V2A CONSULTING Puerto Rico Banking Industry Report

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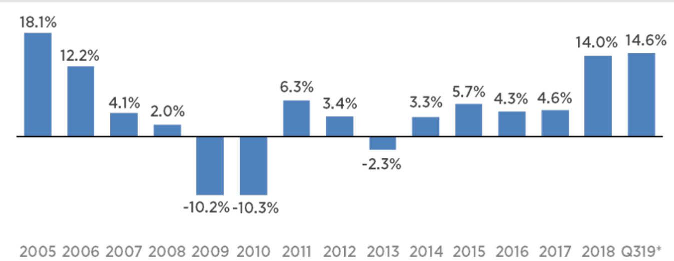
The local banking industry registered another strong quarter in Q3 2019, posting an industry-wide YTD 2019 annualized Pre-Tax ROE of 14.6%. All banks achieved double-digit profitability levels when looking at YTD Pre-Tax ROE, with Popular leading the way with 19.1%, followed by Scotia with 11.9%, FirstBank with 11.1%, Santander with 10.7%, and Oriental with 10.4%. The surviving banks have been able to perform well despite a challenging operating market and a still sluggish economic recovery. The slow pace of disbursements of post-disaster federal funds has thwarted a more robust recovery from materializing. While there have been some positive developments, like a historically low unemployment rate (7.7% in Oct. 2019), Puerto Rico is still very far from being on a sustainable growth path, and questions remain about growth drivers once post-disaster funds are depleted. In this issue, we analyze expected market share distributions in the wake of the latest wave of consolidations. In June 2019 Oriental announced the acquisition of Scotia's Puerto Rico operations, while in October 2019 FirstBank reported the purchase of Santander's Puerto Rico operations. With these latest acquisitions, local commercial banks will come to dominate the local market.

PROFITABILITY > "The industry-wide YTD 2019 Pre-Tax ROE reached 14.6%, closely approaching pre-2006 profitability levels" The profitability of the local banking sector in Q3 2019 continued to build on a strong first half of 2019. The industry-wide YTD 2019 annualized Pre-Tax ROE reached 14.6%, the highest level of profitability since 2005. The banks that have survived several waves of consolidation throughout the past decade have effectively navigated through turbulent economic times by strategically and opportunistically deploying excess capital, controlling expenses, rightsizing their branch network, cleaning their balance sheets of toxic assets, following strict underwriting guidelines, and focusing on strong performing loan segments.

Despite some signs of improvement in the macroeconomic environment, economic performance has been sluggish at best. The Puerto Rico Economic Activity Index ("EDB-EAI") increased by 5.8% in FY 2019 (ending June 30, 2019), after six consecutive years of decline. However, EAI for September 2019 stood at 121.2, still below pre-hurricane levels (Aug. 2017) of 121.3. After two full years of a post-disaster recovery and reconstruction process, economic activity has yet to surpass pre-Hurricanes Irma and Maria levels.

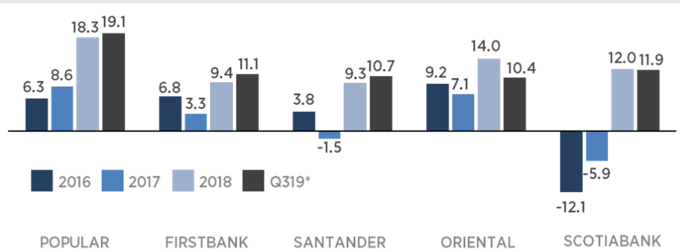
The slow disbursement of appropriated post-disaster federal funds has held back what could have been a more robust economic recovery and an even stronger performance of the banking sector. Of the close to $43 billion that have been appropriated by Congress for hurricane recovery and reconstruction efforts, Puerto Rico has only received roughly a third. Federal agencies have pointed to a lack of adequate oversight and financial monitoring mechanisms, as well as to concerns about waste, fraud, and abuse to justify the delays. The extent to which post-disaster federal contracts are going to nonlocal firms is also diminishing the impact of post-disaster federal funds. According to the Center or a New Economy, as of Sep. 2019, US mainland firms were awarded $4.89 billion (88% of the total) in federal contracts, while PR firms were granted $0.66 billion (12%).

