Puerto Rico Banking Industry Report

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INSIDE THIS ISSUE:

The local banking industry's profitability on a consolidated basis has rebounded strongly in the wake of Hurricanes Irma and Maria, reaching a Pre-Tax ROE of 17.4% in Q2 2018, making it the highest quarterly profitability level in a decade. The liquidity position of local banks, particularly of Popular, has experienced a material improvement, with total deposits reaching $54.1 billion as of the end of Q2 2018 from $48.8 billion in Q3 2017, a $5.3 billion or 10.9% increase. Hurricane-related private insurance claims paid out to policyholders and post-disaster federal assistance funds deposited in private banks have largely driven this surge in deposits. This newfound liquidity will need to be put to productive use, either through increased lending or investments. The unadjusted nonperforming loans ratio showed some improvement in Q2 2018, decreasing from 9.2% to 8.8%, temporarily appeasing concerns of a spike in delinquencies. Capital positions of banks continue exceedingly strong, reporting an industry-wide Tier 1 Risk-Based Capital Ratio of 21.5%. The deployment of excess capital through organic and inorganic growth opportunities (e.g. Popular's Reliable purchase), stock repurchases or dividend payments to shareholders must be strategically pondered. Moreover, in this revamped issue we analyze Post-Hurricane Maria foreclosure relief efforts and their impact on banks and the housing market.

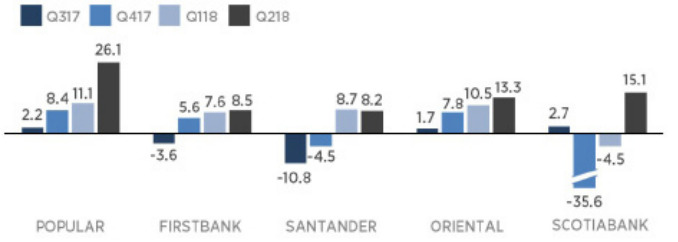
PROFITABILITY > "The local banking industry's Pre-Tax ROE in Q2 2018 reached 17.4%, highest quarter profitability since Q1 2008" Local banks, on a consolidated basis, experienced strong growth in profitability in Q2 2018, registering the highest quarterly Pre-Tax ROE (17.4%) since Q1 2008, as the Island's economy gradually continues to recover and post-disaster rebuilding efforts pick up steam (see Figure 1). While myriad challenges and downside risks certainly remain (i.e. uncertainties regarding bankruptcy proceedings under PROMESA[2], impact of curtailing public expenditures, unsettling projections of population decline[3], among others) the headwinds faced by local banks in the aftermath of one of the largest and most devastating hurricanes in history seem to be short lived. As has occurred in other disaster-impacted areas, Katrina in New Orleans and, more recently, Harvey in Houston, the hurricane-induced dip in revenues and the nonrecurring spike in expenses are temporary. They are normally followed by an increase in deposits and strong lending activity driven by the disbursement of insurance claims and recovery and reconstruction efforts.

Improvement in the Economic Development Bank's Economic Activity Index (EDB-EAI), a coincident index composed of nonfarm employment, cement sales, gasoline consumption, and electricity generation, has been sluggish at best. While on an upward trend on a month-by-month (MoM) basis from December 2017 to June 2018, it continues to be in negative territory on a year-over-year (YoY) basis. This closely followed index, which is highly correlated to Puerto Rico's real gross national product (GNP), will likely enter into positive territory on a YoY basis in the second half of 2018 as post-disaster disbursements and reconstruction efforts continue their course.

FIGURE 1: Industry Pre-Tax ROE Trend by Quarter* (Q1 2015 – Q2 2018)[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%.

FIGURE 2: Quarterly Pre-Tax ROE (%) by Bank (Q3 2017 – Q2 2018)



When analyzing profitability by bank, Popular leads the way with an annualized Q2 2018 Pre-Tax ROE of 26.1% in Q2 2018 (see Figure 2) and an annualized YTD 2018 Pre-Tax ROE of 18.6% (see Figure 3). Popular, which manages $37.8 billion in assets representing 57% of total assets as of the end of Q2 2018, performed better vis-à-vis the industry due to higher financial leverage, which was partially offset by lower interest income. Popular registered by far the highest assets-to-equity ratio of 9.8, followed by Oriental with 6.6 (see Annex 1). With the purchase of Reliable, Wells Fargo's auto finance business in Puerto Rico, Popular further expands its income-generating capacity and becomes the indisputable leader of the local auto finance industry[4]. Oriental reported the second highest YTD 2018 Pre-Tax ROE with 11.9%, followed by Santander with 8.5% and FirstBank with 8.1%. Scotia posted the second highest quarterly profitability in Q2 2018 (15.1%) after being in the negative for the previous two quarters.

FIGURE 3: Reconciliation of the Industry's Pre-Tax ROE and each bank's Pre-Tax ROE by income-expense category (YTD 2018)

LIQUIDITY > "Total deposits of the banking industry have increased by $5.3 billion or 10.9% since the historic 2017 hurricane season (Q3 2017)" Total deposits for the banking industry as a whole have been increasing materially in the wake of Hurricanes Irma and Maria, from $48.8 billion as of the end of Q3 2017 to $54.1 billion at the end of Q2 2018, representing an increase of $5.3 billion or 10.9% (see Figure 4). Much of this increase can be attributed to private insurance disbursements, implementation of temporary moratoriums on borrower obligations, and federal assistance funds. Based on an analysis by the Office of the Insurance Commissioner of Puerto Rico, the New Fiscal Plan estimates private insurance disbursements of $8 billion through FY2026, of which roughly $4.4 billion or 55% from FY2018 to FY2020. Insurance disbursements will continue to fuel deposit growth, as has occurred in other disaster-stricken areas. For example, New Orleans banks following Hurricane Katrina (2005) experienced an annual deposit growth of 30%, from 10% prior to the hurricane.[5] As deposits grow, the liquidity position of banks will continue to strengthen, and banks will need to look for productive ways to deploy the liquid assets. This may be done through increased lending to continue fueling the reconstruction and economic recovery efforts or expanding their investment portfolios. Furthermore, brokered deposits currently only represent 3% of total deposits from more than 40% in 2008 (see Figure 4 and Annexes 2 and 4).

