businesses are coming increasingly back on line, transaction volumes recover and loan demand picks up fueled by the reconstruction effort.

Figure 6: Industry Cost to Income Ratio (%) Trend by Quarter (Q1 2014 – Q4 2017)



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

Figure 7: Cost to Income Ratio (%) by Bank (Q1 2017 – Q4 2017)

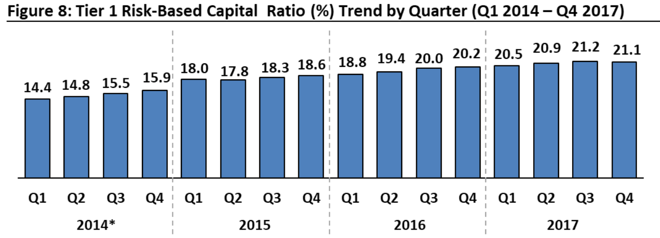


CAPITAL ADEQUACY: "Robust capital buffers of banks will help absorb potential losses, if downside risks on the horizon materialize"

The banking industry's capital adequacy, as gauged by the Tier 1 Risk-Based Capital Ratio, reached 21.1% in Q4 2014, a razor-thin 10 basis points lower than Q3 2017 (see Fig. 8). This is the first quarter there has been a decrease of any degree in this ratio since Q2 2015, with 10 consecutive quarters of a sustained upward trend. These historically high capital levels will help local banks mitigate losses if "severely adverse" economic scenarios were to materialize. When analyzing capital adequacy by bank, Santander and Scotia, the two banks posting negative Pre-Tax ROEs in Q4 2017, boasted the highest Tier 1 Risk-Based Capital Ratios, with 28% and 43%, respectively.

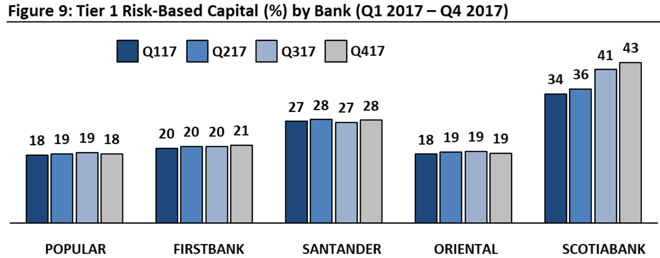
Local banks, looking for ways to effectively deploy their capital, have conducted stock repurchases (e.g. Popular's $75mn common stock repurchase concluded in 2017), effectuated stockholder dividend payments, acquired high performing loan portfolios, and seized opportunities in other markets (Oriental launched a commercial loan program in the U.S.). Popular is seeking to further solidify its leadership position by acquiring Reliable Financial Services Inc., the Wells Fargo's auto loan business in Puerto Rico. The transaction entails the acquisition of $1.5 billion (bn) in auto loans and $340mn in commercial loans, expected to close during Q2 2018.

Figure 8: Tier 1 Risk-Based Capital Ratio (%) Trend by Quarter (Q1 2014 – Q4 2017)



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

Figure 9: Tier 1 Risk-Based Capital (%) by Bank (Q1 2017 – Q4 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

(2) In Feb. 2018, nonfarm employment reached 848.3K, a 3.2% decrease or loss of 27,700 jobs with respect to Aug. 2017 (876K, month prior to the hurricanes).

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HURRICANE RELIEF MEASURES: *"Post-moratorium payments must be monitored given risks of delinquency spike"*

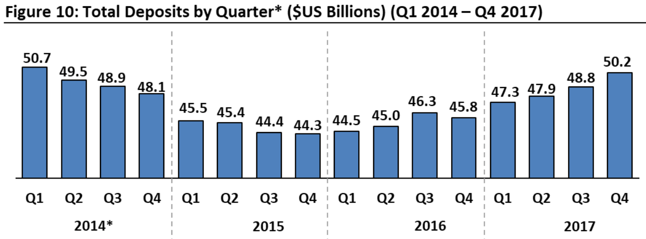
In the wake of Hurricanes Irma and María which ravaged Puerto Rico on September 2017, local banks put forth hurricane-relief measures to help their borrowers mitigate their losses, as is commonly done in post-disaster scenarios. The first and subsequent post-moratorium payments should be closely monitored to be keenly vigilant of potential asset quality deterioration. In post-Katrina disaster areas in Mississippi and Louisiana, mortgage delinquencies spiked by 25 percentage points shortly after the storm, quickly returning to pre-storm levels.

