V2A Vision To Action
Strategic Management Consultants

Puerto Rico Banking Industry Report

Issue IX January to June 2011

EXECUTIVE SUMMARY: The Q2 2011 results confirm the success of the measures taken in the past years to reduce non-performing assets and maintain appropriate capital levels. With banks ready to grow their core businesses in a challenging economic scenario with limited organic growth opportunities, a new competitive landscape has emerged. In this new landscape, stealing share through superior service and innovative marketing ideas while protecting margins will be the name of the game. So far, some banks have fared better than others under this new landscape, particularly in the commercial credit business where competition is most fierce. While we are optimistic that the banking sector credit performance will continue to improve and the market will slowly recover, it is still possible that the economy deteriorates further and that banks will need to refocus on loss mitigation.

Special points of interest:

- Total annualized operating income for the local banking sector of $0.6B is close to 2006 levels, when credit provision was still low.
- Oriental and Scotia are the only banks growing the total non-FDIC covered commercial loan portfolio year on year.
- While still optimistic regarding the stabilization of the local economy and the recovery of the banking sector, recent events have increased the chances of a further economic deterioration that could force banks to loss mitigation mode again.

Inside this issue:

2011 RESULTS: Positive ROE opens the door for a new competitive landscape

The return to positive profitability that we observed in the first quarter of 2011 is confirmed by the second quarter results. The banking sector as a whole reached a Pre-Tax ROE of 10.1% in the first half of 2011 after two consecutive years of negative results (see Figure 1).

Total annualized core operating income (Net Interest Margin + Fess - Provision - Operating Expenses) for the first half of 2011 was US$0.6B, close to the 2006 number, when the banking sector's books had not yet been impacted by large credit provisions (see Figure 2).

After two years of intensive efforts to reduce credit exposure and large write offs, banks' balance sheets are in a healthier position. This is clearly reflected in the reduction of the provision to net interest margin (NIM) and fees ratio from 58% in 2009 and 55% in 2010 to 26% in 2011. At the same time, banks have made progress in increasing their NIM in order to compensate, at least partially, for the deterioration in profitability suffered in the past years. NIM to total assets increased from 2.6% in 2008 to 3.5% in the first half of 2011 (2).

As a result of these efforts, all banks, with the exception of FirstBank, had positive results in the first half of 2011, with Scotia and Popular showing the highest Pre-Tax ROEs (18.5% and 17.1%, respectively) (see Figure 3).

While banks were able to generate substantial net income in 2011, deposits remained stable (0% growth year on year) and assets continued to decline under a challenging economic environment (12% drop year on year) (see Figure 4). As we mentioned in our previous Issue, the consequence of these factors has been a combination of excess liquidity and limited growth opportunities. As a result, a new competitive environment has emerged where:

1. additional attention is placed on increasing profitability,
2. stealing share is the main organic growth driver, and
3. there are renewed consolidation pressures.

Regarding the first point, banks are likely to continue enhancing their top line by increasing their NIM and, particularly, by reducing their cost of funds (COF). They will also seek for ways to improve their cost to income through process improvement efforts and controlling discretionary expenses.

In regards to the second point, there should be fierce competition to retain, or steal, the best customers in the market (specifically the medium commercial and corporate), who despite the prolonged recession continue to maintain wealth and to have sound credit profiles. To do that, banks will need to set up sophisticated targeting and segmentation tools and test their profitability models in order to provide these clients with attractive value propositions. The ability to understand their needs and to provide the right service levels to satisfy these needs will also be key.

Finally, a second wave of consolidations may materialize in the second half of 2011 or during 2012. Specifically, with FirstBank coming as a new player after the infusion of capital by several private equity firms, there is rumor about a possible consolidation with another institution that would allow the resulting bank to compete with Banco Popular.

