Puerto Rico Banking Industry Report

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The Puerto Rico banking industry closed the year 2018 on a high note, registering a Pre-Tax ROE of 14%, the highest level of profitability since 2005. The divergence between the profitability of local banks and US commercial banks narrowed significantly in 2018 with US commercial banks reporting a Pre-Tax ROE of 15.1%. The local banking industry has become increasingly concentrated with Popular holding $37.9 billion (58%) in assets of an industry total of $65.9 billion, and the three largest banks, i.e. Popular, FirstBank and Oriental, accounting for 84% of the total. The industry-wide cost to income reached 55.9% in 2018, the lowest level since prior to the onset of the economic downturn of 2006. With few opportunities to deploy excess capital, capital levels continue to strengthen with an industry level Tier 1 Risk-Based Capital Ratio of 21.7% in 2018, compared to less than 10% in 2008. Asset quality has also been moving in the right direction, with the industry closing 2018 with a nonperforming loans ratio of 6.8%. Concerns over post-hurricane asset quality deterioration have largely dissipated. The strong profitability performance of banks in 2018 was accompanied by a strengthening of their balance sheets with total assets increasing by 5.7%, deposits by 7.9% and the industry credit portfolio by 2.8%. Given the latest trends in profitability levers, upcoming recovery funds and economic forecasts, we expect a similar or even stronger performance in 2019.

PROFITABILITY > "The local banking sector ended 2018 with the highest level of profitability since 2005, posting an industry-wide Pre-Tax ROE of 14%" The 2018 year-end profitability performance of local banks on a consolidated basis far exceeded previous years' levels, registering a Pre-Tax ROE of 14.0% versus an average of 3.1% in the prior 5 years and an average of less than 1% (0.7%) in the previous 10 years (see Figure 1). Year-end double-digit profitability levels have not been seen since prior to the onset of Puerto Rico's deep and prolonged economic downturn which dates back to 2006. The boost in profitability of banks operating in Puerto Rico in 2018 narrowed the gap with United States (US) peer banks. US commercial banks on a consolidated basis registered a 2018 Pre-Tax ROE of 15.1%, only 1.1 percentage points above the local banking sector. In contrast, this gap in profitability between PR banks and US commercial banks averaged 8.5 percentage points between 2015 and 2017 (see Q3 2018 report and V2A Insight titled "2018, a turning point for the profitability of local banks?" for a more thorough benchmark analysis of the performance of local banks against that of their US peer banks).

FIGURE 1: Industry Pre-Tax ROE Trend (2005 – 2018)(1)

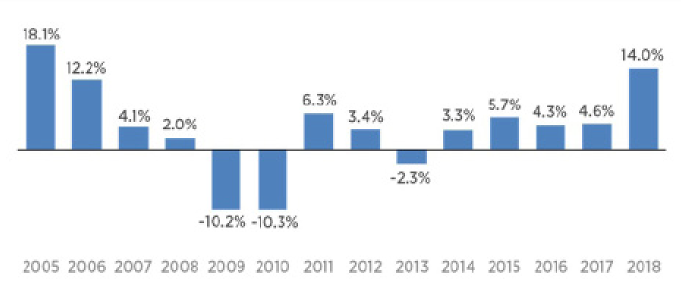
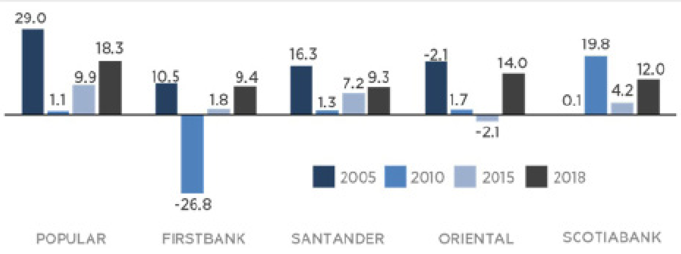


FIGURE 2: Pre-Tax ROE (%) Trend by Bank (2005, 2010, 2015 & 2018)

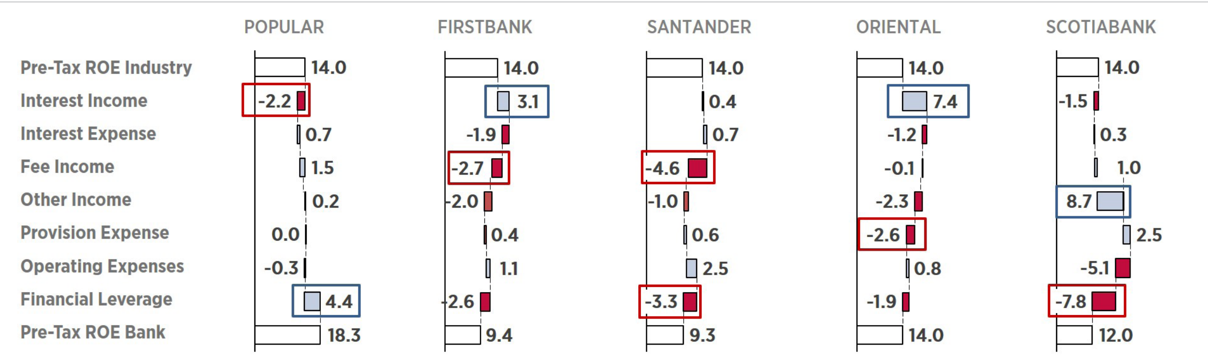


When analyzing profitability by bank, Popular boasted the highest Pre-Tax ROE in 2018 (18.3%). As seen in Figure 3, Popular's financial leverage, with an assets-to-equity ratio of 10, largely drove its stronger profitability performance vis-à-vis the industry. There is a sizable gap between Popular and its peers in terms of financial leverage, with Oriental recording the second highest assets-to-equity ratio at 6.7 and Scotia the lowest at 4.6 (see Annex 1). Oriental, managing 10% of total assets, registered the second highest Pre-Tax ROE at 14.0%. When comparing its profitability with that of the industry, its interest income fared better but was offset by higher provision expenses, lower financial leverage, and lower other income. Scotia reported the third highest Pre-Tax ROE in 2018 (12%), closing the year with a Q4 Pre-Tax ROE of 26.2%. The high Q4 2018 profitability was driven by an unusual non-interest income of $47M (amortization of FDIC indemnification asset related to the acquisition of RG Bank in 2010). Scotia's 2018 positive results follow two consecutive years of being in the red with a Pre-Tax ROE of -5.9% in 2017 and -12.1% in 2016. FirstBank and Santander reported the lowest, but still strong, profitability levels, with Pre-Tax ROEs of 9.4% and 9.3%, respectively. When comparing FirstBank's profitability with that of the industry, it reported lower fee income and a lower financial leverage, partially offset by higher interest income. Santander similarly reported lower fee income and a lower financial leverage with respect to the industry.