FIGURE 1: Industry Pre-Tax ROE Trend (2005 – Q3 2019)(1)



* Annualized Jan. – Sep. 2019 Pre-Tax ROE. Source: Federal Deposit Insurance Corporation (FDIC).
(1) Citibank PR is not reported separately from Citibank US. The bank is not included in the report analyses.

FIGURE 2: Pre-Tax ROE (%) Trend by Bank (2016 – Q3 2019)

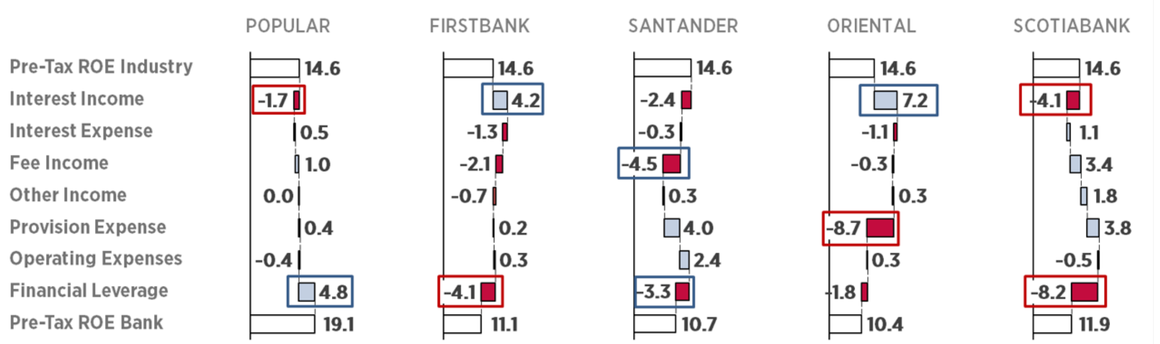


* Annualized Jan. – Sep. 2019 Pre-Tax ROE. Source: Federal Deposit Insurance Corporation (FDIC).

Beyond the pace of post-disaster federal funds disbursements, there remain many questions regarding future drivers of growth once post-disaster funds are depleted. These funds will inexorably come to an end and Puerto Rico will need internal growth dynamics to exhibit sustained growth and development.

When analyzing profitability by bank, all banks, including Scotia and Santander which will be absorbed by Oriental and FirstBank, respectively, posted double digit profitability levels. Popular led the way with a YTD 2019 Pre-Tax ROE of 19.1%, followed by Scotia (11.9%), FirstBank (11.1%), Santander (10.7%), and Oriental (10.4%). Popular's stronger profitability performance vis-à-vis the industry was largely driven by higher financial leverage, posting an assets-to-equity ratio of 10.0 vs. 5.5 for the industry excluding Popular.

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



Better than Industry

Worse than Industry

Source: Federal Deposit Insurance Corporation (FDIC), quarterly results calls, analysis by "Financial Institutions Practice" V2A.

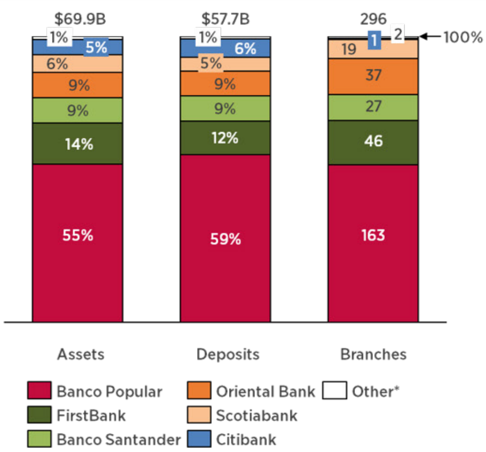
2019 BANKING CONSOLIDATIONS > **"Puerto Rico's deep and prolonged economic crisis has fueled several waves of banking consolidations during the last decade, with the latest wave seeing the exit of Scotia (SBPR) and Santander (BSPR), banks that will be acquired by Oriental and FirstBank, respectively"** Over the last decade, Puerto Rico's banking sector has experienced several waves of consolidation, reducing the number of banks from 10 in 2009 to 3 in 2019-2020, once the acquisitions of BSPR and SBPR are completed. A protracted economic downturn dating back to 2006 has driven a reduction of commercial banking assets from roughly $100 billion in 2009 to $70.4 billion as of the end of Q3 2019. It should be noted, however, that the downward trend in assets has reverted since 2016, increasing from $57.4 billion in Q1 2016 to $70.4 billion.

