Puerto Rico
Banking Industry
Report

INSIDE THIS ISSUE:

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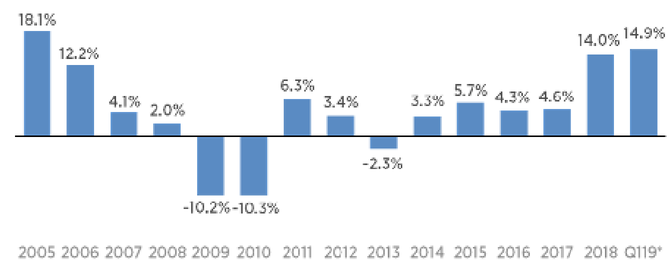
The local banking industry kicked off the year with a strong performance in the first quarter of 2019, posting an industry-wide Pre-Tax ROE of 14.9%, the highest level of profitability since 2005. Popular led the way with the highest level of profitability, achieving a Pre-Tax ROE of 21.0%, followed by Oriental (14.6%), FirstBank (10.9%), Santander (8.9%), and Scotia (6.3%). Furthermore, the capital position of the industry is exceedingly strong, posting a Tier 1 Risk-Based Capital Ratio of 21.8%, credit quality metrics continue to improve, registering a nonperforming loans ratio of 6.3%, deposits continue to surge, and the industry-wide credit portfolio is stable. Local banks, which have learned to effectively navigate through turbulent economic waters, are well positioned to seize opportunities during the post-disaster reconstruction period. The pace of disbursements of the $45 - $50 billion in federal disaster relief funds which have been allocated thus far has been very slow, resulting in a lackluster effect on the local economy. In this issue, we review the latest trends of loan originations and outstanding credit portfolio, both in terms of growth and loan type mix. The mortgage lending business has reduced significantly and is likely to continue this downward trend given demographic changes, lower rates of household formation, and higher interest rates. As a result, banks may have to rethink their mortgage business going forward, including their mortgage servicing business. On the other hand, the consumer and commercial loan segments may help compensate for the drop in mortgage activity given the most recent consumption and economic activity indicators.

PROFITABILITY > "The local banking industry delivered a Pre-Tax ROE of 14.9% in Q1 2019 on an annualized basis, the highest level of profitability since 2005" Local banks started 2019 with strong profitability numbers, posting a Pre-Tax ROE of 14.9% in the first quarter on an annualized basis. This follows a robust profitability performance in 2018 when the industry's Pre-Tax ROE reached 14.0%. These double-digit ROEs have not been seen since prior to the onset of the economic downturn in 2006 (see Figure 1).

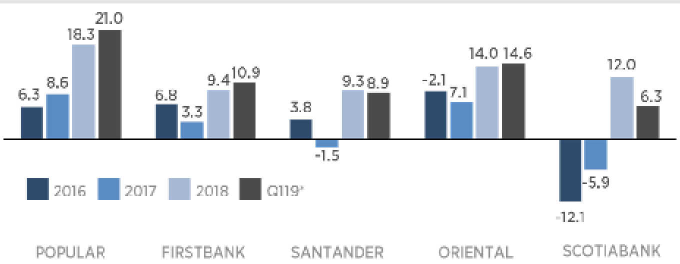
Banks have been able to effectively seize upon opportunities that have arisen in Puerto Rico's post-hurricane reality and slowly improving economic environment. Short- and medium-term economic performance has been and will continue to be largely dependent on the amount and pace of post-disaster funds. Unfortunately, the sluggish pace of disbursements thus far has not corresponded with the sense of urgency and need for the funds. Furthermore, the disbursed funds have had a limited impact in economic activity. The Economic Development Bank's Economic Activity Index (EDB-EAI) stood at 121.3 in April 2019, the same level as in August 2017, the month prior to Hurricanes Irma and Maria. Congress has allocated approximately $45-$50 billion in federal disaster funds, $11 billion of which have been disbursed. In the latest Certified Fiscal Plan (May 9, 2019), the fiscal oversight and management board estimated that $63.6 billion in private and federal disaster relief funds will be disbursed from FY2018 to FY2024. Despite the expected inflow of funds, the growth prospects contained in the fiscal plan are modest at best. The board estimates that the real gross national product (GNP), post-measures and structural reforms, will increase by 4% in FY2019 (ending June 30, 2019), 1.5% in FY2020, returning to contraction and stagnation in FY2021 and beyond. Notwithstanding the lackluster growth prospects, banks have largely acclimatized to the challenging operating context and are well poised to take advantage of any opportunities that may surface.

FIGURE 1: Industry Pre-Tax ROE Trend (2005 – Q1 2019)[1]



* Annualized Q1 2019 Pre-Tax ROE.