Figure 1: Pre Tax ROE 2005-YTD 2011

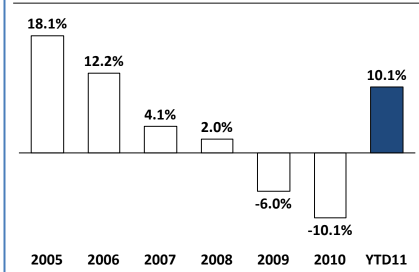
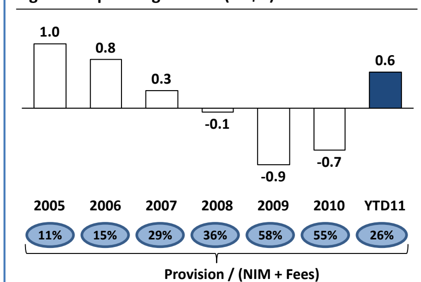


Figure 2: Operating Income (US$B)*



* NIM + Fees - Provision - Operating Expenses. 2011 annualized

Figure 3: Pre-Tax ROE by Bank (YTD 2011) (1)

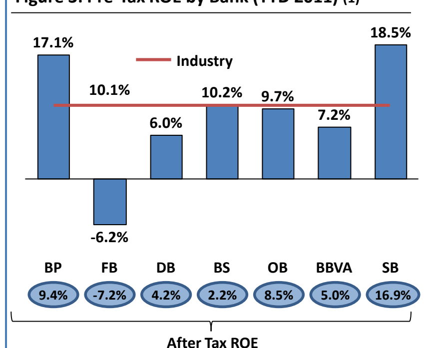
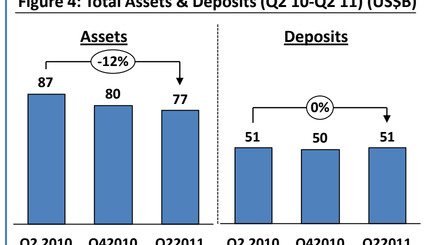


Figure 4: Total Assets & Deposits (Q2 10-Q2 11) (US$B)



Source: Federal Deposit Insurance Corporation (FDIC), "Call Reports", 10-Q SEC filings, quarterly results calls, analysis by "Financial Institutions Practice" V2A.

(1) Citibank Puerto Rico financial data is not reported separately from Citibank US and, consequently, the bank is not included in the report analyses.

(2) Higher NIM for institutions that participated in the consolidation process is also the result of applying the Statement of Position 03-3 to account for income related to acquired portfolios.

COMPETING IN A CHALLENGING ENVIRONMENT: banks focus on growth by competing for share while protecting margins ...

The banking sector has managed to be profitable again and has rebalanced its focus from loss mitigation to business growth under a very challenging environment. As mentioned before, gaining share from other banks in the best segments in terms of profitability and credit performance, and protecting, or even increasing, margins will be the name of the game in the new competitive scenario. Based on that, we can take a look at recent trends in these two areas.

Regarding the competitive environment, the commercial loan business seems to be the main focus of banks' growth strategies. Total commercial loan originations experienced a 39% increase between the 1st half of 2010 and the 1st half of 2011 and accounted for 73% of the total originations growth between these two periods (see Figure 5). However, the $1.9B in total commercial originations during the 1st half of 2011 is still far from the semiannual $3.8B experienced in 2007. In fact, total commercial originations were not large enough to compensate for write offs and the natural maturity of the banking system's commercial loan portfolio during this time period. As a result, total commercial loan balances, excluding the FDIC covered portfolios, decreased by 4% from June 2010 to June 2011 (see Figure 6).

This represents a challenge for larger banks like Popular, FirstBank and Santander, whose commercial loan portfolios have reduced in the past year. It will be difficult for these banks to reverse this trend because loan originations, despite showing significant growth, are not likely to reach pre-recession levels in the near future. Additionally, banks with a smaller non-FDIC covered portfolio base seem to be using their flexibility to compete effectively. While their base is still low, both Oriental and Scotia are growing their total non-FDIC covered commercial loan portfolio. With the local business still struggling in a difficult economic environment, this growth is probably the result of the banks' efforts to attract clients from other institutions.

Regarding margins protection/enhancement, the industry's operating expenses to NIM+Fees experienced an improvement between the 2nd half of 2010 and the 1st half of 2011, reducing from 60% to 57% (See Figure 7). All banks except from Scotia saw this ratio either decrease or remain stable during this period of time.

In Figure 8 we can observe the main drivers of the banks' improvement or deterioration of their net operating income excl. provision (NOIEP) to average assets. The clear outperformers were Oriental and Santander, whose ratios increased by 58bps and 53bps, respectively. Oriental's improvement was driven by its top line, particularly interest income, which was positively impacted by the better than expected performance of the FDIC covered portfolio, and fee income. Santander's improvement was driven by a reduction in COF and non-salary related operating expenses.