The first wave of consolidations took place in April 2010 with the Federal Deposit Insurance Corporation-assisted transactions involving Westernbank, Eurobank and R-G Financial Corp, followed by Oriental's acquisition of BBVA PR in 2012, and Doral's failure and closure in the early part of 2015. Furthermore, in June 2019, the announcement of Oriental's acquisition of SBPR was made, and more recently, in October 2019, FirstBank announced the purchase of BSPR operations.

The exit of SBPR and BSPR will impact the competitive dynamics of the local banking sector, and change market share distributions across the different credit business segments. FirstBank's acquisition of BSPR will allow it to recapture the second position in total assets, increasing its market share from 14% to 23% (see Fig. 4). FirstBank will also increase its deposits' share from 12% to 21%. Oriental's purchase of SBPR will in turn increase its assets market share from 9% to 15%, and its deposits market share from 9% to 14%. Popular will continue to lead the market with an assets market share of 55% and a deposits market share of 59%. The branch networks of FirstBank and Oriental will also materially increase with these acquisitions, growing from 46 to 73, and from 37 to 56, respectively. It should be noted that our analysis assumes FirstBank and Oriental will acquire all of BSPR's and SBPR's assets and deposits.

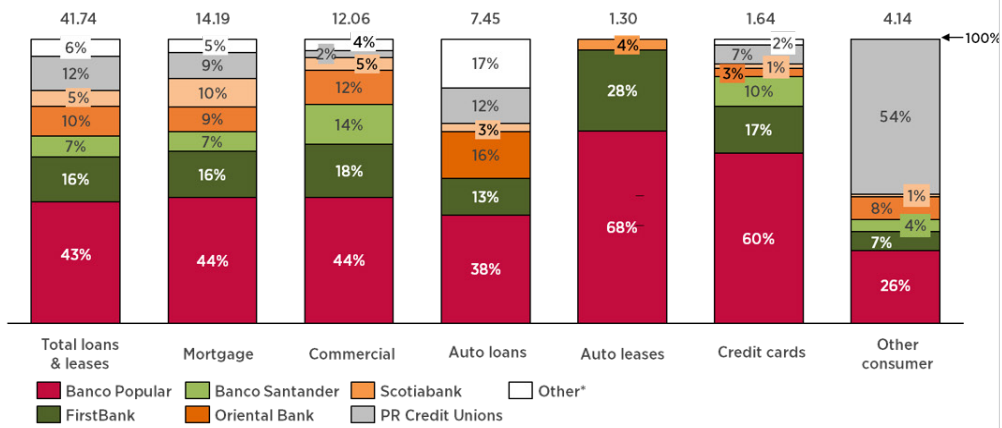
Figure 5 shows the distribution of the various credit financing businesses among market players and clearly depicts how FirstBank's purchase of BSPR will solidify its second position in the local banking market. The acquisition of BSPR provides FirstBank with a very strong commercial lending portfolio particularly in the small business and investment banking segments, and, to a lower extent, a sizeable credit cards business. FirstBank's market share could increase from 18% to 32% in the commercial business and from 17% to 27% in credit cards. FirstBank will be able to leverage BSPR's relationship with American Express which brings a unique set of credit card products targeted to the affluent consumer. Oriental's market share in certain credit businesses will also be impacted by its acquisition of SBPR. Its mortgage business market share will increase from 9% to 19%, commercial from 12% to 17%, and auto loans from 16% to 19%. Finally, it is important to mention the large participation of local credit unions in the "Other consumer" category (mainly personal loans) where they hold a 54% market share.