FIGURE 2: Pre-Tax ROE (%) Trend by Bank (2016 – Q1 2019)

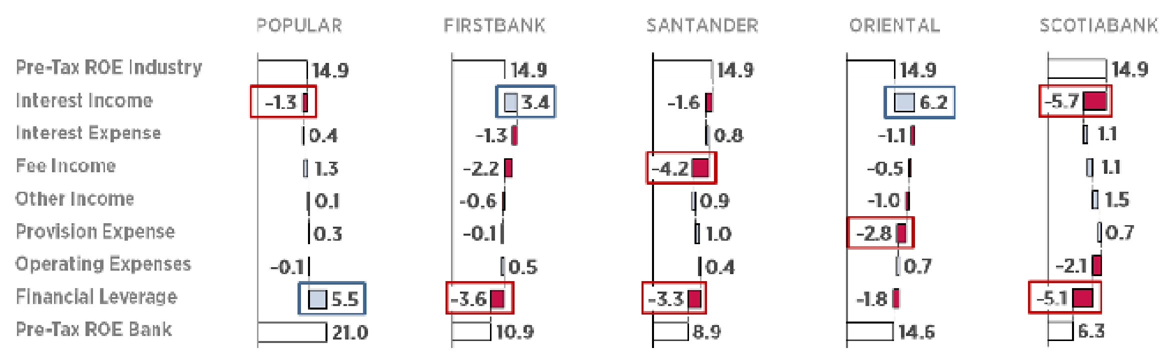


* Annualized Q1 2019 Pre-Tax ROE.

When analyzing profitability by bank in Q1 2019, Popular leads its peers with a Pre-Tax ROE of 21.0%. Its materially higher financial leverage, registering an assets-to-equity ratio of 10.0 in Q1 2019, compared to an industry leverage of 5.5 when excluding Popular, largely drove its profitability when compared to the industry. Puerto Rico's banking sector is highly concentrated, as is often the case in developed economies, with Popular managing 58% of total assets, 62% of deposits, and 51% of gross loans and leases. Oriental posted the second highest level of profitability, with a Pre-Tax ROE of 14.6%, followed by FirstBank with 10.9%. Santander and Scotia, whose main market of operation is not Puerto Rico and operate locally as affiliates of large multinational financial entities, registered the lowest Pre-Tax ROEs, with 8.9% and 6.3%, respectively.

FIGURE 3: Reconciliation of the Industry's Pre-Tax ROE and each bank's Pre-Tax ROE by income-expense category (Q1 2019)

Better than Industry
Worse than Industry



LOAN ORIGINATION AND CREDIT PORTFOLIO TRENDS > "The commercial and residential mortgage segments have taken a hard hit during the protracted crisis, clearly reflected in local banks' loan originations and credit portfolios" The local banking industry started the year on a firm footing and is on track to having another strong year, characterized by high profitability, improvement in key profitability levers, surging deposits, and a stable credit portfolio. In order to further increase their profitability, banks may need to make important strategic decisions to strengthen the performance of the mortgage loan origination and servicing business.

Total loan originations have been decreasing considerably since peaking in 2012 at $12.4 billion, falling by almost 50% to $6.5 billion in 2018 (see Figure 4). All lending business segments have contracted, with commercial and industrial loans experiencing the greatest reduction in percentage terms (-53%), closely followed by mortgage loans (-49%). Personal loan originations have also experienced a sharp decline since 2012 (-38%), but at a lesser degree than commercial and mortgage loans.

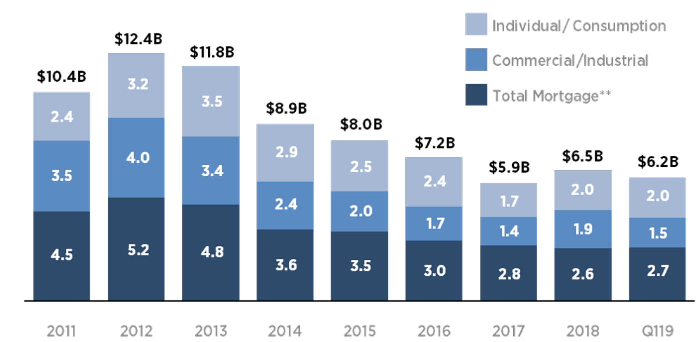
These sizeable reductions in loan originations have resulted in a significant decrease in the banking credit portfolio and in a change in mix. The industry's credit portfolio peaked at the end of 2012, reaching $49.6 billion, contracting to $34.0 billion as of the end of Q1 2019, a decrease of $15.7 billion or 32% (see Figure 5). The mortgage portfolio in this time period decreased from $19 billion to $13.5 billion (40% of the total), falling by $5.5 billion or 29%. The commercial, construction, and public sector portfolio contracted to an even greater degree, decreasing from $23 billion to $13.2 billion (39% of the total), representing a drop of close to $10 billion or 43%. The personal loan portfolio has remained quite stable, reaching $6.8 billion at the end of 2012 and reducing by 4% or $300 million to $6.5 billion at the end of Q1 2019. This greater stability in the industry's personal loan portfolio is due to: 1) The resilience of the personal consumption during the crisis (6% decrease in real terms from 2012 to 2018 vs 11% decrease of real GNP), 2) The personal loan originations declining at a slower clip than other loan originations, and 3) The purchase of personal loan portfolios by local banks (e.g. the purchase of Reliable Auto by Banco Popular).