Popular has seen its deposits grow the most among local banks, reaching $32.7 billion at the end of Q2 2018 (quarter-over-quarter increase of $1.9 billion). The deposits of the largest banking institution represent 60.5% of the total, followed by FirstBank with 17.1% and Oriental with 9%. Santander and Scotia, which operate locally as affiliates of large multinational financial entities, reported deposits of $4.2 billion (7.7%) and $3.1 billion (5.7%), respectively.

ASSET QUALITY > "The unadjusted nonperforming loans ratio fell to 8.8% in Q2 2018, after rising to above 9% in the wake of the hurricanes" The industry-wide unadjusted nonperforming loans ratio[6], defined as loans past due 90 days or more and still accruing plus loans in nonaccrual status divided by total loans and leases, dropped to 8.8% in Q2 2018 from 9.2% in Q1 2018, quelling, to some extent, concerns of a potential spike in delinquencies driven by the economic and financial hardships faced by households and businesses in the post-disaster context. Post-disaster loan moratoriums, which impacted asset quality following the September 2017 hurricanes, will be closely examined subsequently in pages 3 and 4.

When looking at the health of the labor market, which impacts banks' asset quality metrics, we see that the unemployment rate reached 9.1% in July 2018, a historically low number. Notwithstanding, the labor force participation rate remains abysmally low, reaching 41% (62.9% in the US).

CAPITAL ADEQUACY > "Capital position of local banks remains strong with a Tier 1 Risk-Based Capital Ratio of 21.5% in Q2 2018" The Tier 1 Risk-Based Capital Ratio of the local banking industry on a consolidated basis slightly dipped in Q2 2018 to 21.5% from 21.8%. Nevertheless, capital ratios of local banks largely exceed "well capitalized" levels, placing them in a favorable position in the event that economic conditions deteriorate and losses ensue. In 2007 and 2008 this metric stood at less than 10%.

Given this strong capital position, banks are under pressure to efficiently and effectively deploy their excess capital through either stock repurchases, dividend payments to shareholders, organic growth, or inorganic growth through opportunistic portfolio purchases. Popular, for example, followed an inorganic growth strategy with the acquisition of Reliable, Wells Fargo's auto finance business in the island, agreeing to purchase approximately $1.9 billion in auto-related loans. This transaction served as a catalyst for the bank to become the leader of Puerto Rico's auto financing sector with a 49% auto loan market share and a 69% share in auto leasing. Furthermore, Popular, which terminated its loss-share agreements with the FDIC, announced an up to $125 million common stock repurchase plan.

FIGURE 4: Total Deposits Trend by Quarter ($US Billions) (Q1 2015 – Q2 2018)

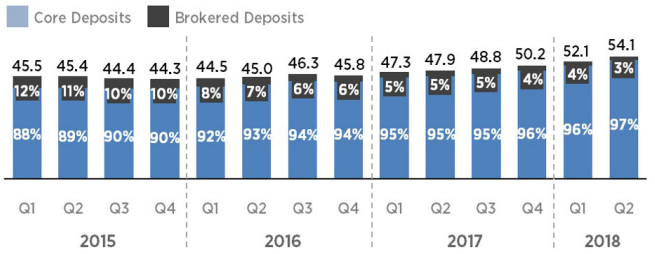


FIGURE 5: Total Deposits by Bank by Quarter ($US Billions) (Q3 2017 – Q2 2018)

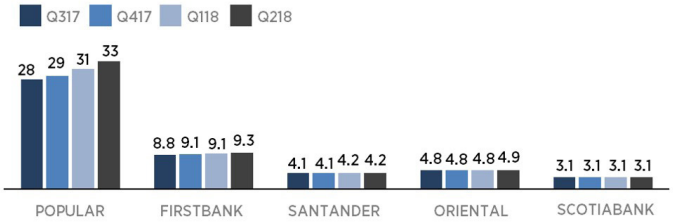
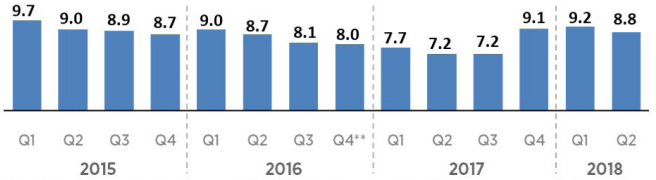
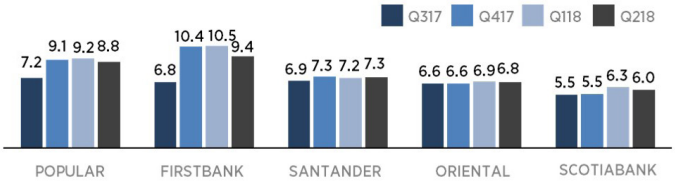


FIGURE 6: Industry Unadjusted Nonperforming Loans Ratio* (%) (Q1 '15 - Q2 '18)



* Unadjusted nonperforming loans ratio is defined as loans past due 90 days or more and still accruing plus loans in nonaccrual status divided by total loans and leases.

FIGURE 7: Unadjusted Nonperforming Loans Ratio* by Bank (Q3 2017 – Q2 2018)



* Unadjusted nonperforming loans ratio is defined as loans past due 90 days or more and still accruing plus loans in nonaccrual status divided by total loans and leases.