Figure 4: Assets (%), deposits (%) and branches by bank



Source: Office of the Commissioner of Financial Institutions (OCFI)
*Includes Banesco and Banco Cooperativo

Figure 5: Loan & Lease portfolio distribution by credit financing entity/group (US$B, %)



Source: Office of the Commissioner of Financial Institutions (OCFI)
*Includes Government, non-depository institutions, federal credit unions and AAELA for **Mortgage**, Citibank, Banesco and Banco Cooperativo for **Commercial**, Toyota Credit PR, BMW Financial Services and federal credit unions for **Auto Loans**, and federal credit unions for **Credit Cards**

FINAL REMARKS > Local banks continue to exhibit double-digit profitability levels despite a slow-paced economic recovery and slow disbursement of post-disaster federal funds. We can expect an even stronger performance of the economy and local banks if the appropriated funds are more quickly disbursed. The local banking industry is undergoing another wave of consolidations in 2019-2020 with the acquisitions of Scotia and Santander by Oriental and FirstBank, respectively, acquisitions which will materially reconfigure the market share distributions of several key credit businesses, particularly the mortgage business, commercial lending, and credit cards.

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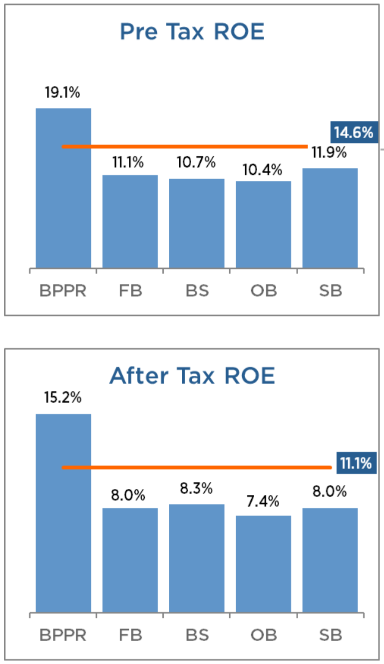
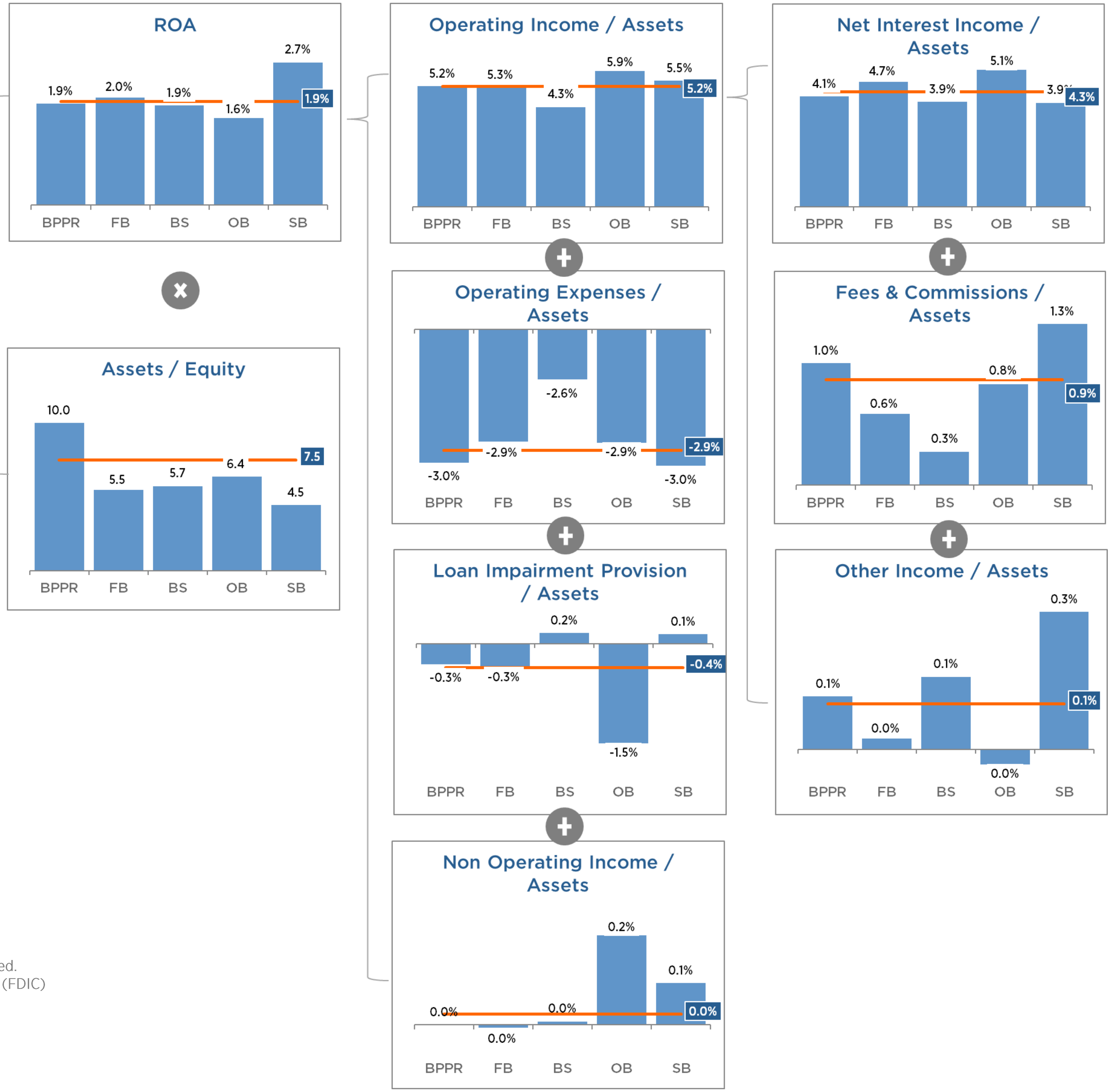