Recent trends of key economic indicators point to an improvement in private consumption levels, particularly after the significant reduction of household debt after 13 years of economic hardship, and to a stabilizing commercial sector, with private employment increasing and the expected positive impact of federal disaster funds. However, the future of the mortgage sector does not look promising. Past and future demographic trends, historically high housing inventory levels, and relatively higher interest rates are likely to continue putting downward pressure on housing and mortgage demand.

Regarding demographic trends, Puerto Rico's population forecasts point to continued shrinkage, fueled by population displacement and a negative rate of natural increase, with deaths surpassing births since 2015. The forecasted demographic shifts will also dampen housing formation and residential mortgage demand. The population between 25 and 49 years old reached 1.22 million in 2010, decreasing to 1.01 million in 2019, and is projected to reach 920,305 in 2025, according to U.S. Census Bureau's forecasts (see Figure 6). On the other hand, the population 65 years and older has been increasing significantly, from close to 550,000 in 2010 (15% of total population), to 680,000 in 2019 (21%), with a forecast of 760,000 in 2025 (25%). Annual household formation, a key variable driving housing demand, exceeded 20,000 in the 1990s, and has dropped to less than 2,500 in the current decade.

Regarding housing inventory levels, a total of 344,694 houses were vacant in 2017 (22% of the total housing inventory in Puerto Rico) according to the U.S. Census. This number may increase as the backlog of past due mortgage loans continue through the foreclosure process (see our January to June 2018 Banking Industry Report for more details). Finally, the near-zero fed funds rate era is not likely to repeat itself for some time. During 2018, the U.S. central bank's policymaking Federal Open Market Committee increased the fed funds rate four times (currently between 2.25% and 2.5%). In the April 30-May 1, 2019 meeting it decided to delay any rate moves given low inflation levels, global markets and trade volatility, and uncertainties regarding Brexit. Depending on how the economy fares, interest rates could go down again but they are not likely to reach the low levels of recent years.

FIGURE 4: Loan Originations by Type ($US Billions) (2011 – Q1 2019*)



* Q1 2019 annualized loan originations.
** Mortgage originations of depository and non-depository financial institutions.

FIGURE 5: Industry Loans and Leases Portfolio ($US Billions)

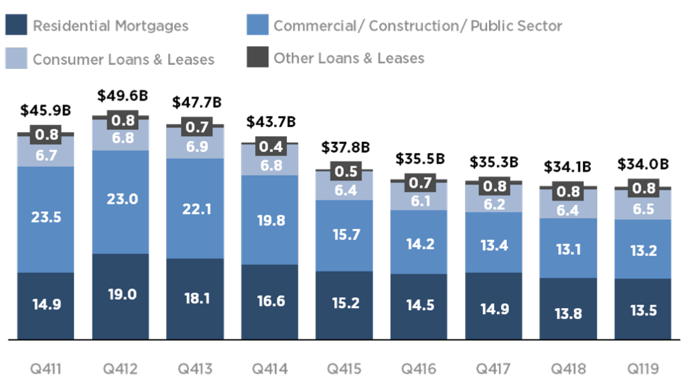
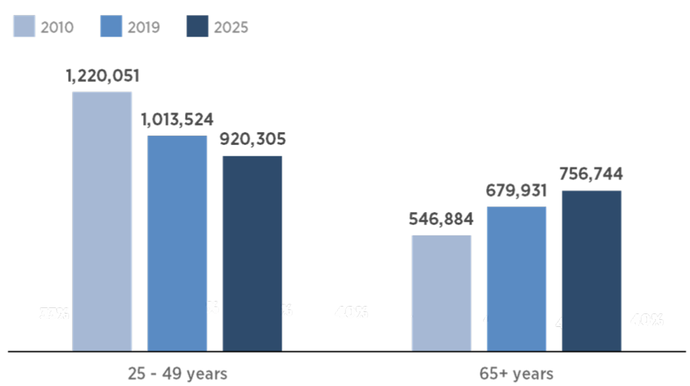


FIGURE 6: Population of Selected Age Groups (Historical, Current, and Forecasts)



Source: U.S. Census Bureau International Data Base (IDB)

RETHINKING THE MORTGAGE ORIGINATION AND SERVICING BUSINESS >

"While local banks kicked off the year on a strong footing and have a positive outlook for the remainder of 2019, they should rethink their mortgage originating and servicing business going forward, and look to other business segments to counteract the shrinkage of this historically important segment" Given the latest trends and projections, local banks should prepare themselves to fight for and adapt to a smaller mortgage market. As the relative weight of the residential mortgage portfolio of the local banking industry comes closer to mainland U.S. levels (PR: 40% vs. U.S.: 24%, see Figure 7), local banks should strategize accordingly.