FIGURE 8: Industry Tier 1 Risk-Based Capital Ratio (%) Trend (Q1 2015 – Q2 2018)

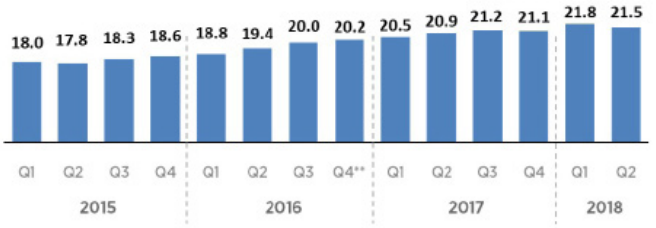
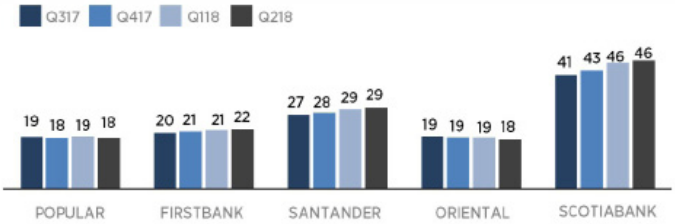


FIGURE 9: Tier 1 Risk-Based Capital Ratio (%) Trend (Q3 2017 – Q2 2018)



POST-MARIA FORECLOSURE RELIEF MEASURES > "Local banks, given post-disaster foreclosure rules and regulations and the strained financial situation of many homeowners, provided 90-day foreclosure moratoriums which were subsequently extended" The devastating Atlantic hurricanes of September 2017 further worsened the already challenging economic panorama in Puerto Rico, weakening the financial condition of many households and homeowners. In order to lessen the financial pressure on families post-disaster, temporary mortgage and foreclosure relief measures and programs were implemented, as is often done in the wake of disasters. The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), government-sponsored enterprises (GSEs) and the guarantors of many mortgage loans, allow their mortgage servicers (mostly Popular and to a lesser extent Scotia in the case of Puerto Rico) to provide suspensions on mortgage payments of at least 90 days, and a moratorium of foreclosure actions of at least 90 days directly after a natural disaster, also advising them to workout remedial plans for delinquent loans. The Federal Housing Administration (FHA), part of the U.S. Department of Housing and Urban Development (HUD) and the Department of Veterans Affairs (VA), government-insured mortgage agencies, also make available mortgage and foreclosure relief programs. Residential mortgages not backed-up by these governnment-related entities may also offer forbearance agreements, but the owners and servicers have more discretion as to how to proceed.

A 90-day halt of foreclosure executions was given to eligible homeowners in presidentially-declared disaster areas. Given the still precarious financial situation of many homeowners after the 90 days expired, the foreclosure relief was extended until March 31, 2018, further extended to May 31, and subsequently to September 16, essentially providing a yearlong moratorium. The Federal Housing Administration also introduced programs to provide relief to eligible howmeowners that will be available once the moratoriums expire: the Disaster Loan Modification and the Disaster Standalone Partial Claim[7] to develop financially sustainable loan repayment plans and avoid payment shocks.

INDUSTRY LOANS AND LEASES COMPOSITION > "Residential mortgages represented, as of the end of Q2 2018, 41% of the industry loans and leases total" Prior to presenting the analysis of post-disaster residential mortgage delinquency and foreclosure numbers, it is suitable to present the current breakdown of loans and leases portfolio by bank and of the industry as a whole, to be cognizant of the relative importance of residential mortgages to the banking sector. The local banking industry's loans and leases portfolio on a consolidated basis reached $34.5 billion as of the end of Q2 2018, with residential mortgages representing 41% (see Figure 10). This is a decrease of $9.3 billion or 21% with respect to Q4 2014. Close to three quarters (72%) of this drop was driven by a decrease in construction, and public sector loans, as banks have aggressively cleaned their balance sheets of toxic and government-related assets, while the industry-wide residential mortgage portfolio decreased by $2.3 billion or 14% in said time period (25% of the drop). When analyzing the loan mix by bank, Scotia had the highest percentage of residential mortgages as a percent of total loans and leases with 63%, followed by Popular with 44% (see Figure 11). Oriental, with the industry's highest percentage of its loan mix in consumer loans and leases (32%), also had the lowest percentage in mortgages (29%).

FIGURE 10: Industry Loans and Leases Portfolio ($US Billions)

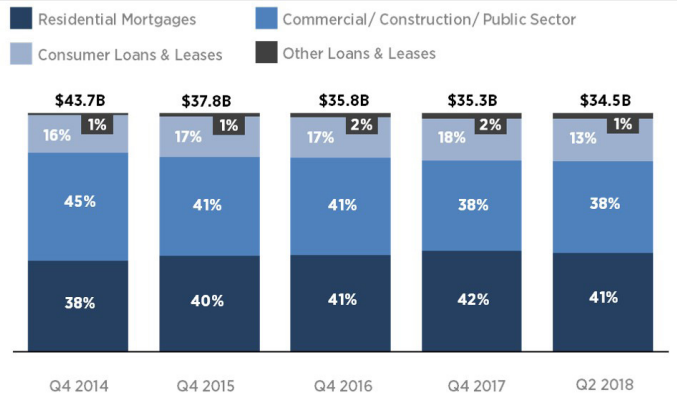
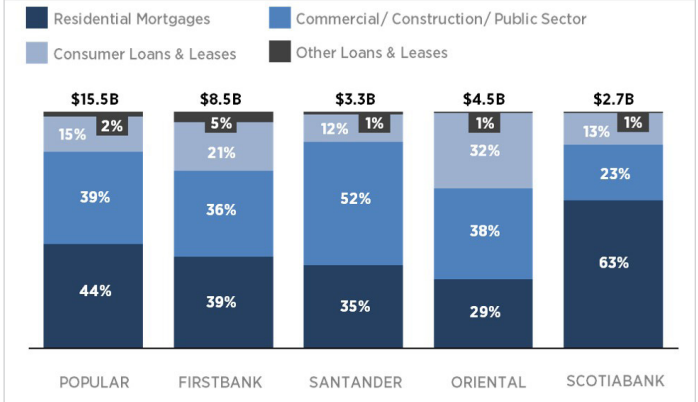