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

Better than Industry

Worse than Industry



PRODUCTIVITY > "The industry-wide cost-to-income ratio reached 55.9% in 2018, the best efficiency level since 2005" As expected, given the materially stronger profitability performance of local banks in 2018 with respect to previous years, the industry experienced a notable improvement in its productivity levels, posting an industry-wide cost to income ratio of 55.9% in 2018, from 63.8% in 2017 and 72.7% in 2016, the highest level of efficiency since 2005 as seen in Figure 4. Banks' efforts to rationalize costs and improve operational efficiency have clearly yielded results.

The asset reduction trend that had characterized the local banking industry since the onset of the economic downturn reached bottom in Q4 2015 at $57.3 billion after having surpassed the $100 billion mark in 2005. At the close of Q4 2018 total assets stood at $65.9 billion, a $3.5 billion or 5.7% increase with respect to the close of 2017 and a $8.6 billion or 15% increase with respect to the low point reached in Q4 2015. While the industry on a consolidated basis has experienced an increase in assets, it has been able to concurrently maintain operating expenses stable, reflected in a decreasing opex-to-assets ratio. The opex-to-assets ratio decreased to 3.0% in 2018, from 3.5% in 2016 and 3.2% in 2017.

When analyzing productivity by bank, Oriental posted a significantly lower cost to income ratio than its peers, reaching 49.4% versus an industry level of 55.9% and also a higher net income per employee (see Figure 5 and Annex 2). Oriental was followed by Santander (56.0%), Popular (56.3%), Scotia (56.7%), and FirstBank (58.1%).

CAPITAL ADEQUACY > "Local banks' capital levels continued to rise in 2018, closing the year with an industry level Tier 1 Risk-Based Capital Ratio of 21.7%" Given few opportunities in the local market to deploy excess capital, the long-standing upward trajectory of capital levels continued in 2018, with the industry level Tier 1 Risk-Based Capital Ratio reaching 21.7%. In 2008 this ratio stood at below 10% (9.7%), more than doubling in the last decade (see Figure 6). While there are few opportunities for organic or inorganic growth in the local market, some promising ones do arise. Popular seized the largest opportunity for inorganic growth in 2018 with the acquisition of Reliable, Wells Fargo's auto finance business in Puerto Rico. It purchased roughly $2 billion in auto-related loans, solidifying its position as leader of the profitable auto financing sector. When other new opportunities emerge, they will be highly sought after by local banks, particularly those whose main jurisdiction of operation is Puerto Rico (i.e. Popular, FirstBank, Oriental).

Stock repurchases and dividend disbursements for the most part have been the order of the day for local banks when it comes to capital utilization. Popular, for example, announced that it will be increasing its quarterly common stock dividend from $0.25 to $0.30 per share in 2019, and will deploy $250 million as part of a common stock repurchase program. FirstBank has been paying a cash dividend payment of $0.03 per share to its shareholders and will do so in 2019 as well.

ASSET QUALITY > "The nonperforming loans ratio of the local banking industry dropped to 6.8% as of the end of 2018, after experiencing a spike in the wake of the 2017 hurricanes" The nonperforming loans ratio has shown material improvements in recent quarters, dropping to 6.8% at the close of 2018, after reaching double-digit levels in the 2009 to 2012 period (see Figure 8). Concerns regarding asset quality deterioration and loan losses briefly resurfaced in the aftermath of the hurricanes, with the nonperforming loans ratio spiking to 9.1%. However, these concerns have dissipated in recent quarters as nonperforming loans inflows have reduced significantly and credit delinquency has returned to pre-hurricane levels.

When analyzing asset quality by bank, FirstBank, Oriental and Santander registered comparable nonperforming loans ratios ranging from 5.4% to 5.9% (see Figure 9). Popular, which terminated its FDIC loss-share agreement in 2018, posted a nonpeforming loans ratio of 6.7%. Scotia continues to post the highest delinquency ratio at 15.3%, even after seeing this ratio decrease from more than 20%.

Going forward, the downward trend of delinquent loans should lead to decreases in loan loss provision, collection costs, loss mitigation, foreclosures and REO management expenses.

FIGURE 4: Industry Cost to Income Ratio (%) Trend (2005 – 2018)

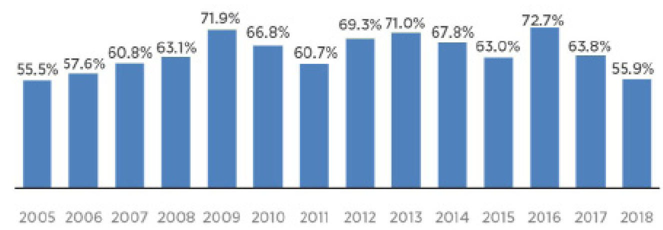


FIGURE 5: Cost to Income Ratio (%) by Bank ('05, '10, '15, '18)

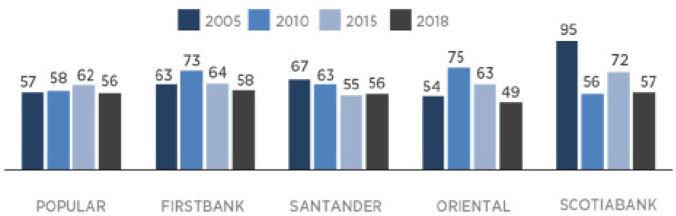


FIGURE 6: Industry Tier 1 Risk-Based Capital Ratio (%) Trend (2005 – 2018)

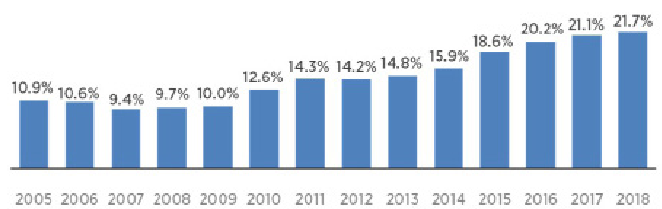


FIGURE 7: Tier 1 Risk-Based Capital Ratio (%) by Bank ('05, '10, '15, '18)