On the opposite side, Scotia saw a marginal reduction of 9 bps driven by lower fees and higher non-salary related operating expenses, but it continues to maintain the 2nd highest ratio after Popular. Doral saw the improvement in interest income and COF fully offset by a reduction in fees and commissions. Its operating income to average assets remained stable and continues to be below the other players' ratios.

In general, banks seem to understand the relevance of maintaining top line revenue growth while controlling expenses in the new environment. This is evidenced by the NIM improvement and the reduction in operating expenses in the 1st half of 2011.

Figure 5: Total Loan Originations ($B)

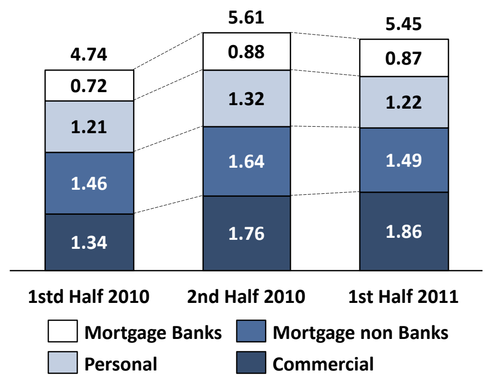
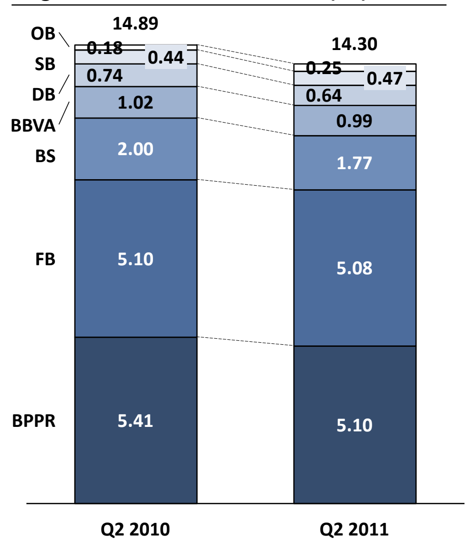


Figure 6: Total Commercial L&L ($B)*



* Excludes FDIC covered portfolios

Figure 7: Operating Expenses / (NIM + Fees)

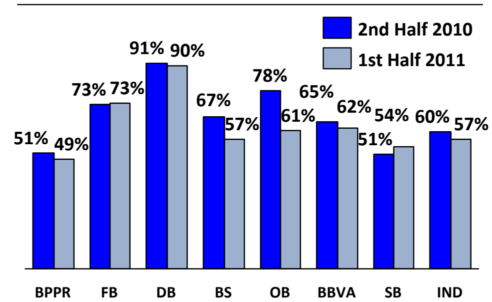


Figure 8: Reconciliation of 2nd Half 2010 Net Operating Income Excl. Provision (NOIEP) and 1st Half 2011 NOIEP by Bank (% of avg. Assets)

Better than 2nd Half 2010 — Worse than 2nd Half 2010

	POPULAR	FIRSTBANK	DORAL	SANTANDER	ORIENTAL	BBVA	SCOTIA
2nd Half 2010 NOIEP	2.81	0.73	0.33	1.44	0.42	1.32	2.76
Interest Income	0.09	0.00	0.34	0.13	0.43	0.04	0.50
Cost of Funds	0.13	0.07	0.21	0.21	0.00	0.06	0.03
Fees & Commissions	0.01	0.27	0.62	0.16	0.18	0.10	0.40
Salaries Expense	0.04	0.12	0.10	0.01	0.02	0.11	0.01
Other Oper. Expense	0.09	0.13	0.20	0.29	0.01	0.09	0.22
1st Half 2011 NOIEP	2.99	0.82	0.35	1.97	1.00	1.50	2.67

The "PUERTO RICO BANKING INDUSTRY REPORT" is a quarterly publication. In order to receive back issues or the "DOMINICAN REPUBLIC BANKING INDUSTRY REPORT" please contact:

René Yamín
Director, V2A
(reneyamin@v-2-a.com)

Juan Pablo González
Engagement Manager, V2A
(juangonzalez@v-2-a.com)

Xavier Diví
Associate, V2A
(xavierdivi@v-2-a.com)

V2A, Inc.
District View Plaza (Suite 401)
644 Ave Fernández Juncos
San Juan, PR 00907-3122

Tel.: (787) 9197303
www.v-2-a.com

… but could be forced to loss mitigation and workout mode again if the economy deteriorates further

After spending two years reducing credit exposure and leverage, local banks seem to be putting more attention on their commercial activities. While we expect this trend to persist in the future, a further deterioration of the economic environment could force banks to redirect their focus back to loss mitigation.