FIGURE 11: Loans and Leases Portfolio by Bank of Q2 2018 ($US Billions)



FORECLOSURE MORATORIUM IMPACT > "The foreclosure moratorium has dramatically decreased the number of foreclosures, from 1,723 in Q2 2017 to 1,001 in Q3 2017 and 97 in Q4 2017" As with almost all initiatives, unintended consequences usually surface. In this case, the stalling of foreclosures has impacted the housing and mortgage markets considerably. During normal times, banks bring foreclosed properties to market, adding to the inventory of properties for sale. Given the 12 month moratorium on foreclosures, the number of available for sale foreclosed properties has decreased, while the number of delinquent mortgage loans have increased (i.e. past 90 day portfolio increases). In Figure 12 we see a clear drop in foreclosed units in Q3 2017 and subsequent quarters, from 1,723 residential units foreclosed in Q2 2017 to 1,001 in Q3 2017 and 97 in Q4 2017. While the residential units foreclosed have picked up in Q1 and Q2 of 2018, 501 and 428, respectively, they remain much lower than pre-disaster numbers. From September 2017 to June 2018, only 1,125 residential units were foreclosed. If the monthly average number of residential units foreclosed from January to August 2017 had continued (i.e. 547 foreclosed units per month) from September 2017 to June 2018 (essentially removing the exogenous shocks of September 2017) approximately 5,470 residential units would have been foreclosed during that period. In other words, approximately 4,300 to 4,400 properties that in non-moratorium times would have been foreclosed, but as of the end of June 2018 were reported as delinquent. We should therefore expect a wave of foreclosures once the foreclosure moratoriums fully expire.

Figure 13 depicts the breakdown of the industry-wide mortgage portfolio performance, clearly showing that from Q3 2017 to Q4 2017 there was a big jump in the percentage of 90-day delinquent mortgage loans, from 7% to 20%. While there has been a decrease in subsequent quarters, it still remains well above pre-disaster levels. Furthermore, the potential wave of foreclosures will lead to a sudden oversupply of foreclosed properties, exerting downward pressure on home prices.

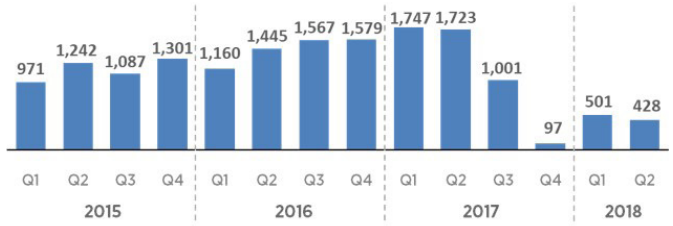
The Office of the Commissioner of Financial Institutions also provides the number of residential mortgages foreclosed by bank. As can be observed in Figure 14, Popular

has significantly decreased the number of foreclosures, from 2,548 in 2017 to 308 in the first half of 2018 on an annualized basis. This reduction should come as no surprise considering that Popular is the main servicer in Puerto Rico for Freddie Mac, Ginnie Mae, and Fannie Mae. However, given that the drop has been so dramatic, it begs the question whether Popular was also "lax" in executing foreclosures of its own portfolio. That would be aligned with the increase in the +90 days past due portfolio which represented 14.9% of Popular's residential mortgage portfolio in June 2018 compared to 7.5% in June 2017. On the opposite side, Santander foreclosed 289 residential properties in 2017 and 273 in the first six months of 2018 (546 on an annualized basis). Scotia and Firstbank did reduce the number of foreclosures in the first half of 2018 (on an annualized basis) when compared to 2017, but not dramatically, from 591 to 420 in the case of Scotia and from 553 to 436 in the case of FirstBank.

We can therefore conclude that the reduction in the available for sale properties in the market is somewhat artificial. We expect that number to increase significantly once the moratorium expires, which may have further consequences for the real estate market. Banks that have reduced foreclosure efforts for their own mortgage portfolio should continue monitoring their delinquency indicators as the moratorium expires. Moreover, banks' mortgage servicing units shoud also assess whether the moratorium has increased or decreased their servicing costs vis-à-vis the fee income they receive from servicing the loans.

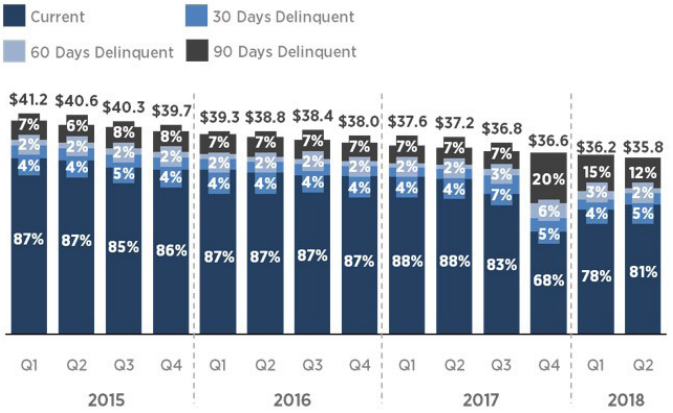
FINAL REMARKS > In summary, the local banking sector has performed quite well in the first half of 2018 considering the myriad challenges in the local operating market. Concerns over a rise in nonperforming loans have been appeased, for now, with the nonperforming loans ratio decreasing in Q2 2018 when compared to the previous two quarters. The stronger liquidity position of banks, given the surge in deposits, creates opportunities for increased lending to fuel the ongoing historic recovery and reconstruction.