In order to adapt to a smaller mortgage market, banks will need to reassess the profitability of each of the different stages of the mortgage business cycle and strategically decide where they want to put their focus on. For example, they may want to focus on originating and selling conforming and/or FHA guaranteed loans or, instead, on originating and keeping non-conforming loans. These two business models (originate + sell vs originate + keep) have very different profitability dynamics. Banks may also need to reevaluate the mix between own originations and loans bought to non-depository mortgage houses. Finally, they may need to change their servicing strategy. These decisions will have an impact on the banks mortgage infrastructure, whether to right size it to the smaller business size or to increase volume to deploy spare capacity.

Based on the most recent mortgage originations data by bank (see Figure 8), Firstbank is the only bank that has been able to somewhat maintain mortgage loan originations in the past 4 years. In fact, Firstbank was the top mortgage originator in 2018, the first time in the whole originations series (1996-2018). The rest of the banks have seen their mortgage loan originations decrease significantly since 2015 (Popular 56%, Santander 48%, Oriental 52% and Scotia 62%). The decrease for banks from 2015 to 2018 has been much greater than for non-depository financial institutions. It is remarkable how non-depository institutions increased their share of FHA conforming mortgage originations from 43% in 2015 to 55% in 2018.

FIGURE 7: Loans and Leases Portfolio by Bank of Q1 2019 ($US Billions)

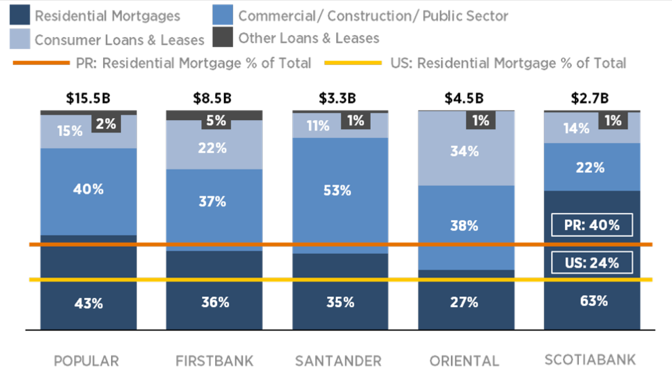
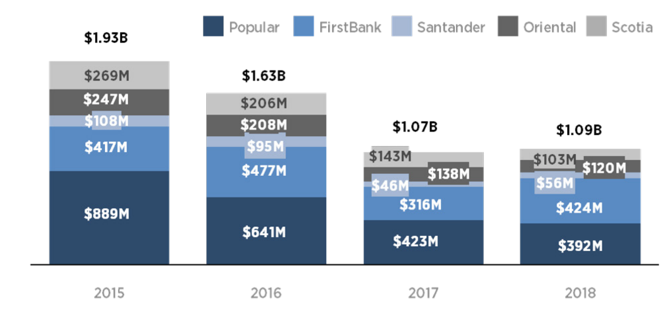


FIGURE 8: Mortgage Loan Originations by Commercial Bank



The mortgage servicing business has been and will continue to be impacted by the reduction of the mortgage activity. As mortgage volumes decrease, it will be harder to justify the sizeable overhead infrastructure in terms of technology and human resources. Moreover, although Puerto Rico's nonperforming assets have declined, they remain high for U.S. standards, making servicing more expensive through higher collections, loss mitigation, and foreclosure efforts. There are other factors that impact the servicing business negatively for banks in Puerto Rico. For example, the average mortgage loan is low in Puerto Rico compared to the US, which reduces the revenue potential per loan. Additionally, banks are highly regulated when compared to non-banking institutions putting banks into a disadvantage against non-banking servicers. Finally, Ginnie, Fannie and Freddie represent a large portion of the portfolios serviced by local banking entities, and they have strict regulatory and compliance requirements. The lower operating costs, particularly in terms of salaries, are an advantage for local servicers but do not compensate for the other negative factors mentioned.

In conclusion, local banks need to carefully reassess their mortgage servicing strategy. They may consider regaining scale by servicing mortgages from other U.S. jurisdictions, look for process efficiencies to offset the negative profitability dynamics mentioned above or consider outsourcing the mortgage servicing processes.

FINAL REMARKS > Local banks performed very well in Q1 2019, posting a Pre-Tax ROE of 14.9% on an annualized basis, and are well positioned to achieve another year of robust profitability performance. Their capital position continues to be strengthened with the industry-wide Tier 1 Risk-Based Capital Ratio reaching 21.8%, and their credit quality metrics also continue to improve, registering a nonperforming loans ratio of 6.3%. The continued inflow of federal disaster funds and "opportunity zone" investments will provide new income generating opportunities for banks. Given the drop in the mortgage loan activity, trend which will likely continue to unfold, local banks should rethink their mortgage loan and servicing business, and look to consumer and commercial loans to offset the decline.