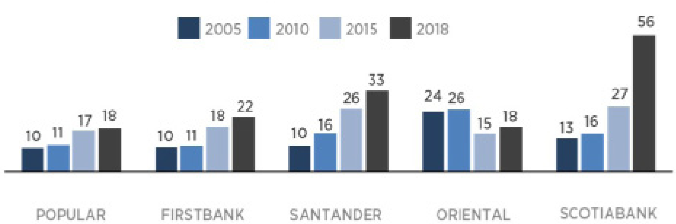
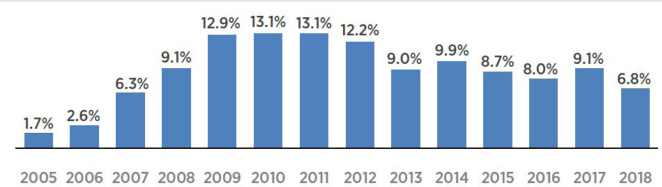
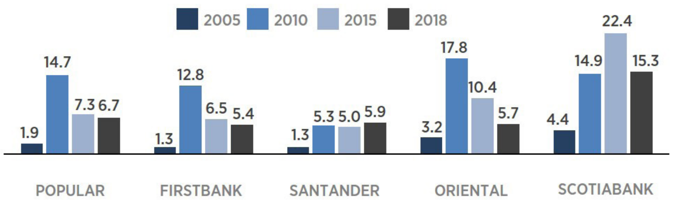


FIGURE 8: Industry Nonperforming Loans Ratio* (%) (2005 – 2018)



* 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 9: Nonperforming Loans Ratio* (%) by Bank ('05, '10, '15, '18)



* 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.

2018 YEAR IN REVIEW > "The strong performance of the local banking industry in 2018 (Pre-Tax ROE of 14%) was accompanied by a strengthening of its financial condition with total assets increasing by 5.7%, deposits by 7.9% and its credit portfolio by 2.8%" Local banks closed 2018 with a strong profitability level and with healthier and more robust balance sheets. Total assets increased by 5.7% during 2018, from $62.4 billion to $65.9 billion, while deposits grew from $50.2 billion in 2017 to $54.1 billion in 2018, an increase of 7.9% or $3.9 billion (see Figure 10). The increase in assets and deposits is mainly attributable to Popular, with the bank's assets increasing by 9.2% or $3.2 billion and its deposits increasing by 14% or $4 billion from 2017 to 2018. Furthermore, the industry's credit portfolio also experienced an increase of 2.8% in 2018, reaching $38.7 billion, after 9 consecutive annual decreases (see Figure 10).

Investments in construction, driven by reconstruction efforts financed through appropriated federal aid and private insurance disbursements, increased in 2018. Cement sales, commonly used as a proxy of construction activity, reached 14.3 million 94lb. bags & bulk in 2018, a 40% increase against 2017 and the highest annual level since 2014. While $46.3 billion in federal recovery funding have been approved, disbursements have been painstakingly slow. Additionally, the new tariffs on steel and aluminum and the locally mandated increase to $15 an hour in the hourly wage of construction workers employed in government construction projects will increase construction costs.

Consumer expenditures also exhibited strong growth in 2018, as reflected by banking customers' debit and credit card activity, loan originations, and retail and auto sales. In the first 10 months of 2018, retail sales reached $27.7 billion, an 18.8% increase compared to the same period in 2017. Auto sales exhibited an annual increase of 28% in 2018 with 108,000 auto units sold. Personal/Consumption loan originations reached close to $2 billion in 2018, increasing by 16.3% with respect to 2017 and accounting for 30% of all loan originations (13% in 2005, see Figure 11). Commercial/ industrial loan originations also increased in 2018, from $1.4 billion to $1.9 billion, representing a 33% increase. Mortgage loan originations, on the other hand, continued its downward trajectory, decreasing by 5% to reach $2.6 billion and accounting for 40% of the total (52% in 2005).

FIGURE 10: Industry Total Assets, Deposits and Loans & Leases Trends ('05 – '18)

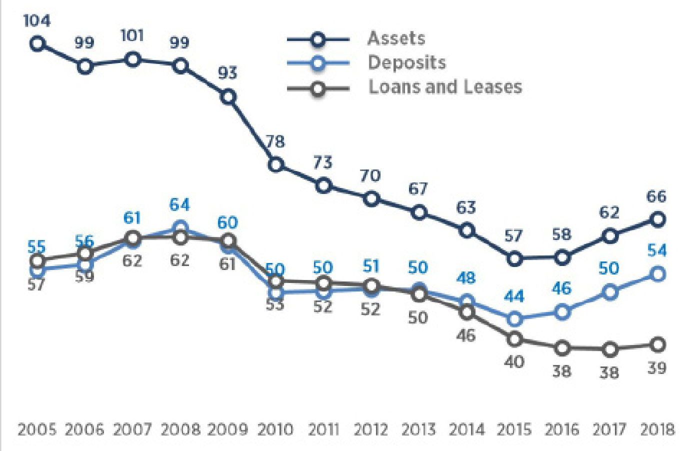
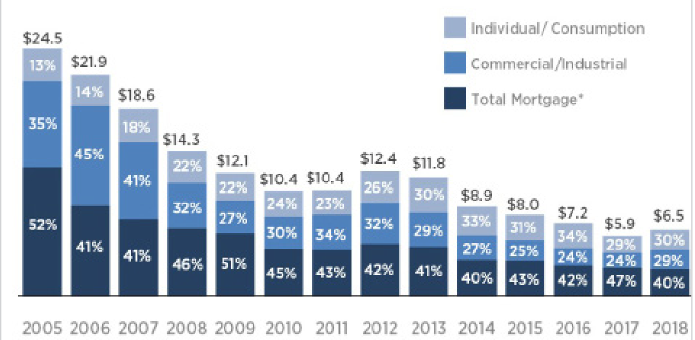


FIGURE 11: Loan Originations by Type ($US Billions) (2005-2018)



* Mortgage originations of depository and non-depository financial institutions.