While these temporary payment deferments were offered to all clients for generally a 3-month period, not all clients participated in said program. In the case of FirstBank, which managed $12.2bn in assets in year-end 2017, 42% of the commercial portfolio participated, 46% of the residential mortgage portfolio, and 82% of the auto and personal loan portfolios. In the case of Popular, which managed $34.7bn in assets as of the end of Q4 2017, representing 56% of the $62.4bn in total commercial banking assets, 300,000 of its customers participated in the bank's loan moratorium program, benefiting from the suspension of collections, foreclosures, and non-charge processes. Oriental reported that 69% of its mortgage portfolio participated in the 3-month moratorium while Santander disclosed that 123,000 of its accounts (mortgage, personal, commercial) were under moratorium until December or January.(3)

2018 OUTLOOK: *" Benefits of inflow of post-disaster funds will be dampened by economic and fiscal uncertainties"*

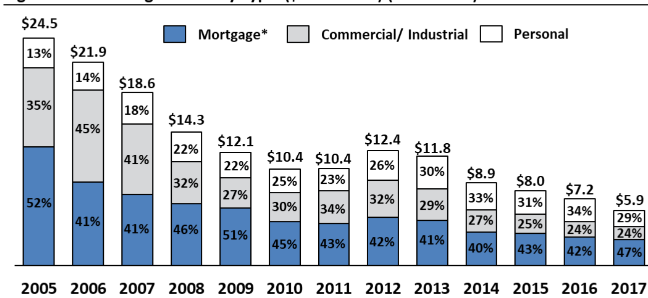
» DEPOSIT GROWTH: Industry-wide deposits at year-end 2017 stood at $50.2bn, a 3% or $1.4bn increase with respect to Q3 and a 10% or $4.4bn increase with respect to year-end 2016. Popular, who acquired $2.3bn in Doral deposits in Q1 2015, was the clear winner in deposit growth increasing its market share from 44.6% in Q4 2014 to 58% in Q4 2017 ($7.6bn increase). All other banks experienced a decrease in deposits when comparing year-end 2014 with year-end 2017. While the inflow of federal and insurance funds in the coming quarters will likely continue to sustain deposit growth in the short-term, the potential shrinkage of banks' customer base due to hurricane-induced out-migration might offset this growth.

Figure 10: Total Deposits by Quarter* ($US Billions) (Q1 2014 – Q4 2017)



*Includes Doral which had $5.0 billion in deposits in Q1 2014, $4.8 billion in Q2 2014, $4.5 billion in Q3 2014, and $4.1 billion in Q4 2014..

Figure 11: Loan Originations by Type ($US Billions) (2005-2017)



Source: Office of the Commissioner of Financial Institutions (OCFI)
*Depository and non-depository financial institutions.

» TAX CUTS AND JOBS ACT: The federal tax reform, enacted on Dec. 2017, poses a number of downside risks to Puerto Rico, threatening the island's high-tech manufacturing sector and critical Act 154 funds which amounted to $2.1bn in fiscal year 2017, representing 22% of General Fund net revenues. The tax law instituted a 12.5% tax on income generated from intangibles (i.e. patents and licenses) in foreign jurisdictions, including Puerto Rico which is treated as a "foreign tax jurisdiction" for federal tax purposes, directly impacting strategic industrial sectors like pharma and medical devices. Estudios Técnicos forecasted that the effects of this legislation will be felt more noticeably after fiscal 2019.(4)