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.

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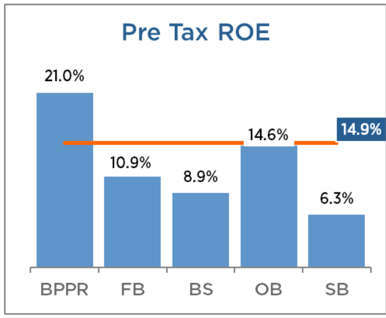

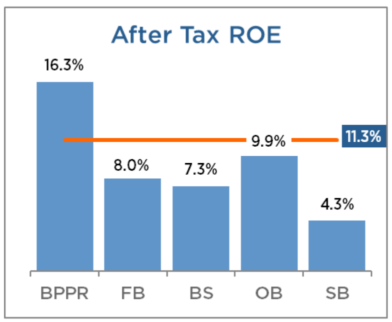

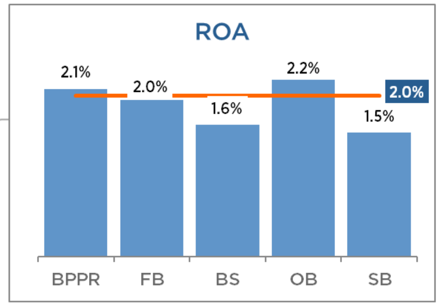

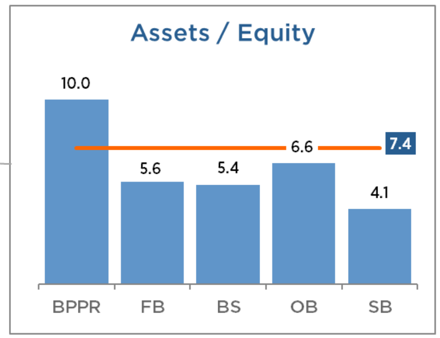

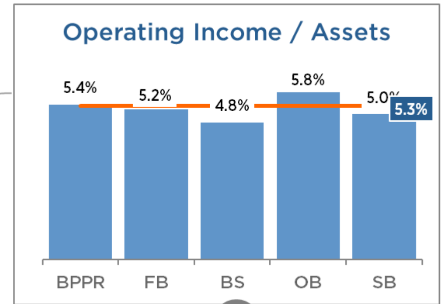

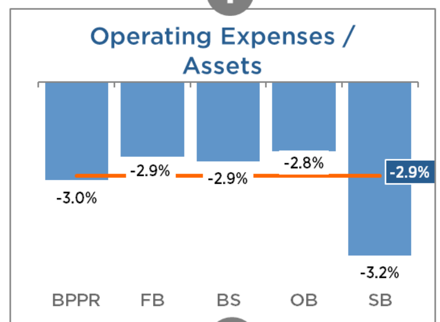

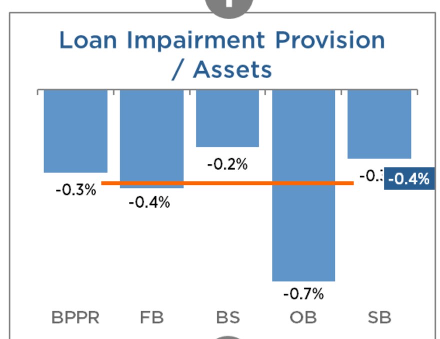

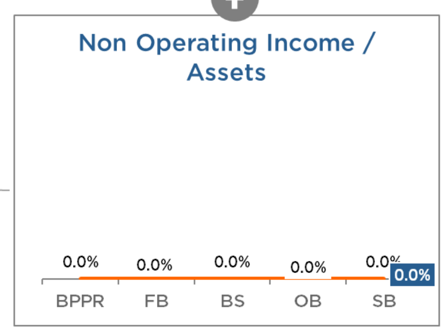

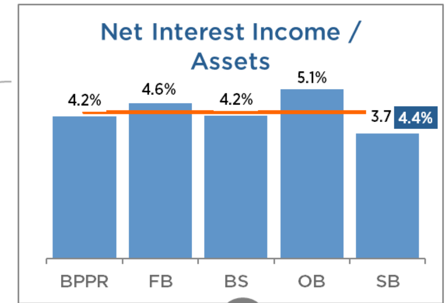

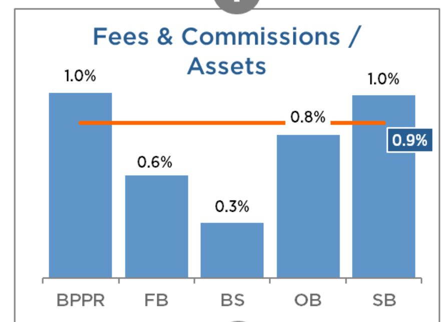

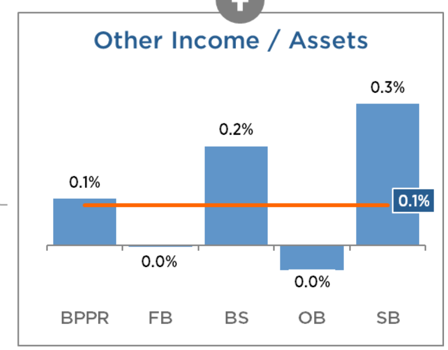

BPPR – Banco Popular de Puerto Rico
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OB - Oriental Bank and Trust
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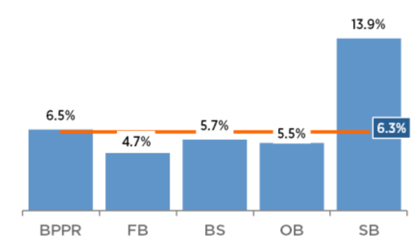