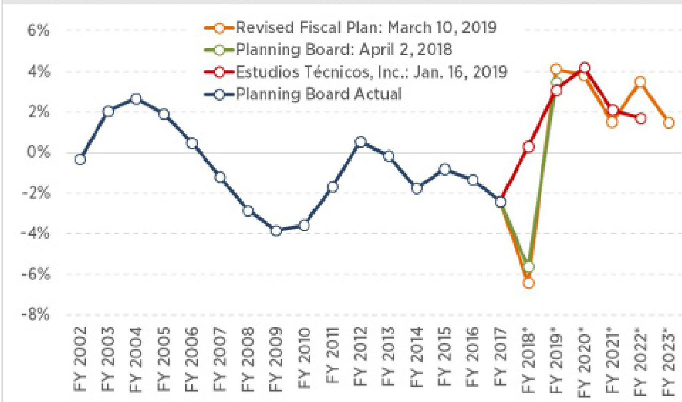
2019 OUTLOOK > "We expect the local banking industry to experience another strong year in 2019 given the latest economic growth forecasts and 2018 year-end trends of most banking profitability levers. While growth in the short- and medium-term will be driven by ongoing post-hurricane reconstruction activity, concerns remain over long-run growth drivers." Regarding profitability levers going into 2019, we expect a widening of the industry's net interest margin (NIM) driven to some degree by Fed tax rate increases, but more importantly, by the future mix of banks' credit portfolios given the mix of the latest loan originations. There has been a shift toward consumer/ personal loans as a share of total loan originations, which tend to carry higher interest rates. Of all loans originated from 2005 to 2010, personal loan originations represented 18% of the total, commercial and industrial loans 36% and mortgage loans 46%. The personal loans share increased to 31% in the 2016 to 2018 period, while the commercial/ industrial and mortgage loans share dropped to 26% and 43%, respectively. As a result of the personal loans originations share increase, when we compare the average interest rate of all loans originated in 2018 versus 2014, we see an increase from 5.7% to 6.8%. When it comes to cost of funds (i.e. interest expense), we do not expect the increases in the federal funds rate to have a significant impact given the high concentration of the local banking industry and, therefore, the limited competitive pressures.

The banking sector is experiencing a favorable downward trajectory in terms of nonperforming loans, after a brief hurricane-induced spike in the first half of 2018, which should in turn reduce loan loss provision expenses. Lower delinquency levels should also translate into lower collection, loss mitigation, foreclosure and REO management expenses. Measures taken by banks to navigate through difficult times, including cost rationalizations (human resource and branches), digitalization, and other operational efficiencies, will help maintain cost to income

While we expect profitability to improve, the biggest challenge going forward will be growth. It is becoming increasingly difficult to find ways of growing inorganically, because opportunistic buyouts of other banks and portfolios are drying up, becoming more and more scarce. On the other hand, opportunities to grow organically will largely depend on the performance of the economy going forward.

Figure 12 provides historical real economic growth numbers and the latest growth forecasts found in the latest revised fiscal plan submitted to the Fiscal Oversight and Management Board (FOMB) on March 10, 2019[2], the Economic Report to the Governor 2017 published by the Puerto Rico Planning Board[3] and the revised forecasts by the consulting firm Estudios Técnicos, Inc. (ETI)[4]. For FY2019 ending in June 30, 2019, the FOMB forecasts a 7.9% growth, the Planning Board 3.5%, and ETI 3.1%.

FIGURE 12: Real Gross Product Historical Growth and Forecasts* (FY 2002-'2023)



* FY 2018 to FY 2023 are forecasts from three sources. Revised Fiscal Plan for Puerto Rico published on March 10, 2019 for FY2018 to FY2023. Planning Board's forecasts published in the Economic Report to the Governor 2017 published on April 2, 2018 for FY 2018 and 2019. Estudios Técnicos, Inc. forecasts for FY2018 to FY 2022 estimated on January 16, 2019.

In order to understand the potential organic growth going forward, we have analyzed the relationship between loan originations and the Puerto Rico real economic output from FY2002 to FY2017. As seen in Figure 13, loan originations are highly correlated with real economic output (gross product at constant prices), with a Pearson correlation coefficient of 0.9726 for FY2002 to FY2017 (R^2 of 0.945). In other words, the variance in loan originations can be largely explained by the variance in real economic output. Using the Estudios Técnicos, Inc. real growth forecast and the aforementioned regression model, we estimate loan originations to reach $8.5 billion in FY2019, $11.8 billion in FY2020, $13.4 billion in FY2021, and $14.8 billion in FY2022 (see Figure 14). Assuming equally spread out loans through time, we estimate loan originations to reach around $10 billion in calendar year 2019.

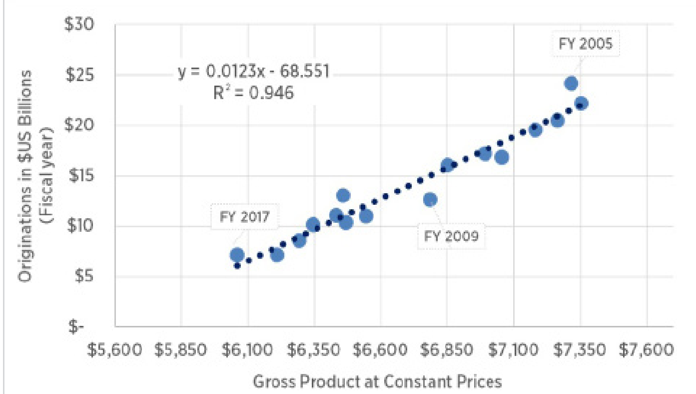
Despite the positive outlook for the Puerto Rican economy and the local banking sector in 2019, there are downside risks at the macro level which must be closely monitored. These risks include the actual amount of federal reconstruction funds that are ultimately appropriated and their respective rate of disbursement. Another risk involves the still unknown effects of the federal Tax Cuts and Jobs Act of 2017 which could undermine Puerto Rico's tax-based competitive advantage. Furthermore, while the population loss post-Maria seems to have been overestimated, concerns still abound regarding net outmigration and the push and pull migratory forces at play. There is also much unease with respect to numerous exogenous factors including the volatility of global affairs, international trade and global financial markets. The Federal Funds rate hikes in 2019 and their impact in loan originations should also be closely observed.

FINAL REMARKS > The local banking industry is undoubtedly well poised to achieve strong financial results in 2019, after a solid 2018, despite challenges in the wake of Hurricane Maria. Most levers of profitability are moving in the right direction for local banks, a good sign for future profitability.