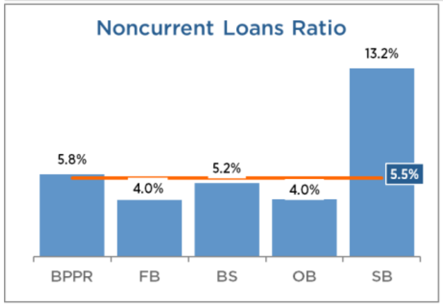


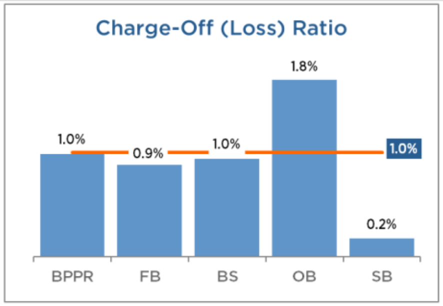
BPPR – Banco Popular de Puerto Rico
FB - FirstBank of Puerto Rico
BS - Banco Santander de Puerto Rico
OB - Oriental Bank and Trust
SB - Scotiabank de Puerto Rico

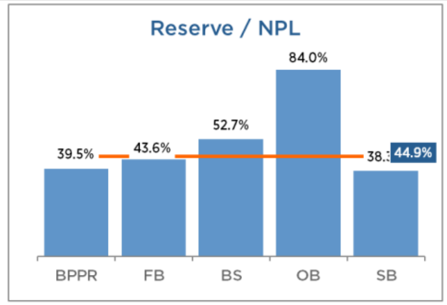
Industry

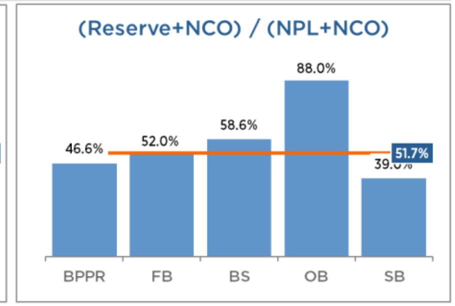
Note 1: Income and expense ratios are annualized.
Source: Federal Deposit Insurance Corporation (FDIC)