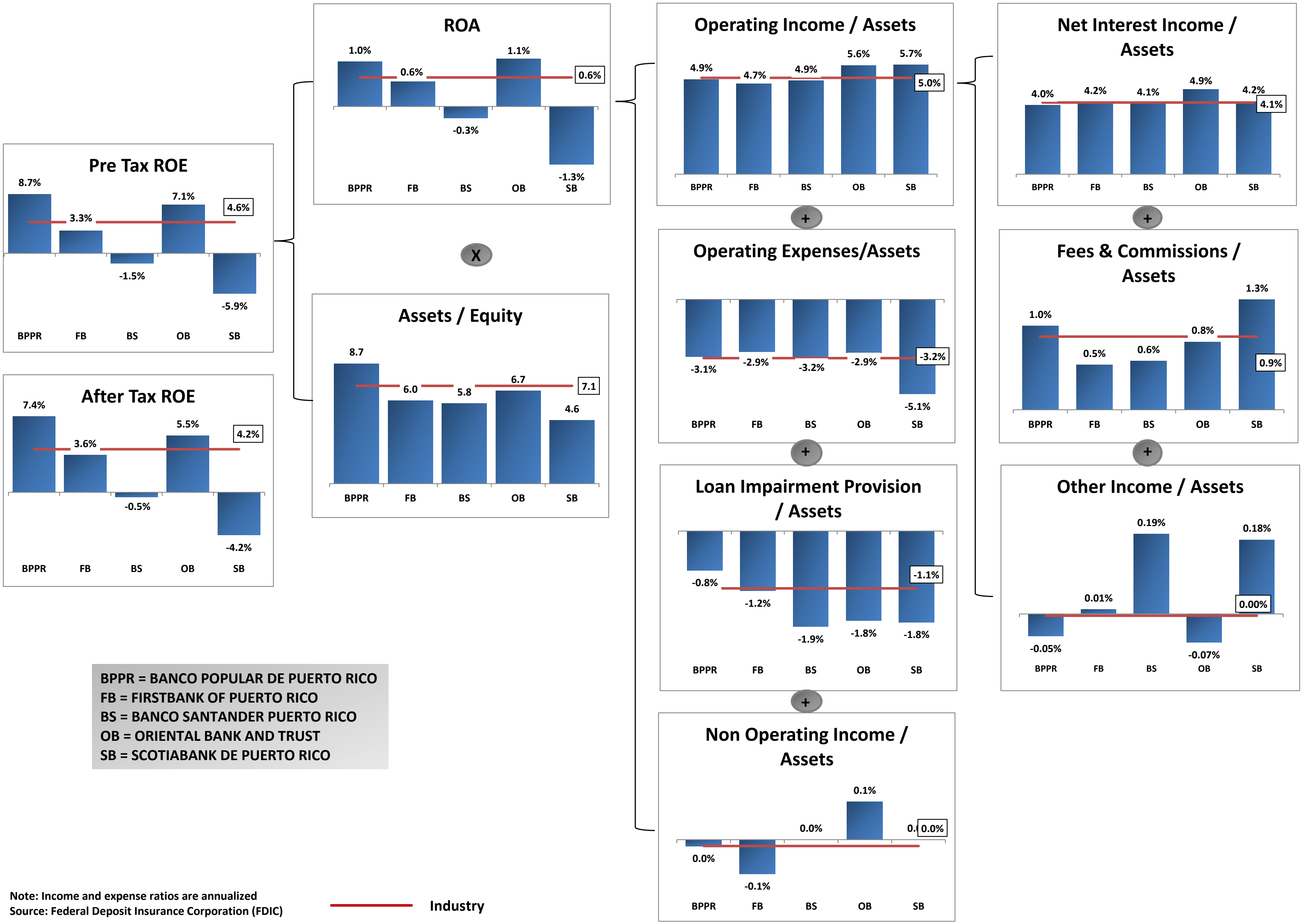
» DISASTER AID: While questions remain of the final amount, net impact, and the quickness of disbursement of funds, billions of dollars will undoubtedly be flowing into the island throughout 2018 and beyond. The most up-to-date fiscal plan assumes $49.1bn in federal assistance as per current law ($12.8bn from Community Development Block Grant Program, 35.3bn in FEMA Public Assistance Funding, and more than $4bn in Community Disaster Loans) and $21bn from private insurance for a total of $70.1bn in disaster relief assistance, to be spent over several years.