Growth remains a challenge going forward with few inorganic growth opportunities in the local banking sector and organic growth largely contingent upon economic performance.

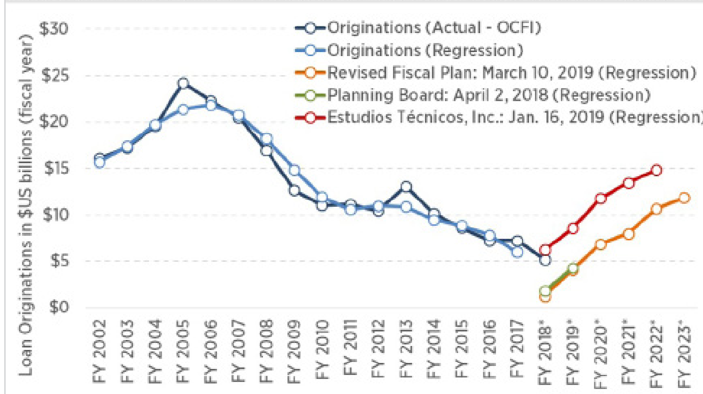
While upcoming recovery funds, e.g., $1.5 billion through the Community Development Block Grant-Disaster Recovery Program (CDBG-DR), and $18.5 billion through the Department of Housing and Urban Development (HUD), will surely stimulate lending, local banks are unlikely to relax their strict credit underwriting policies given the highly turbulent and uncertain environment they have been navigating.

FIGURE 13: Relationship of Loan Originations and Economic Output* (FY '02-'17)



* Loan originations (fiscal years) published by Office of the Commissioner of Financial Institutions of Puerto Rico and Gross National Product at constant prices published by the Puerto Rico Planning Board.

FIGURE 14: Actual, Reg.-Estimated and Reg.-Forecast Loan Originations* (FY'02-'23)



* The dark blue line represents actual total loan originations (mortgage- depository and nondepository, commercial/industrial and personal loans) by fiscal year as reported by the Office of the Commissioner of Financial Institutions (OCFI). The light blue line depicts estimated loan originations using the regression y=0.0123x-68.551 (Pearson correlation coefficient of 0.9726) where y is estimated loan originations by fiscal year and x is the gross national product (GNP) at constant prices. The red line indicates loan origination forecasts using Estudios Técnicos Inc. real GNP forecasts for FY2018 to FY2022, the green line indicates loan origination forecasts using Planning Board base real GNP forecasts for FY2018 and FY2019, and the orange line indicates loan origination forecasts using the Revised Fiscal Plan for Puerto Rico's real GNP forecasts for FY2018 to FY2023 published on March 10, 2019.

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) Revised Fiscal Plan for Puerto Rico as submitted to the Financial Oversight and Management Board for Puerto Rico (March 10, 2019) available at http://www.aafaf.pr.gov/assets/fiscal-plan-pr-fy2020-draft-03-10-2019.pdf

(3) Ecomomic Report to the Governor 2017 published by the Planning Board available at http://jp.pr.gov/

(4) Article in newsismybusiness.com published on Feb. 11, 2019 titled Estudios Técnicos: Reconstruction funds to drive 4.2% economic growth in '20 available at https://newsismybusiness.com/estudios-tecnicos-reconstruction-funds-to-drive-4-2-economic-growth-in-20/

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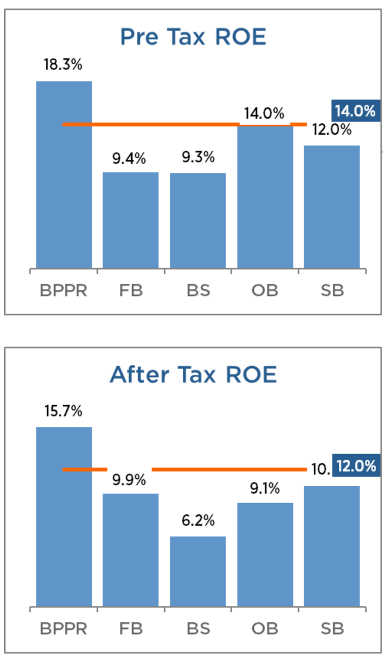
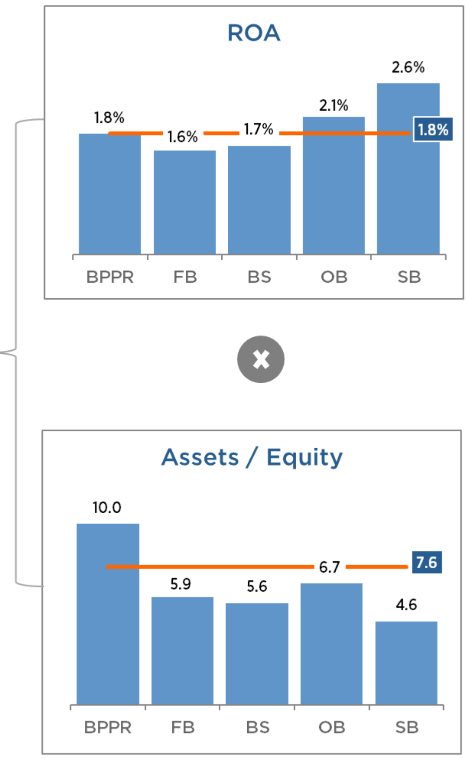
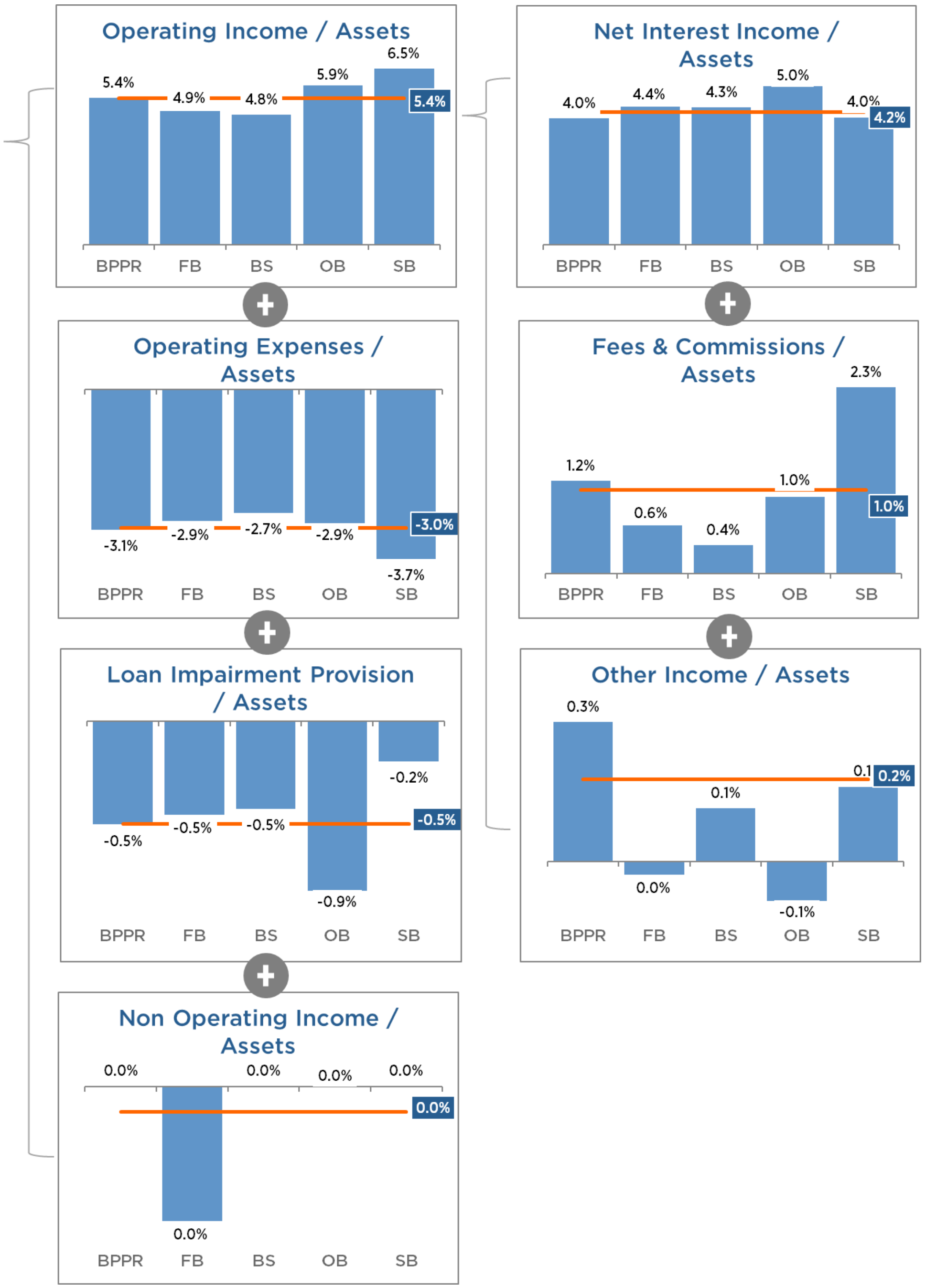