FIGURE 12: Total Residential Units Foreclosed (Q1 2015 – Q2 2018)



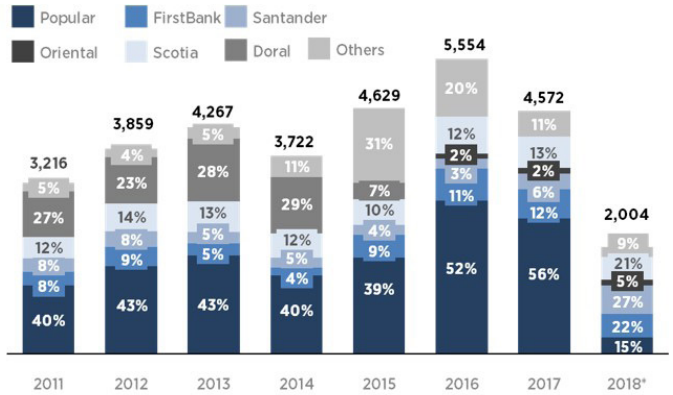
Source: Office of the Commissioner of Financial Institutions (OCFI) of Puerto Rico

FIGURE 13: Mortgage Portfolio Performance ($US billions) (Q1 2015 – YTD 2018*)



Source: Office of the Commissioner of Financial Institutions (OCFI) of Puerto Rico
* End of the quarter

FIGURE 14: Residential Units Foreclosed by Financial Institution (2011 – 2018)



Source: Office of the Commissioner of Financial Institutions (OCFI) of Puerto Rico
* 2018 January to June 2018 annualized.

SOURCES AND ENDNOTES

Figures 1–14: Federal Deposit Insurance Corporation (FDIC), Office of the Commissioner of Financial Institutions (OCFI), 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) PROMESA: Puerto Rico Oversight, Management, and Economic Stability Act of 2016

(3) According to the Financial Oversight and Management Board's (FOMB) demographer, Puerto Rico's population will drop from 3.1 currently to 3 million by 2024, 2.5 million by 2036 and 2 million by 2050.

(4) Link to V2A article on Popular's purchase of Reliable and its implications on the local auto finance market: http://www.v-2-a.com/news-detail/128-113-popular-becomes-the-indisputable-leader-of-the-auto-financing-industry-with-the-acquisition-of-reliable/

(5) Demos, Telis (2017, August 29) For Banks, Harvey's Hit Shouldn't Prove Long-Lasting. Wall Street Journal. Retrieved from https://www.wsj.com/articles/for-banks-harveys-hit-shouldnt-prove-long-lasting-1504032511

(6) The unadjusted nonperforming loans ratio does not exclude FDIC covered portfolios, held for sale portfolios and guaranteed portion of portfolios insured by the U.S. government.

(7) FHA's Disaster Standalone Partial Claim option allows eligible homeowners to resume their pre-disaster mortgage payments without facing a crippling payment shock. A second loan free of interest, payable only when the home sells or is refinanced, may be originated covering up to 12 months of missed mortgage payments.

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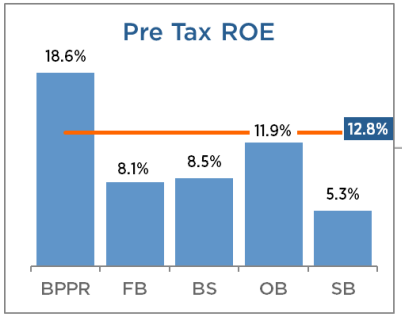
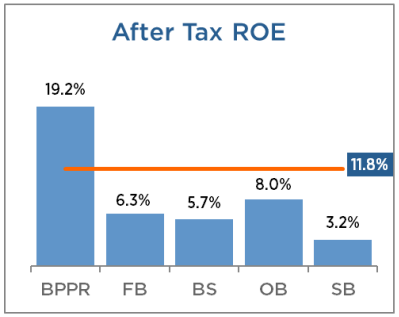
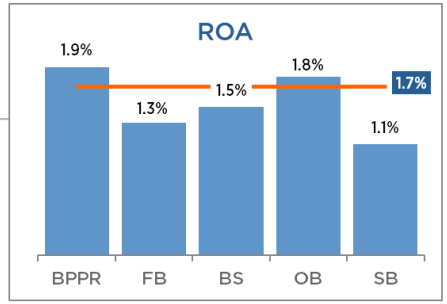
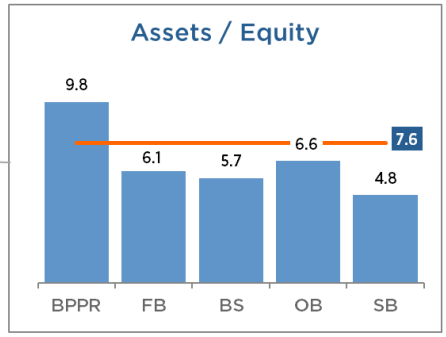
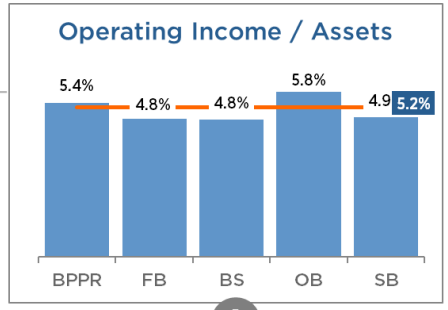
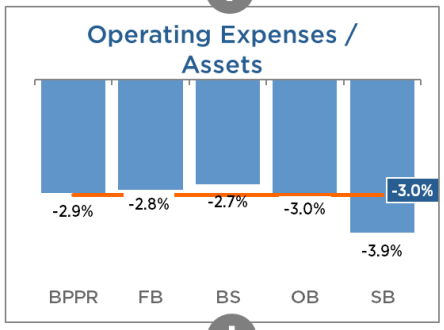