Asset Quality

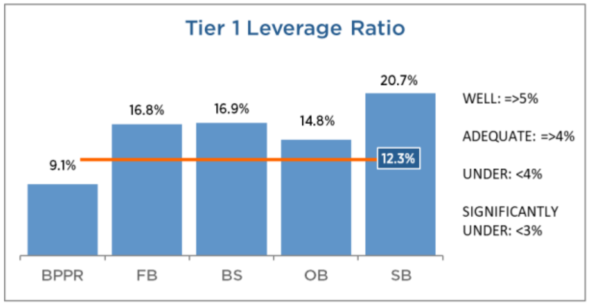


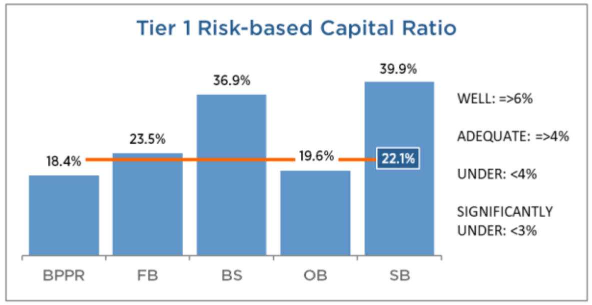


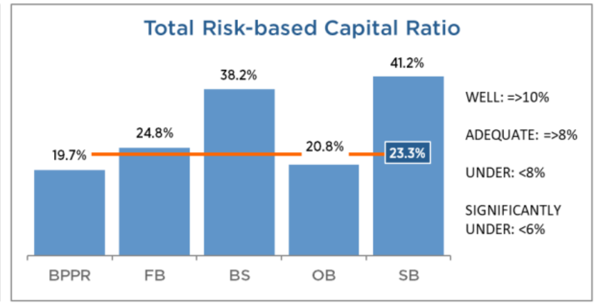




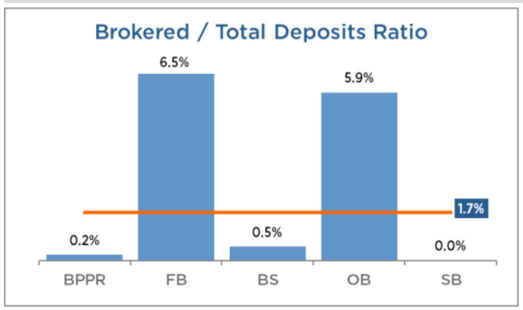
Capital Adequacy

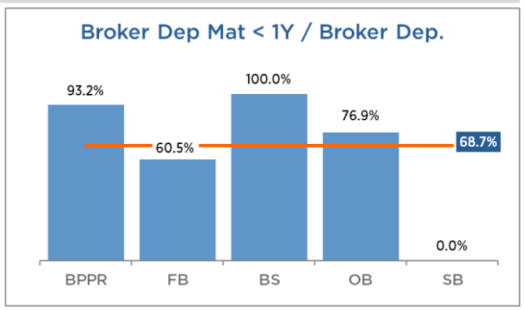




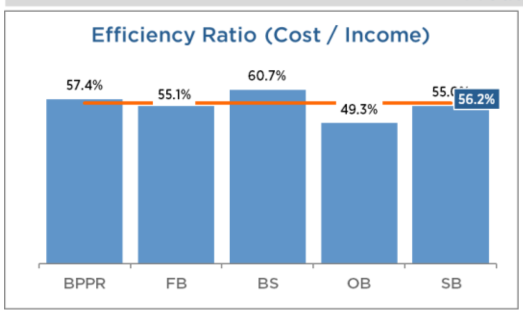


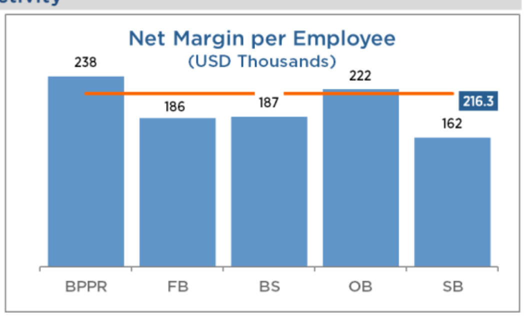
Liquidity





Productivity





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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)