Industry

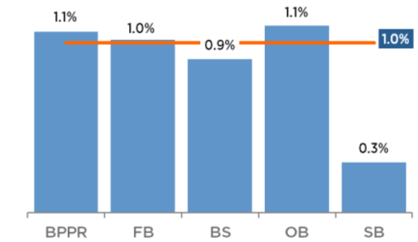
Note 1: Income and expense ratios are annualized.
Source: Federal Deposit Insurance Corporation (FDIC)

Asset Quality

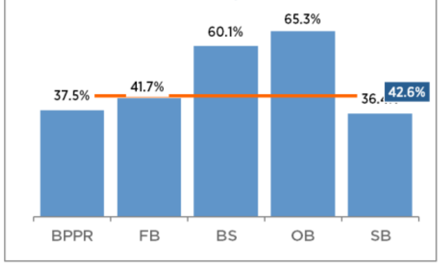
Noncurrent Loans Ratio



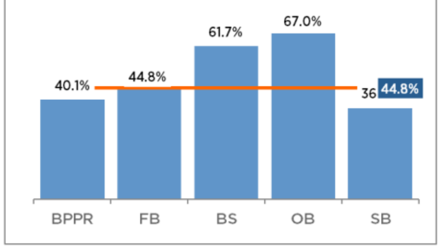
Charge-Off (Loss) Ratio



Reserve / NPL

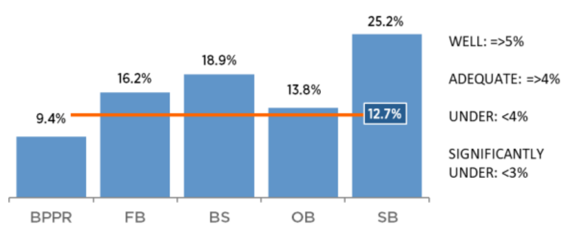


(Reserve+NCO) / (NPL+NCO)

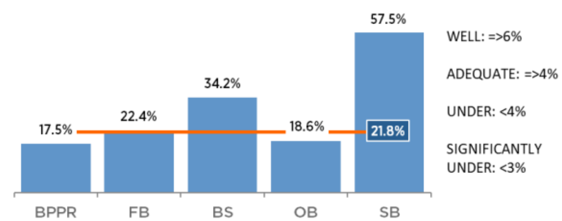


Capital Adequacy

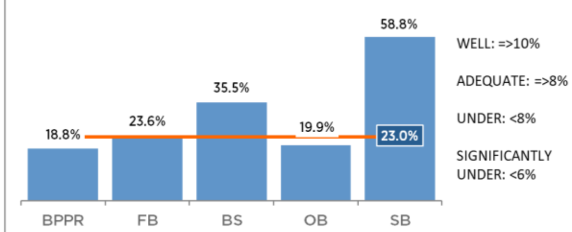
Tier 1 Leverage Ratio



Tier 1 Risk-based Capital Ratio

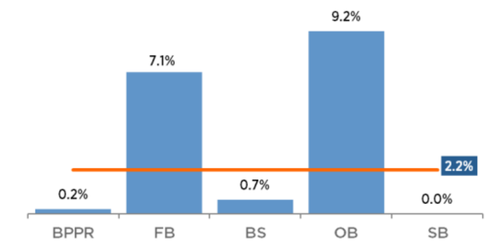


Total Risk-based Capital Ratio

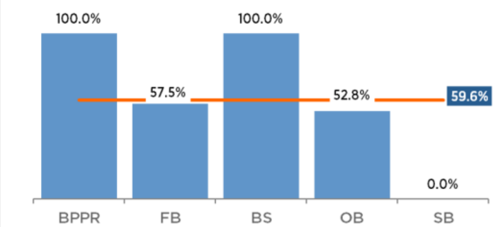


Liquidity

Brokered / Total Deposits Ratio

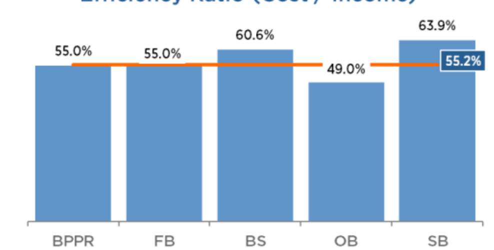


Broker Dep Mat < 1Y / Broker Dep.