» LOAN ORIGINATIONS: Total loan originations (i.e. mortgage, personal, and commercial/ industrial) in 2017 reached $5.9bn, 60% of which were originated in the first half of 2017 (see Figure 11). This represents a decrease of 18% or $1.3bn with respect to 2016 and a decrease of 76% or $18.6bn vis-à-vis 2005. Loan demand will likely normalize in the coming quarters as rebuilding efforts continue to pick up steam. Construction lending, decimated by the current economic crisis, will receive a much needed boost driven by post-disaster recovery and reconstruction efforts.

In sum, the banking sector has demonstrated resilience in the face of a uniquely challenging operating market. On the upside, disaster relief monies will help stimulate banking activity, but on the downside, challenging risks remain.

(3) Coto, D. (2018, January 26). Puerto Rico awaits foreclosure wave as moratoriums expire. Retrieved from http://www.chicagotribune.com.
(4) Estudios Técnicos, Inc. (2018, January) . The Federal Tax Cuts and Jobs Act (TCJA). Retrieved from https://www.estudiostecnicos.com/pdf/perspectivas/2018/.

ANNEX 1: BANKING INDUSTRY PROFITABILITY 2017

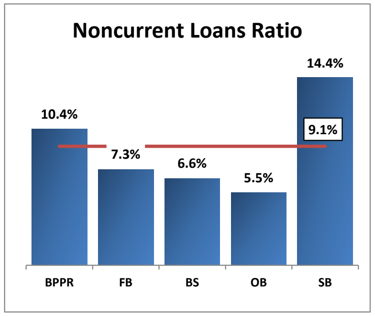


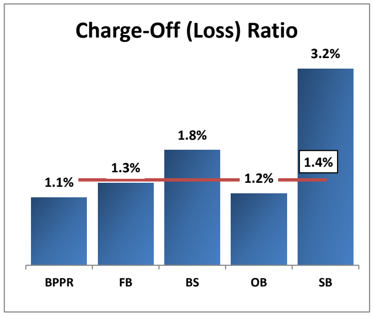
BPPR = BANCO POPULAR DE PUERTO RICO
FB = FIRSTBANK OF PUERTO RICO
BS = BANCO SANTANDER PUERTO RICO
OB = ORIENTAL BANK AND TRUST
SB = SCOTIABANK DE PUERTO RICO

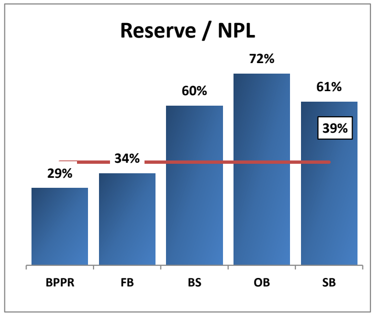
Note: Income and expense ratios are annualized
Source: Federal Deposit Insurance Corporation (FDIC)