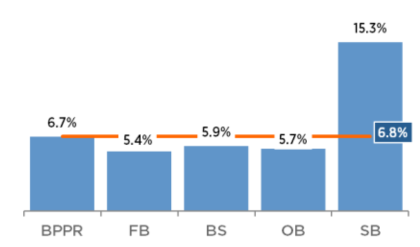
BPPR – Banco Popular de Puerto Rico
FB - FirstBank of Puerto Rico
BS - Banco Santander de Puerto Rico
OB - Oriental Bank and Trust
SB - Scotiabank de Puerto Rico

Industry

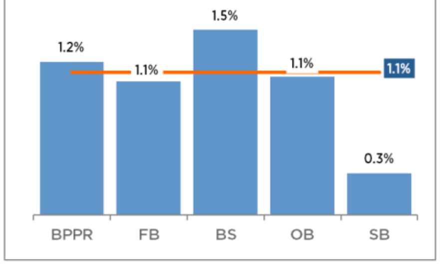
Note 1: Income and expense ratios are annualized.
Source: Federal Deposit Insurance Corporation (FDIC)

Asset Quality

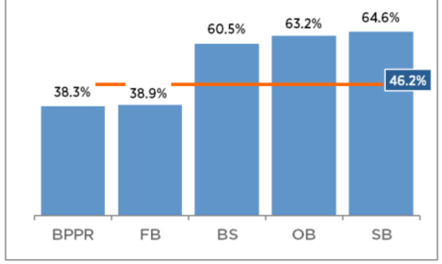
Noncurrent Loans Ratio



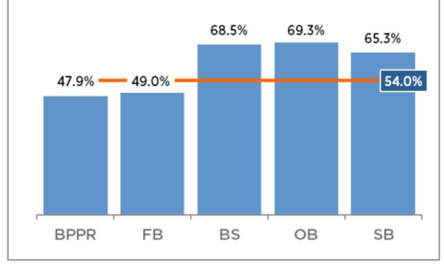
Charge-Off (Loss) Ratio



Reserve / NPL

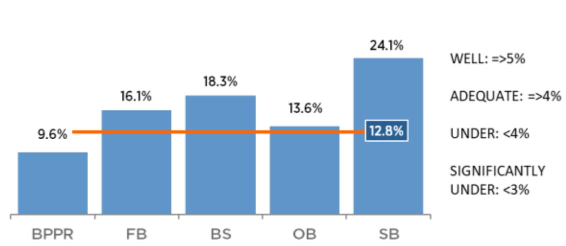


(Reserve+NCO) / (NPL+NCO)