For the moment, there are no signs of strong economic recovery. The economic activity index has remained stable in 2011 but at very low levels and every month shows year on year negative growth (See Figure 9).

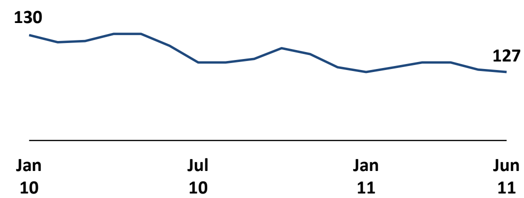
There is also uncertainty on how external factors will play on the local economy. On one side, the risk of the US economy falling back to recession has increased, which, considering its strong ties with the mainland, could have a negative impact on Puerto Rico. Additionally, the large actuarial deficit of the employees' retirement system of Puerto Rico could trigger a downgrade from the rating agencies and dampen consumer confidence and business activity again.

On the other side, oil prices seem to be going down, partly due to the slowdown in the economic activity. In addition, the risk of an interbank interest rate increase in the United States has decreased as a result of the higher recession risk.

The lack of strong recovery and the current economic uncertainty is also reflected in the banking credit indicators. Despite improvement in non-performing loans (NPLs) to total loans since its highest point in the first half of 2010, the ratio remains high and, in fact, experienced a slight deterioration in Q2 2011 (see Figure 10).

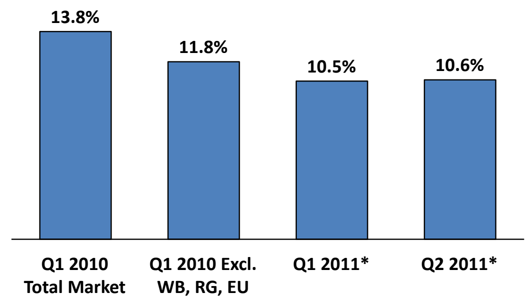
The reserve ratio, which increased between Q1 2010 and Q1 2011, showed a reduction in Q2 2011 (see Figure 11) and could experience a larger decrease in the future if real estate prices drop further. A reduction in the loans collateral value has a direct impact on the reserve calculation and, thus, on the banks' bottom line. There are two main forces that could trigger a decrease in real estate prices: i) a prolonged economic recession, and ii) large pools of properties being sold by banks and specialized companies at low prices. With banks' credit reserves still at low levels, there is limited space to cope with another large reduction in real estate prices.

Figure 9: Economic Activity Index Trend (EAI)*



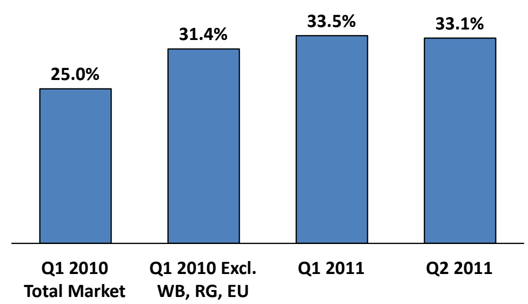
***Comprises payroll employment, total electric power consumption, cement sales and gas consumption**