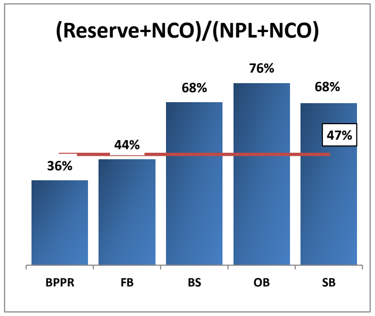
ANNEX 2: BANKING INDUSTRY PERFORMANCE RATIOS 2017

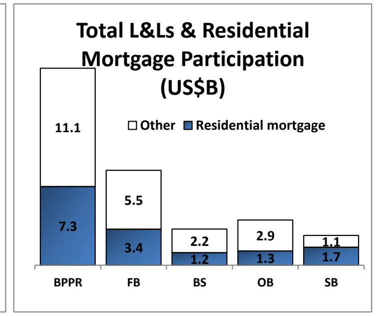
ASSET QUALITY



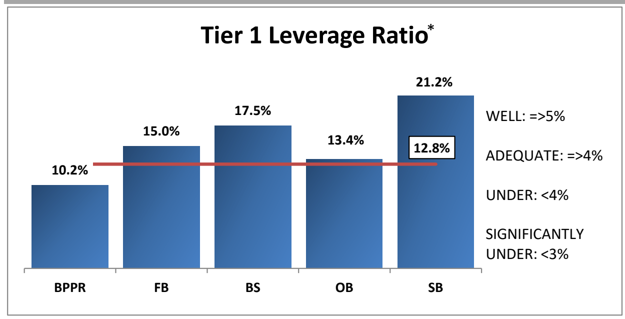


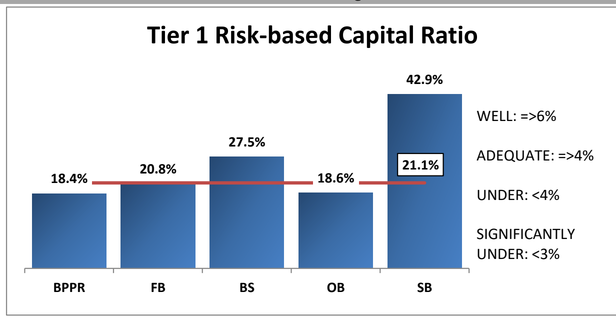


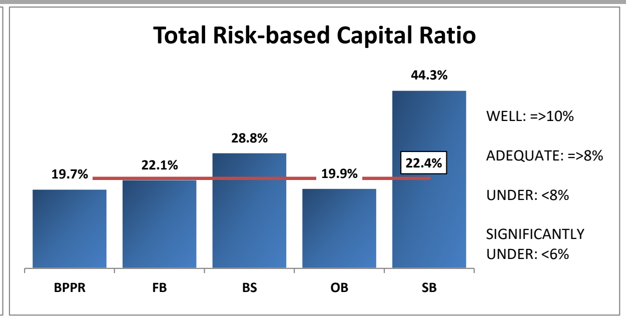




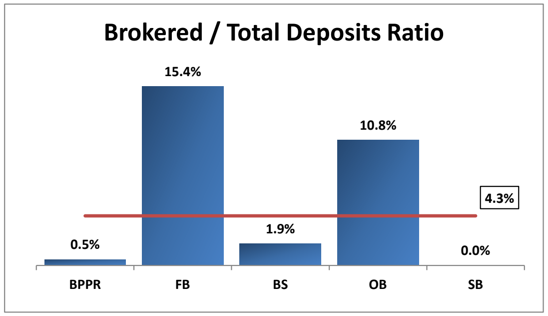