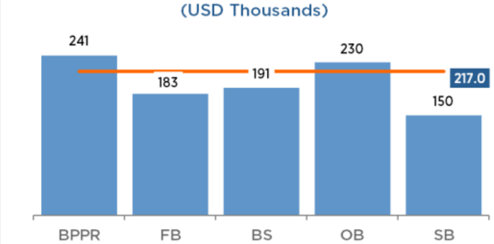


Productivity

Efficiency Ratio (Cost / Income)



Net Margin per Employee
(USD Thousands)



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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)

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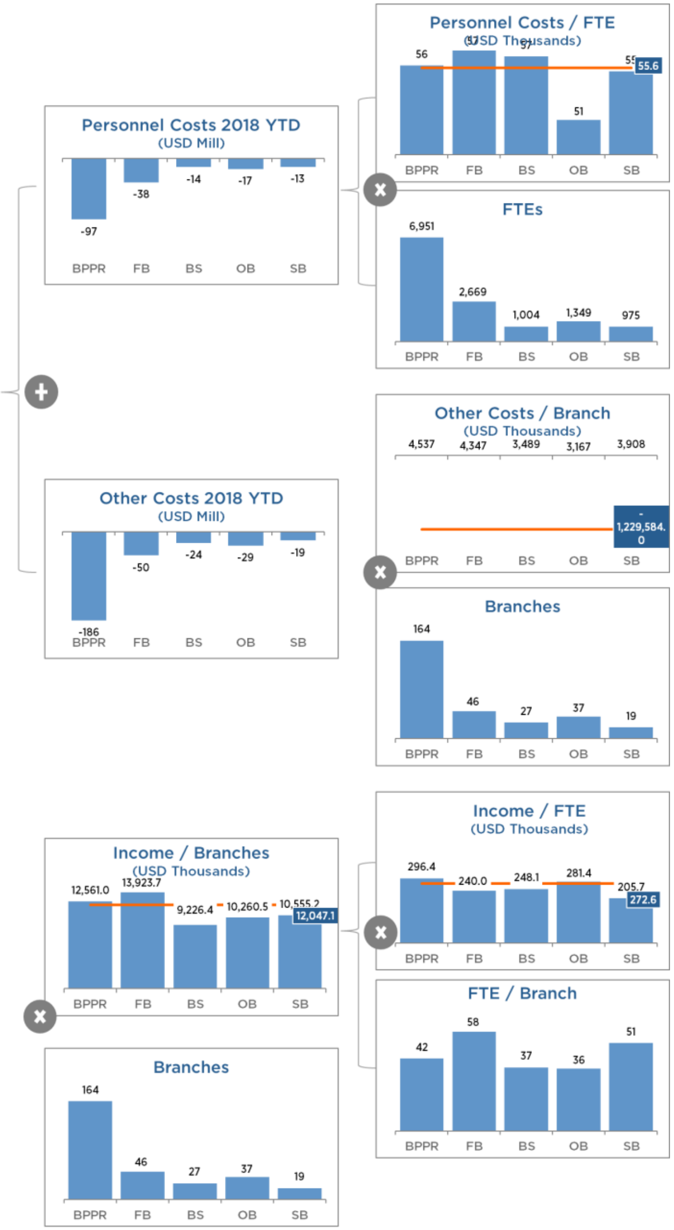
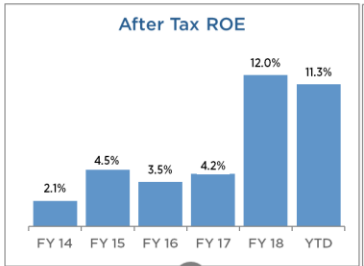
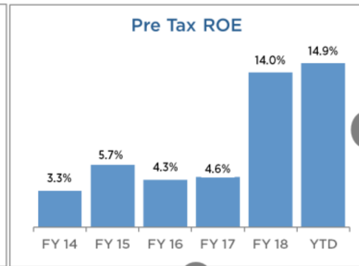
Industry

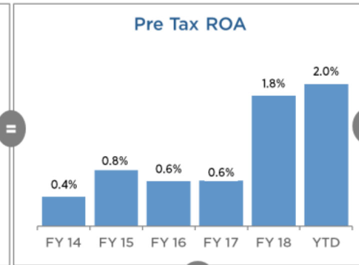
Note 1: Expense and income ratios are annualized.
Note 2: Bank offices as reported by the Office of the Commissioner of Financial Institutions (OCFI) of Puerto Rico as of September 2018.