Figure 10: NPL Ratio 2010-11



*** Excluding L&Ls under loss sharing and BPPR held for sale**

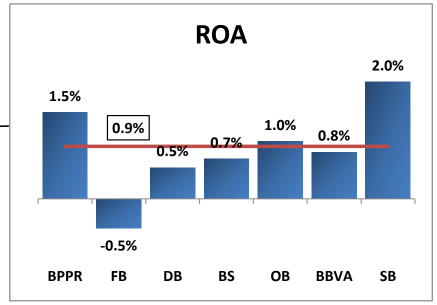
Figure 11: Reserve Ratio 2010-11

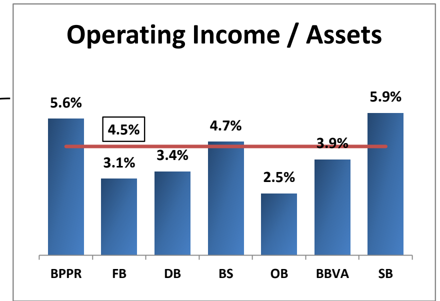


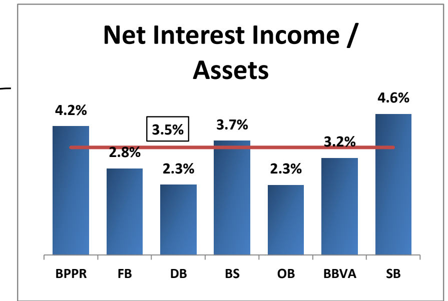
In summary, while we maintain our optimism on the local banking sector after the banks' extraordinary efforts to get rid of toxic assets, we remain cautious. We expect banks to enhance their customer service and come up with innovative ideas to capture the best clients in a context of fierce competition under slow or no overall growth. However, we do not discard a return to deleveraging activities, loss mitigation and reduction of credit exposure if the local economy deteriorates further.

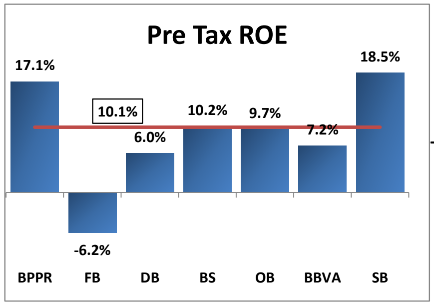
Source: Federal Deposit Insurance Corporation (FDIC), local media, analysis by "Financial Institutions Practice" V2A.

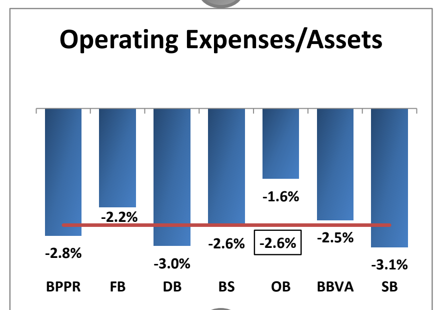
ANNEX 1: BANKING INDUSTRY PROFITABILITY January - June 2011