CAPITAL ADEQUACY

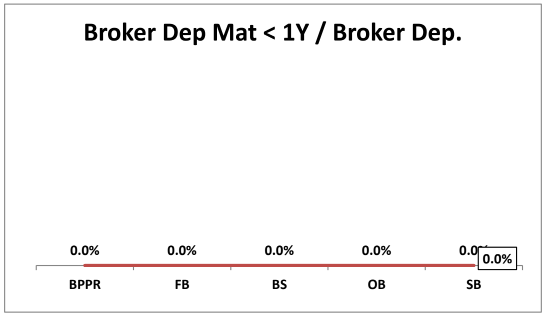




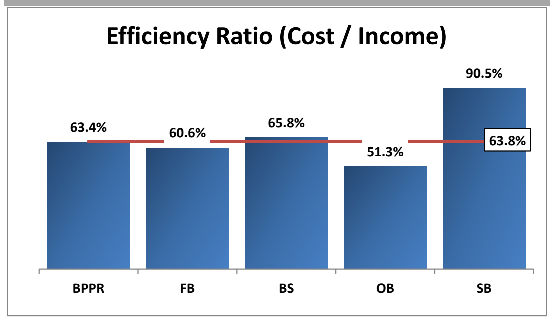


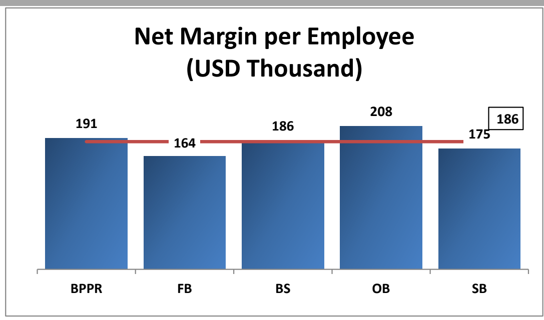
LIQUIDITY





PRODUCTIVITY





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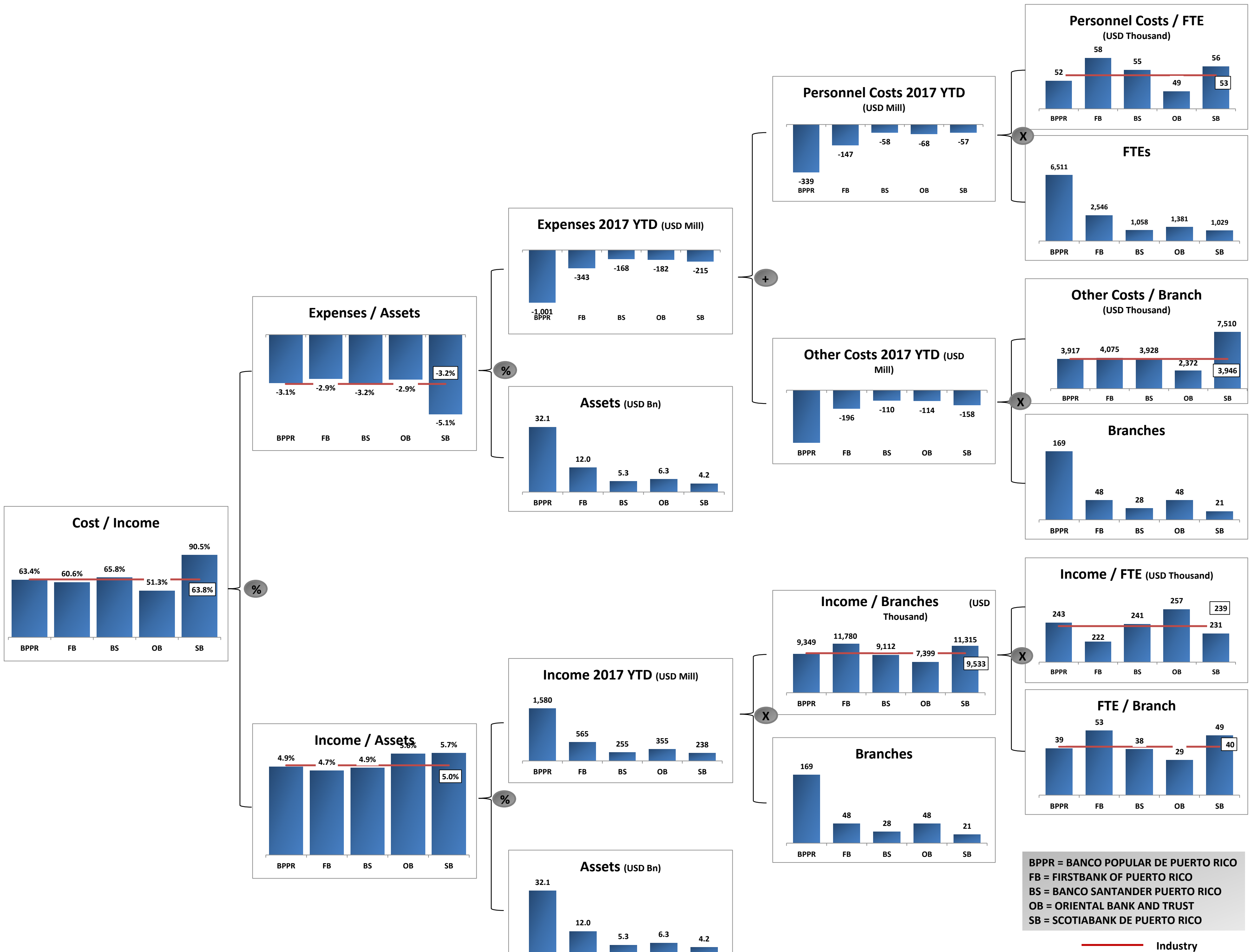
Industry