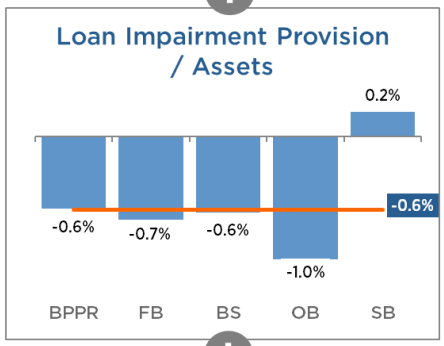


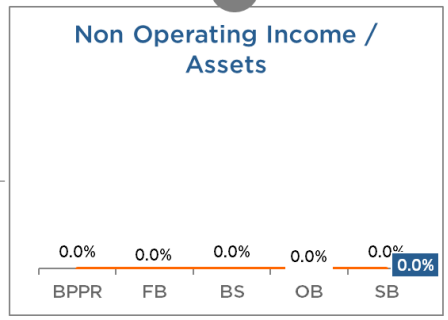


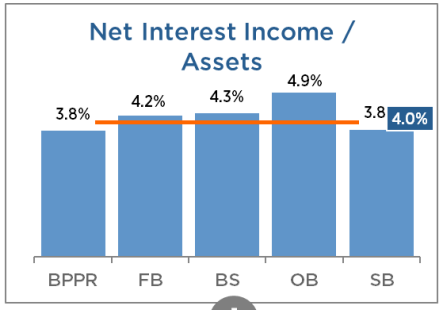


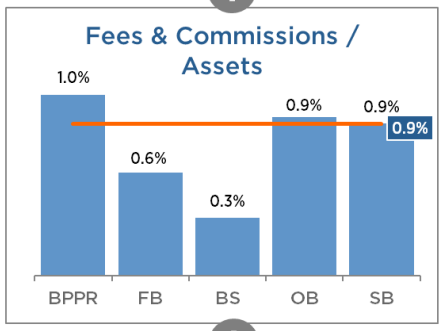


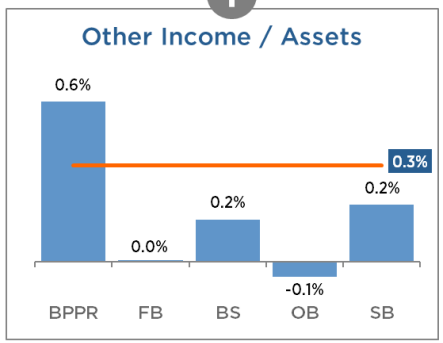












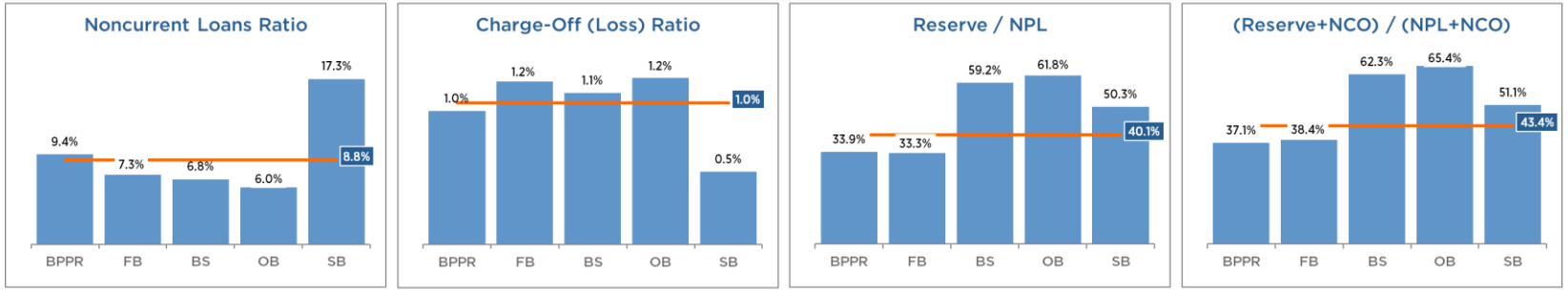
BPPR – Banco Popular de Puerto Rico
FB - FirstBank of Puerto Rico
BS - Banco Santander de Puerto Rico
OB - Oriental Bank and Trust
SB - Scotiabank de Puerto Rico

Industry

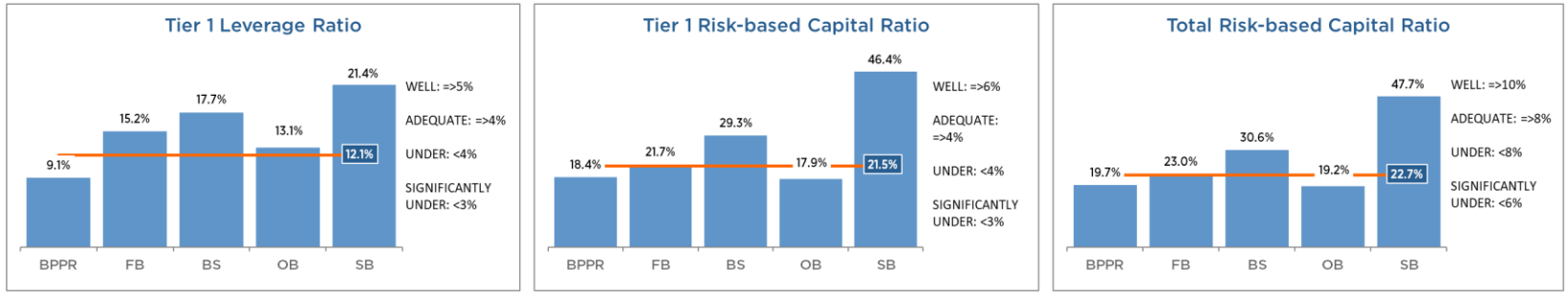
* Also referred to as Core Capital (leverage) Ratio by the FDIC.