BPPR - Banco Popular de Puerto Rico
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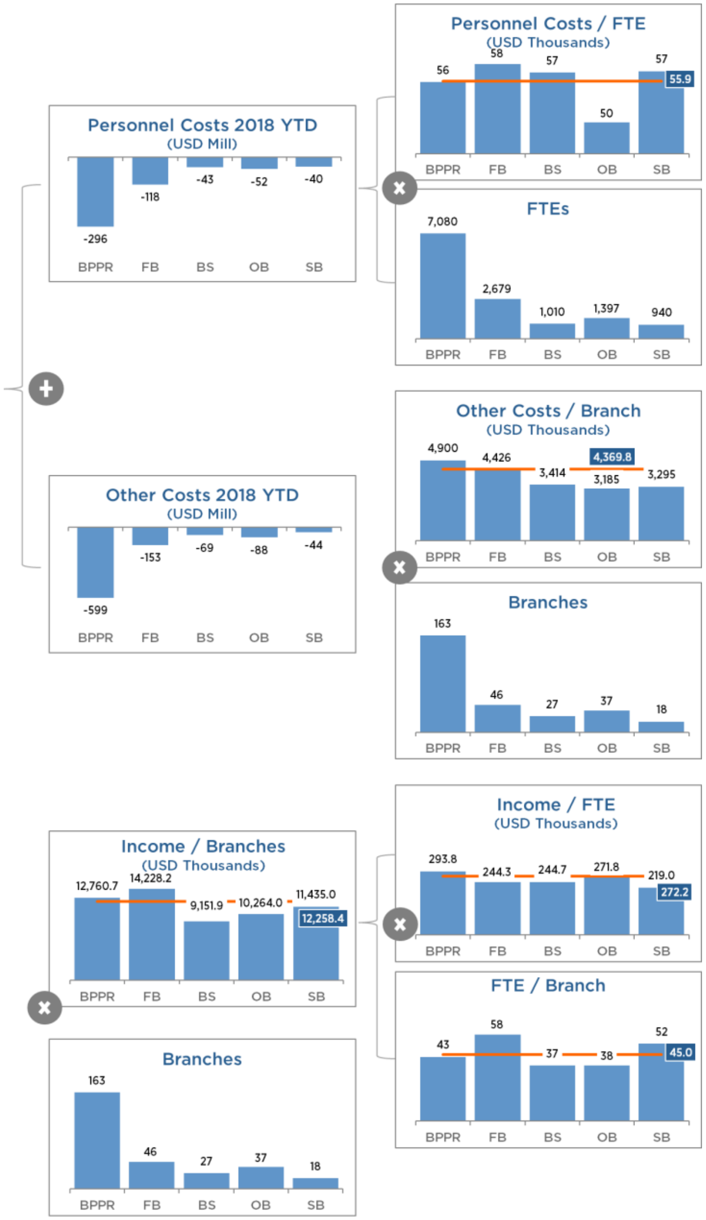
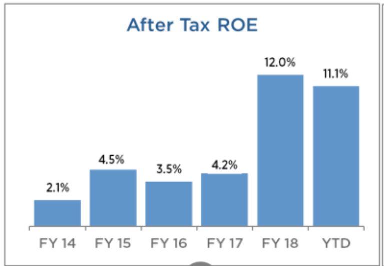
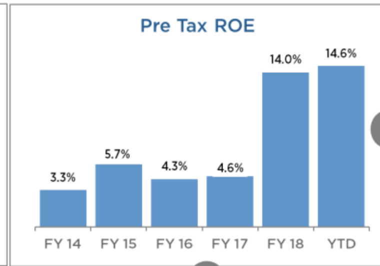
Industry

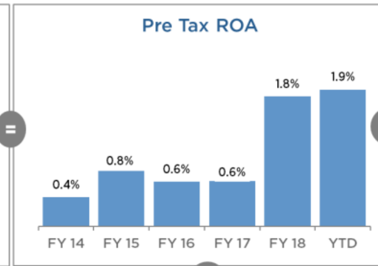
Note 1: Expense and income ratios are annualized.
Note 2: Bank offices as reported by the Office of the Commissioner of Financial Institutions (OCFI) of Puerto Rico as of June 30, 2019. Scotia includes Nova Scotia.