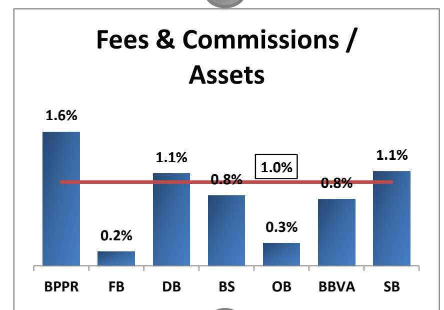


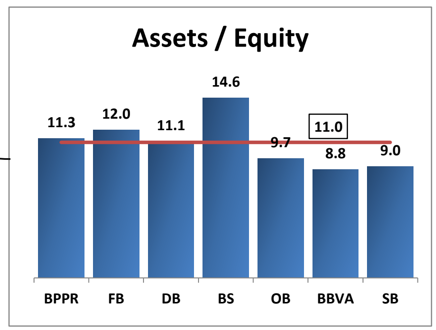


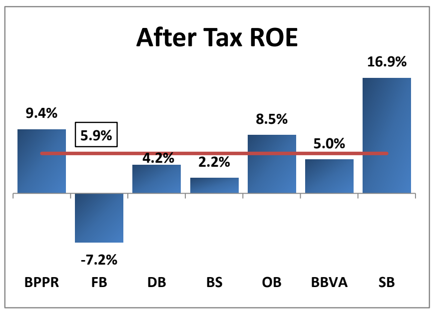


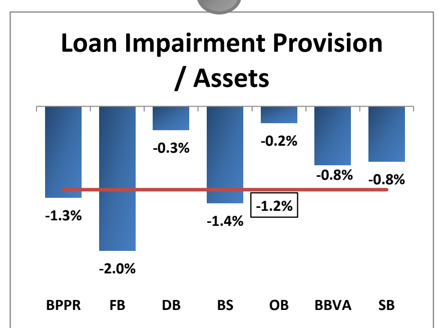


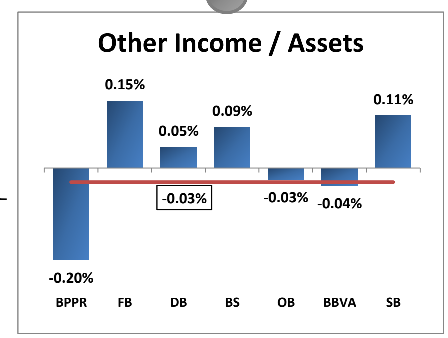




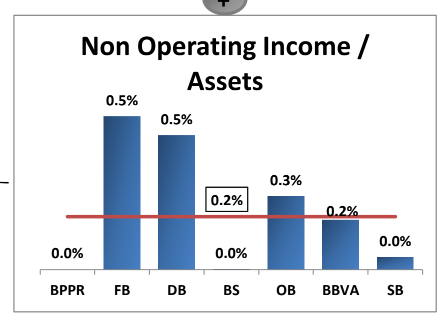








BPPR = BANCO POPULAR DE PUERTO RICO
FB = FIRSTBANK OF PUERTO RICO
DB = DORAL BANK
BS = BANCO SANTANDER PUERTO RICO
OB = ORIENTAL BANK AND TRUST
BBVA = BANCO BILBAO VIZCAYA ARGENTARIA PUERTO RICO
SB = SCOTIABANK DE PUERTO RICO

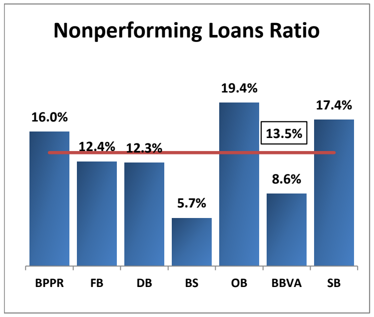


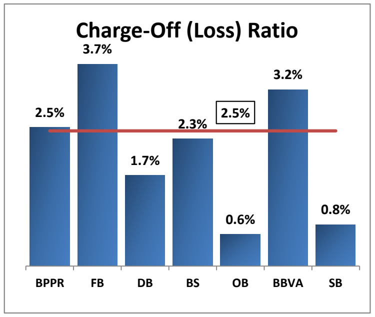
Note: Industry includes acquired banks data in Q1 2010
Source: Federal Deposit Insurance Corporation (FDIC)

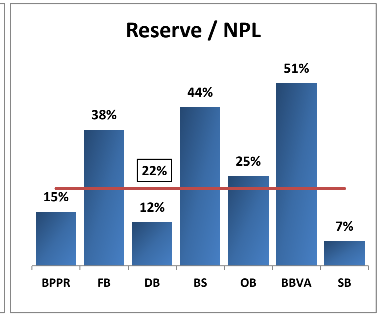
Industry

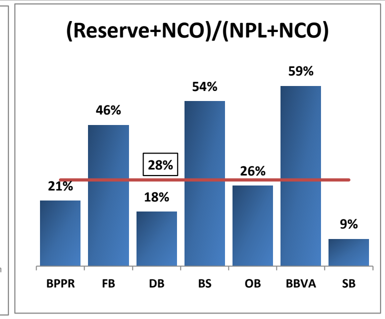
ANNEX 2: BANKING INDUSTRY PERFORMANCE RATIOS January - June 2011