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)

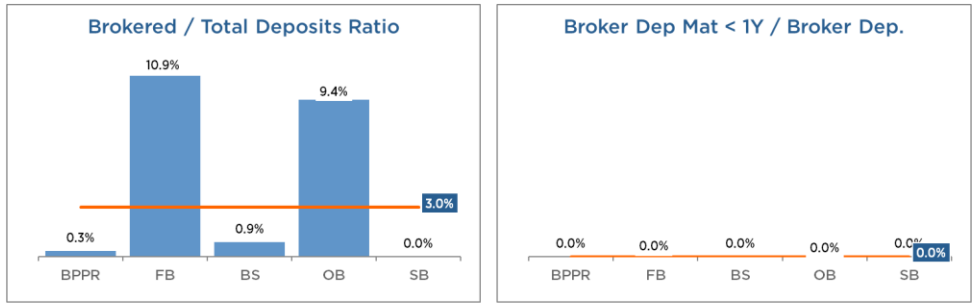
Asset Quality



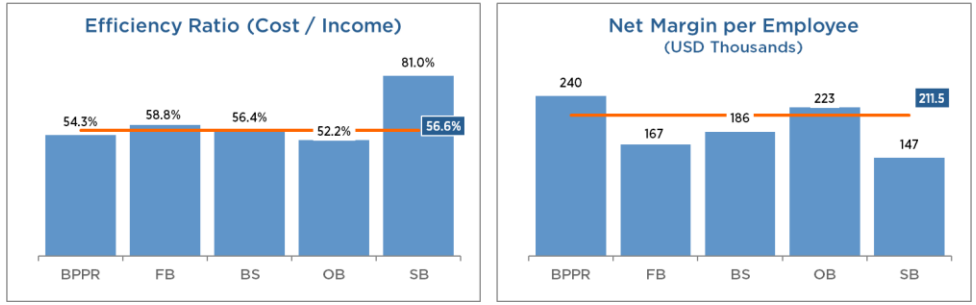
Capital Adequacy



Liquidity



Productivity



BPPR – Banco Popular de Puerto Rico
FB - FirstBank of Puerto Rico
BS - Banco Santander de 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)