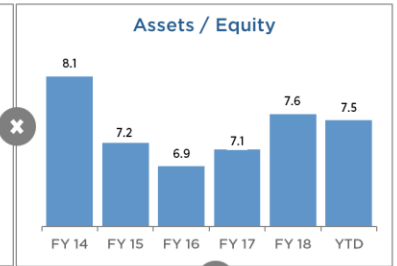


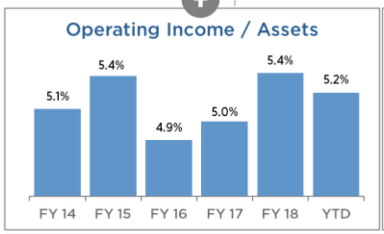
Profitability

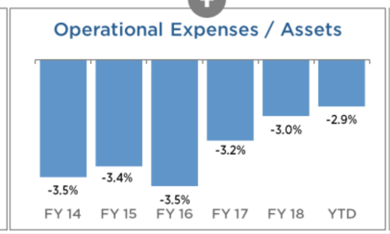


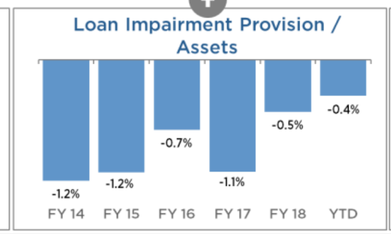


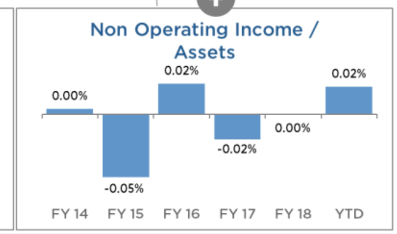




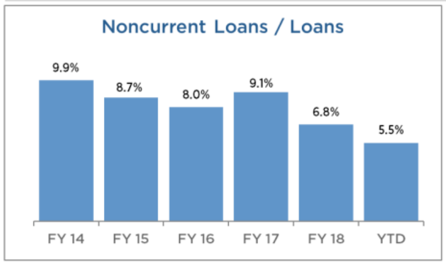


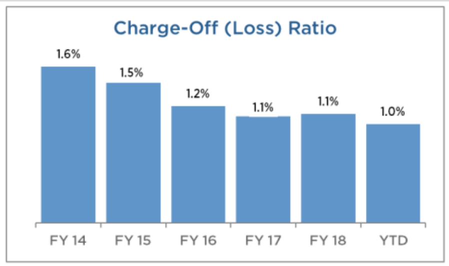


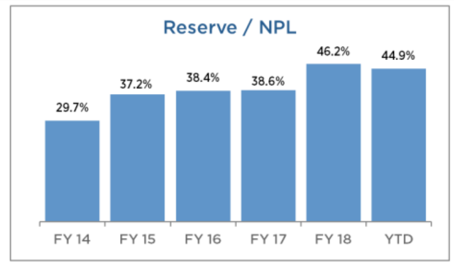


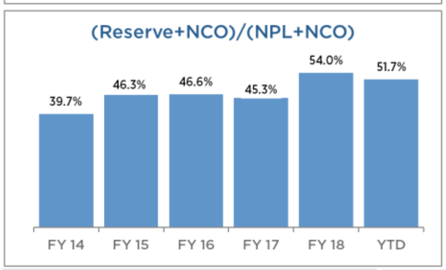


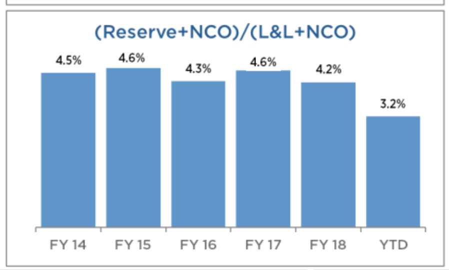
Asset Quality





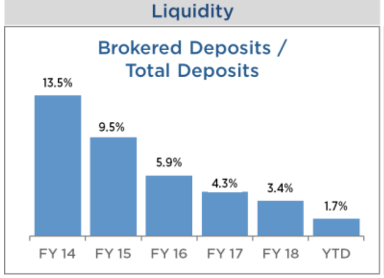




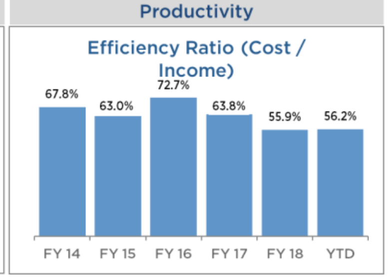


Note 1: Asset quality ratios are not adjusted for FDIC covered and available for sale portfolio.
Note 2: YTD numbers are annualized.
Source: Federal Deposit Insurance Corporation (FDIC)
Note 3: Market originations YTD FY2019: Q1 – Q3 annualized

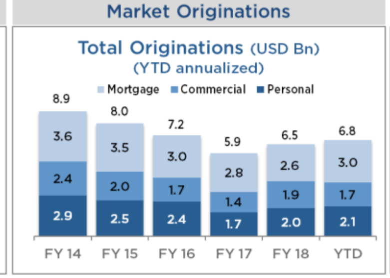
Liquidity



Productivity



Market Originations



Total Assets