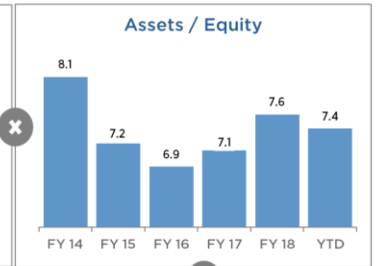


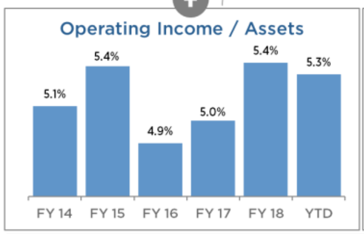
Profitability

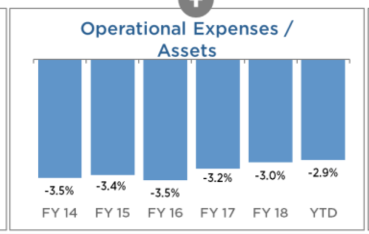


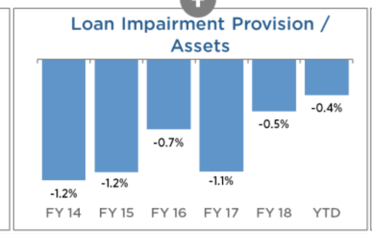


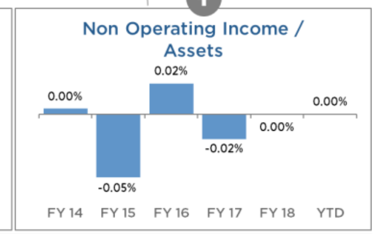




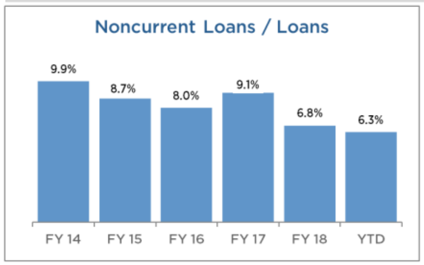


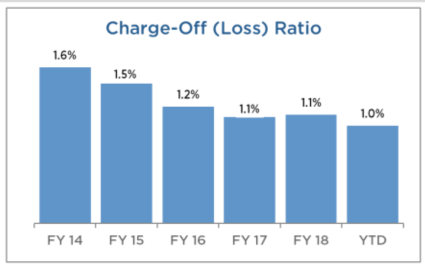


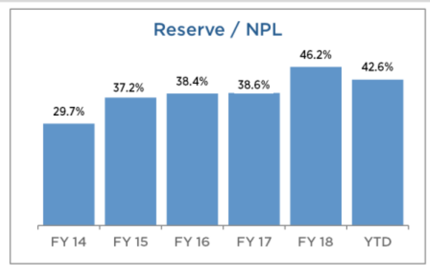


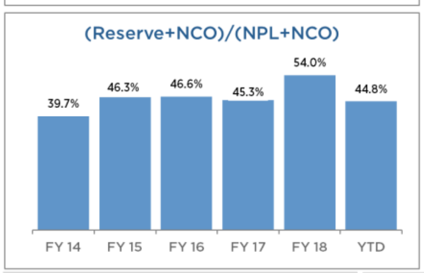


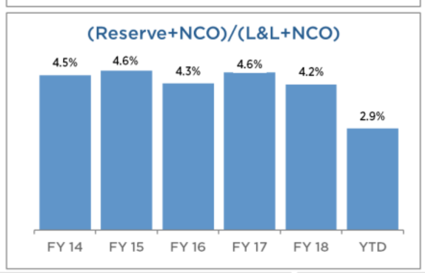
Asset Quality





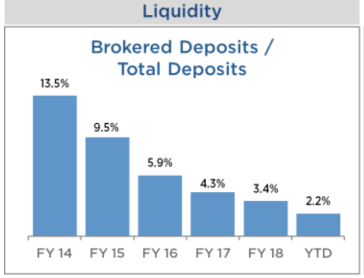




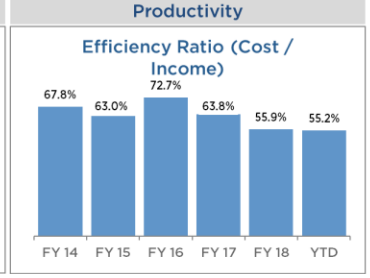


Note 1: Asset quality ratios are not adjusted for FDIC covered and available for sale portfolio.
Note 2: YTD numbers are annualized.
Source: Federal Deposit Insurance Corporation (FDIC)

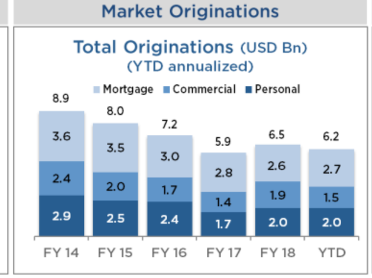
Liquidity



Productivity



Market Originations



Total Assets