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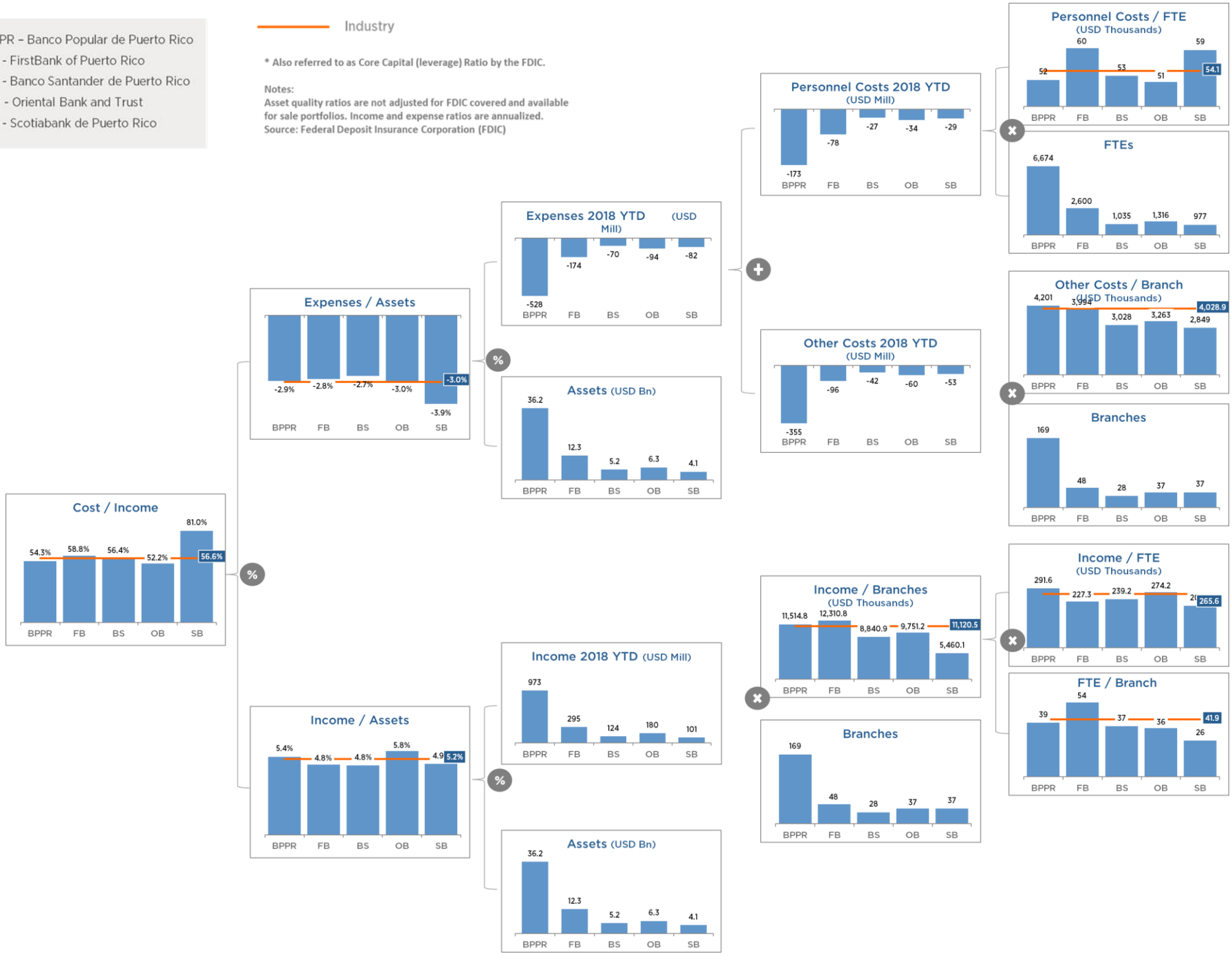
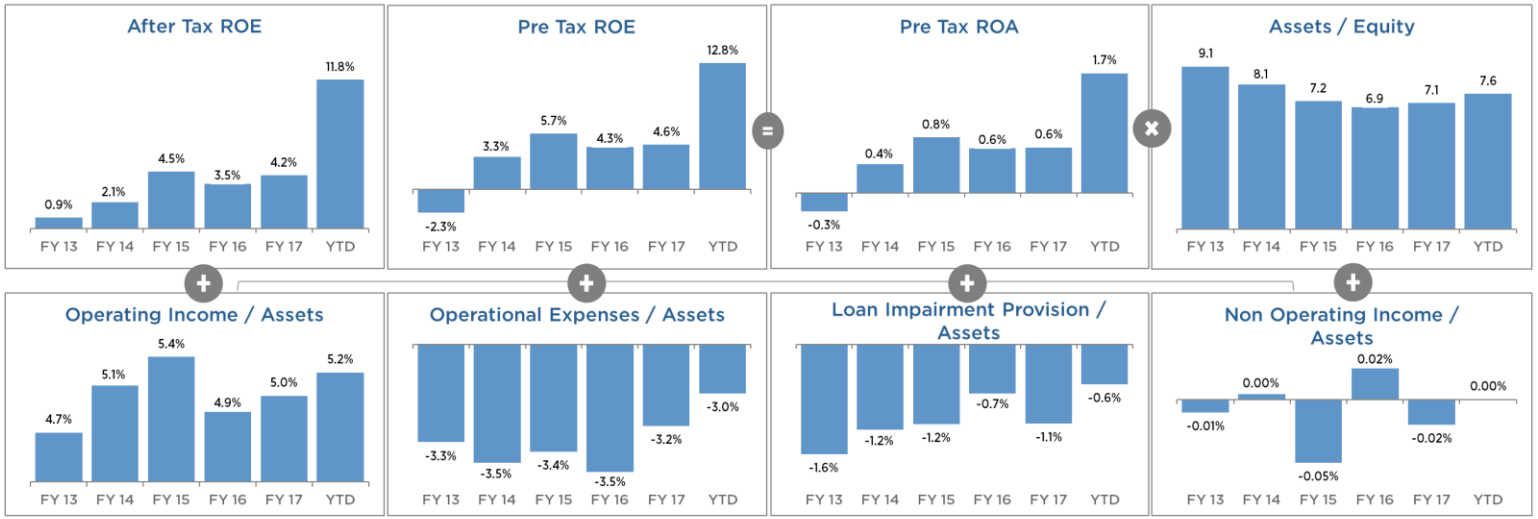
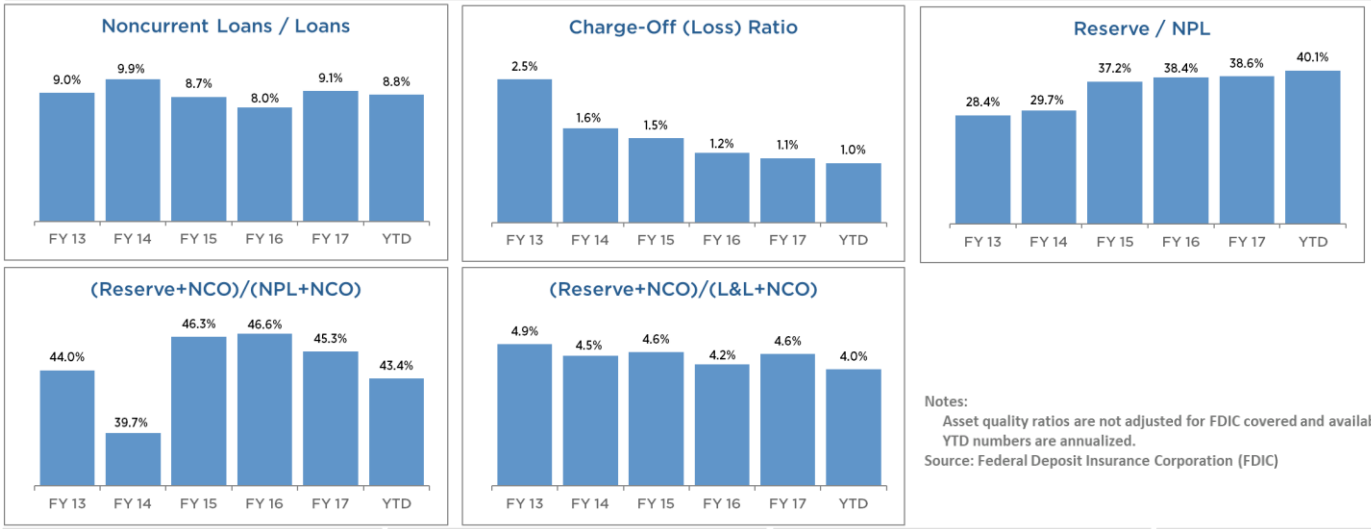


Profitability

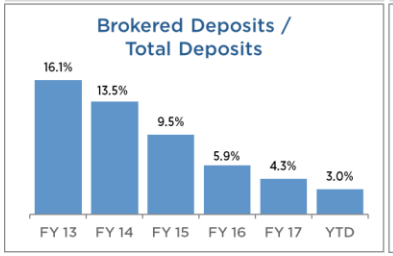


Asset Quality

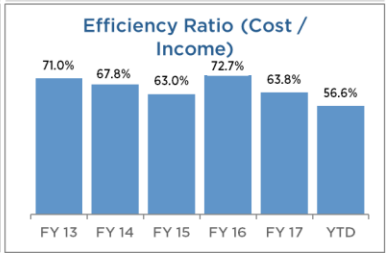


Notes:
Asset quality ratios are not adjusted for FDIC covered and available for sale portfolio.
YTD numbers are annualized.
Source: Federal Deposit Insurance Corporation (FDIC)

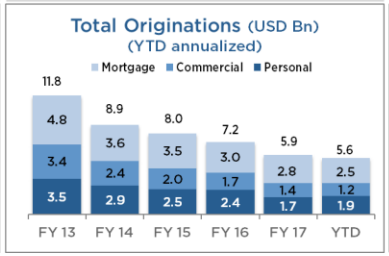
Liquidity



Productivity



Market Originations



Total Assets