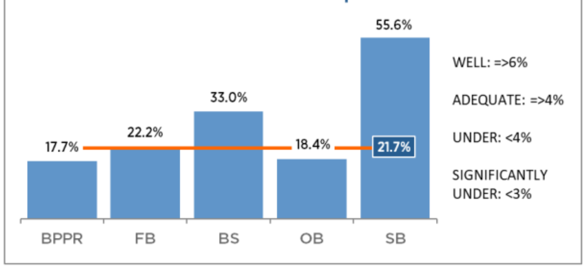


Capital Adequacy

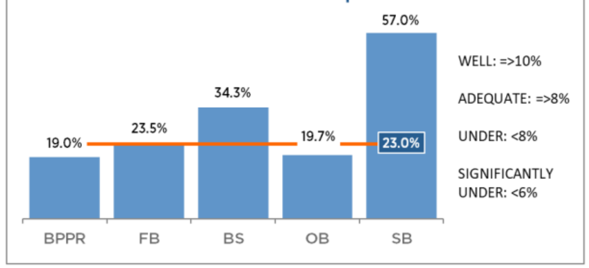
Tier 1 Leverage Ratio



Tier 1 Risk-based Capital Ratio

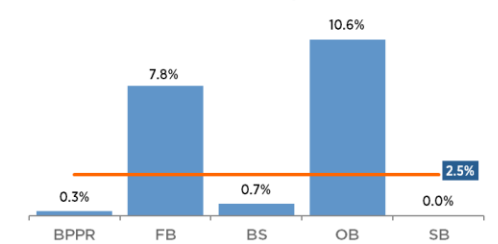


Total Risk-based Capital Ratio

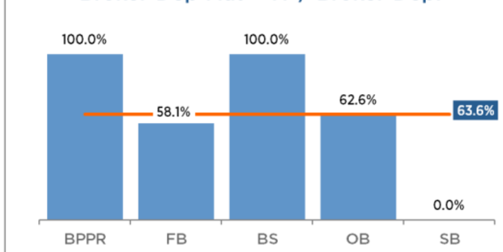


Liquidity

Brokered / Total Deposits Ratio

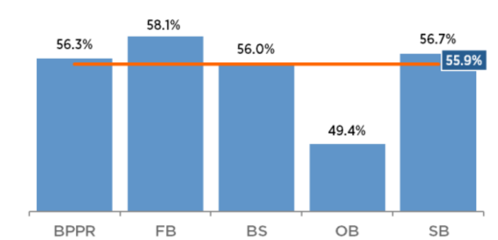


Broker Dep Mat < 1Y / Broker Dep.



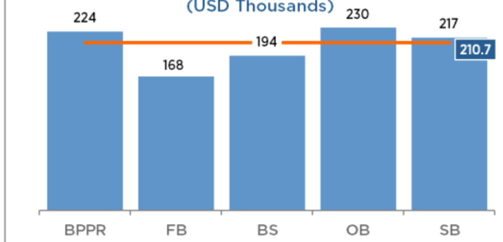
Productivity

Efficiency Ratio (Cost / Income)



Net Margin per Employee

(USD Thousands)



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SB - Scotiabank de Puerto Rico

Industry

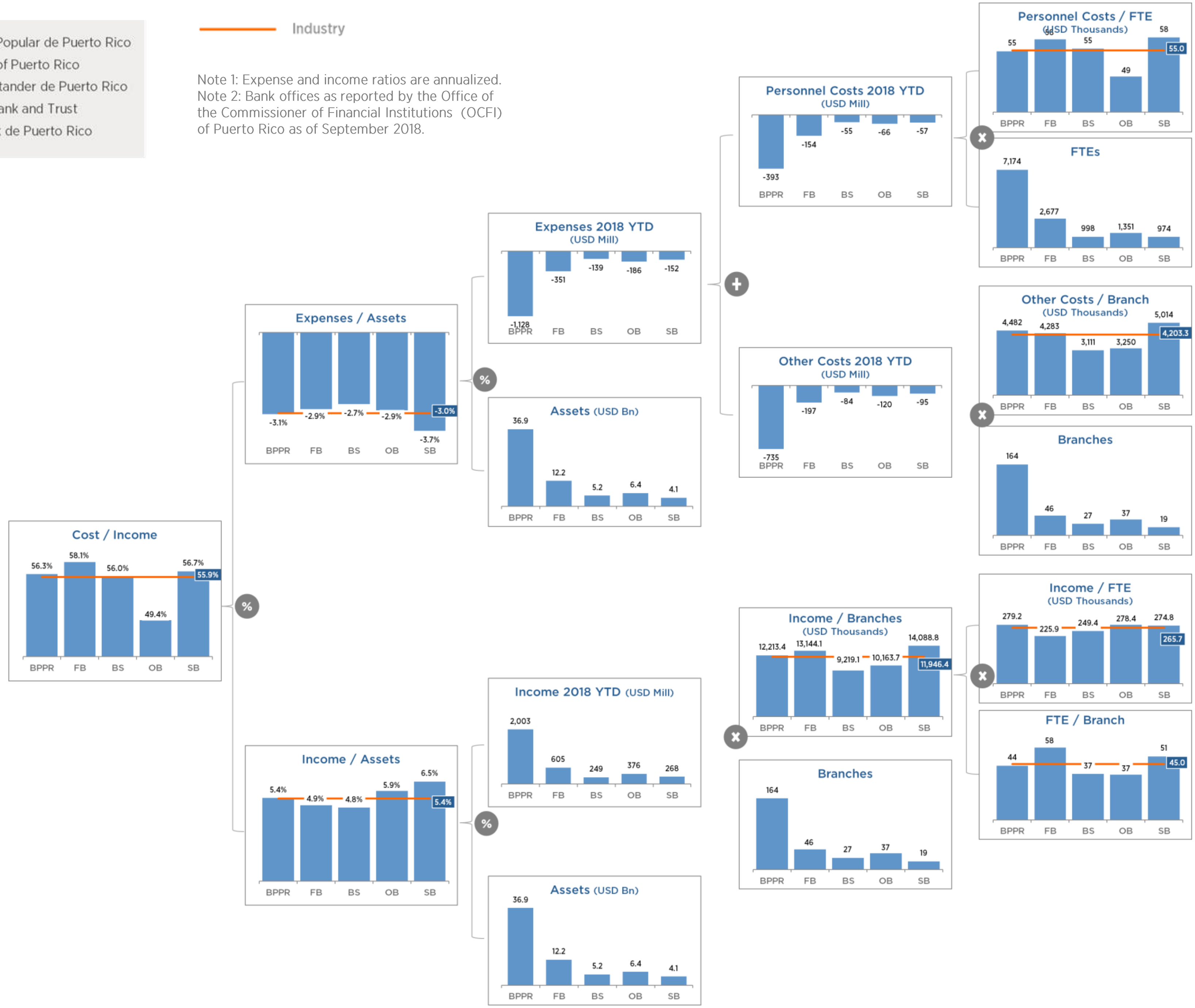
* Also referred to as Core Capital (leverage) Ratio by the FDIC

Note 1: Asset quality ratios are not adjusted for FDIC covered and available for sale portfolios.
Note 2: Income and expense ratios are annualized.
Source: Federal Deposit Insurance Corporation (FDIC)