*** 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)

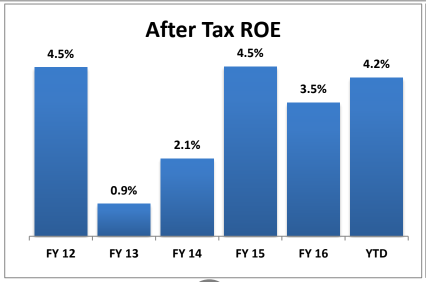
ANNEX 3: BANKING INDUSTRY PRODUCTIVITY 2017

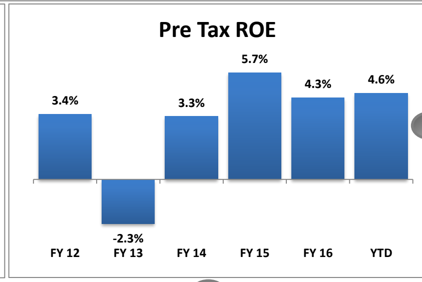


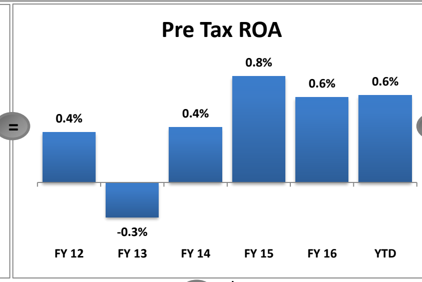
Note 1: Expense and income ratios are annualized.
Note 2: Bank offices as reported by the Office of the Commissioner of Financial Institutions (OCFI) of Puerto Rico as of June 2017.