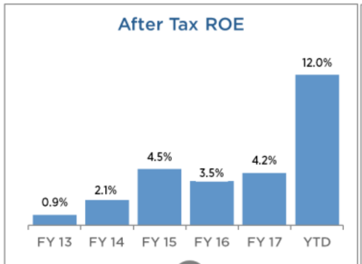
BPPR - Banco Popular de Puerto Rico
FB - FirstBank of Puerto Rico
BS - Banco Santander de Puerto Rico
OB - Oriental Bank and Trust
SB - Scotiabank de Puerto Rico

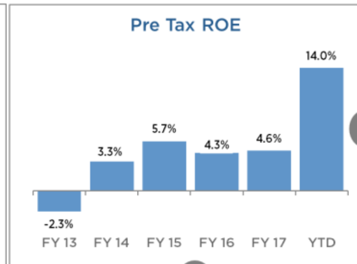
Industry

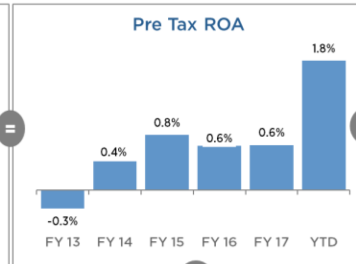
Note 1: Expense and income ratios are annualized.
Note 2: Bank offices as reported by the Office of the Commissioner of Financial Institutions (OCFI) of Puerto Rico as of September 2018.

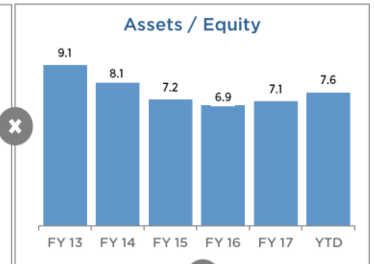


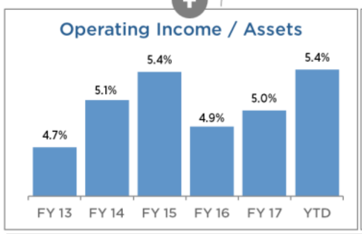
Profitability

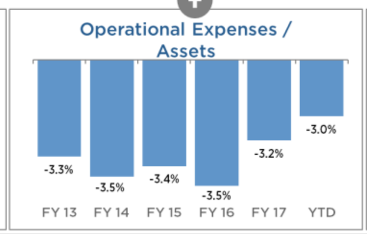


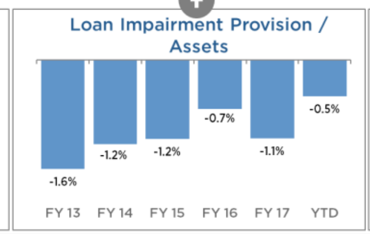


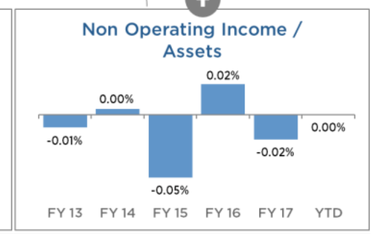




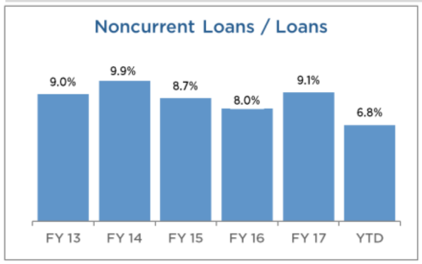


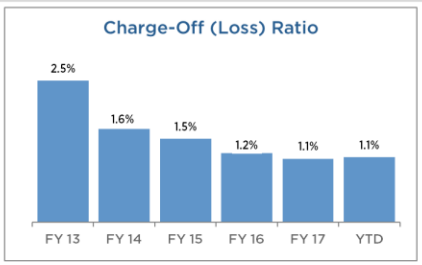


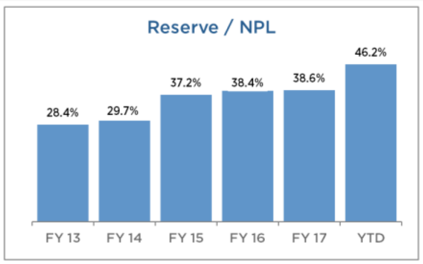


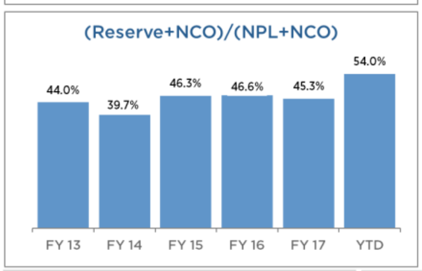


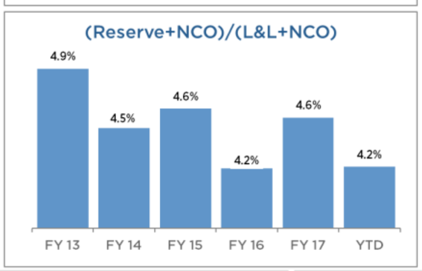
Asset Quality





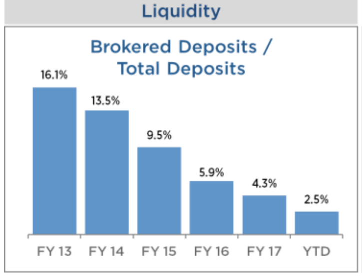




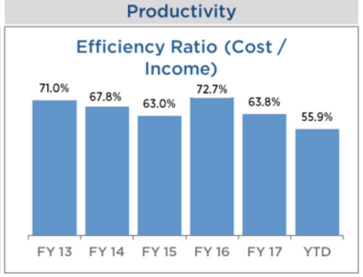


Note 1: Asset quality ratios are not adjusted for FDIC covered and available for sale portfolio.
Note 2: YTD numbers are annualized.
Source: Federal Deposit Insurance Corporation (FDIC)

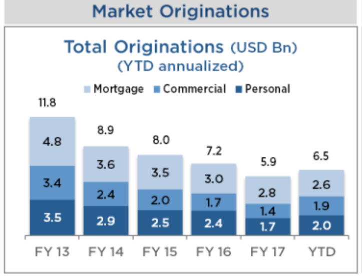
Liquidity



Productivity



Market Originations



Total Assets