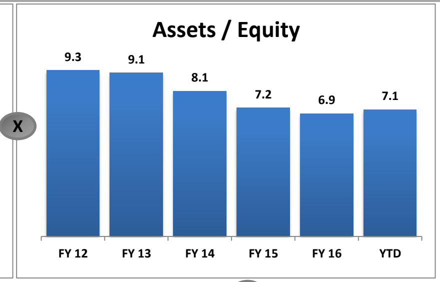
ANNEX 4: INDUSTRY TRENDS - SELECTED METRICS

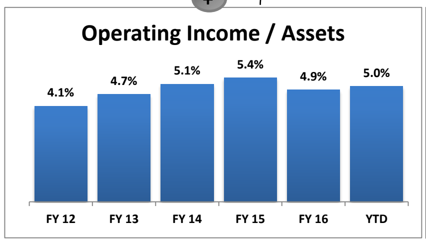
PROFITABILITY

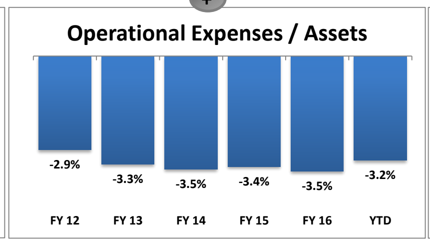


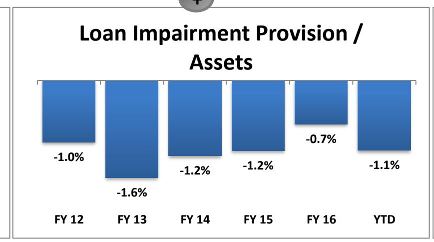


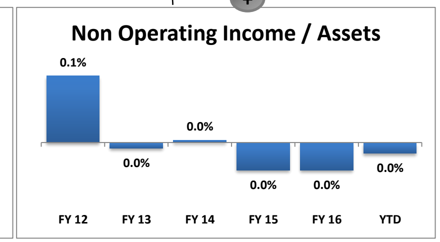




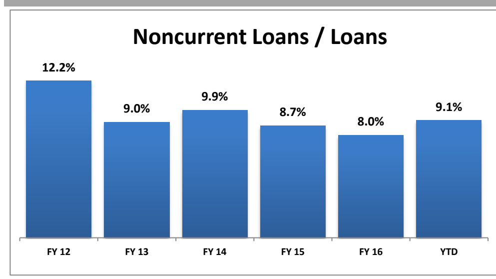


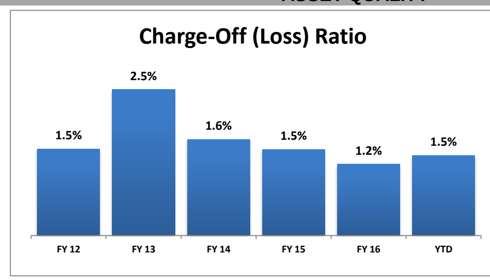


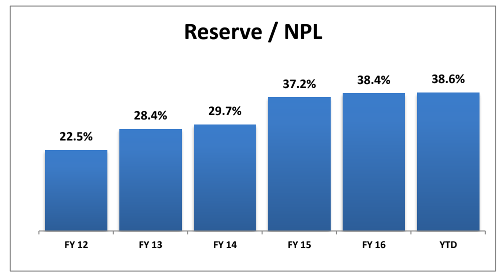


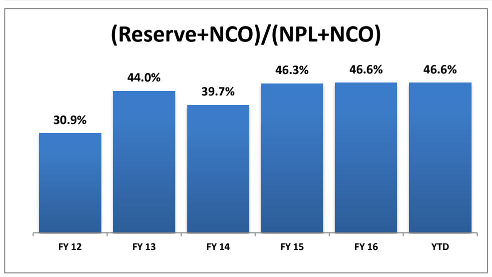


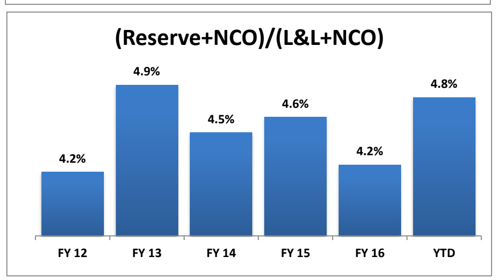
ASSET QUALITY





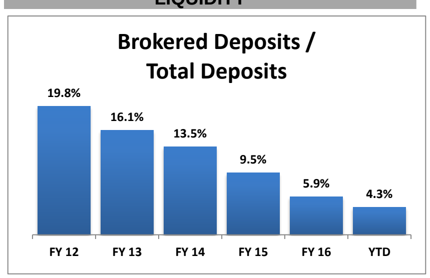




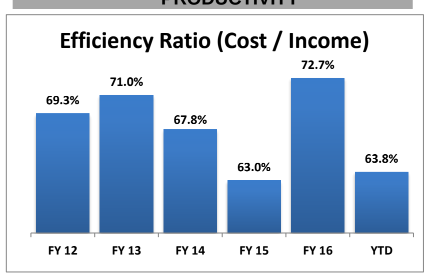


Notes:
Asset quality ratios are not adjusted for FDIC covered and available for sale portfolio.
YTD numbers are annualized.
Source: Federal Deposit Insurance Corporation (FDIC)

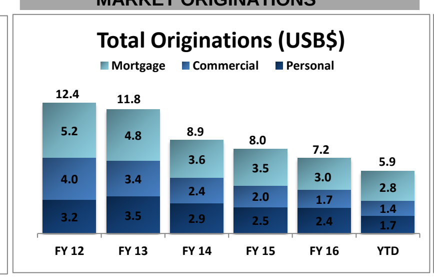
LIQUIDITY



PRODUCTIVITY



MARKET ORIGINATIONS



TOTAL ASSETS