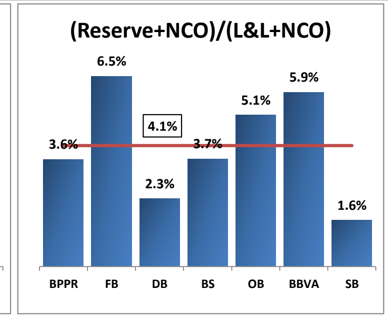
ASSET QUALITY



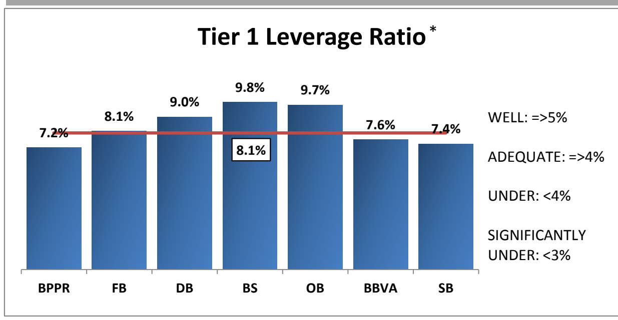


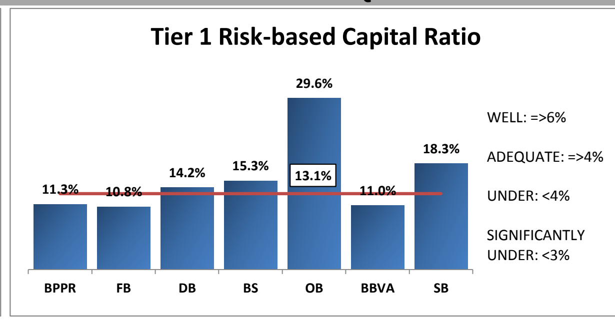


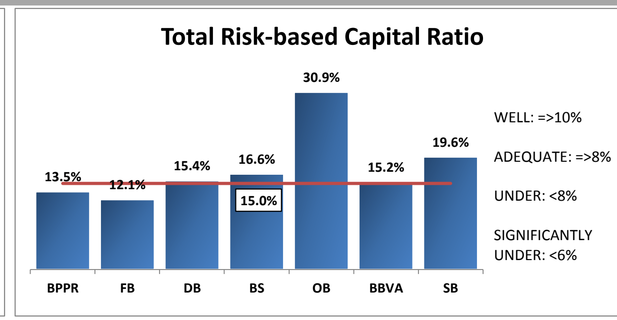




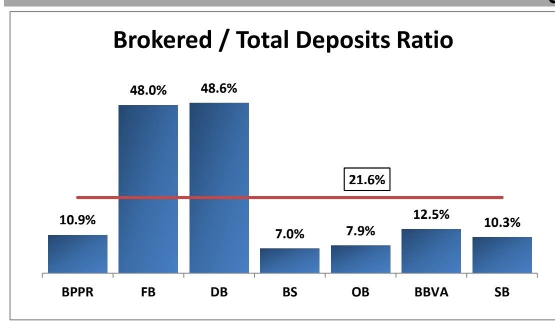
CAPITAL ADEQUACY

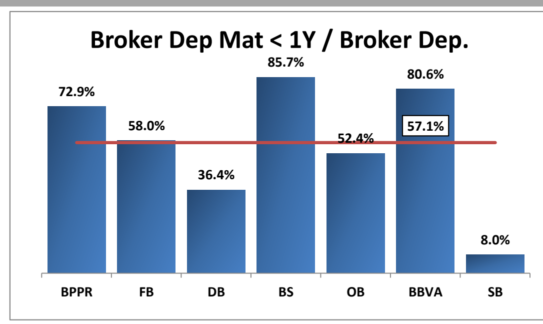




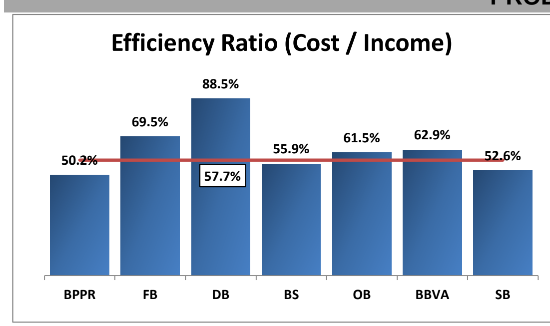


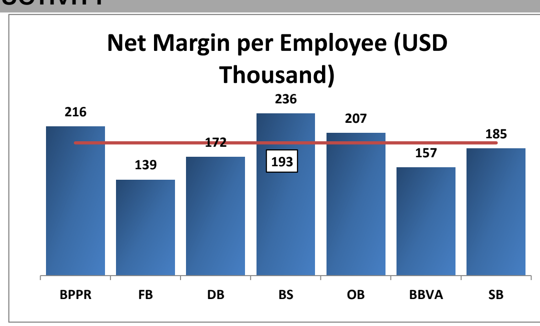
LIQUIDITY





PRODUCTIVITY



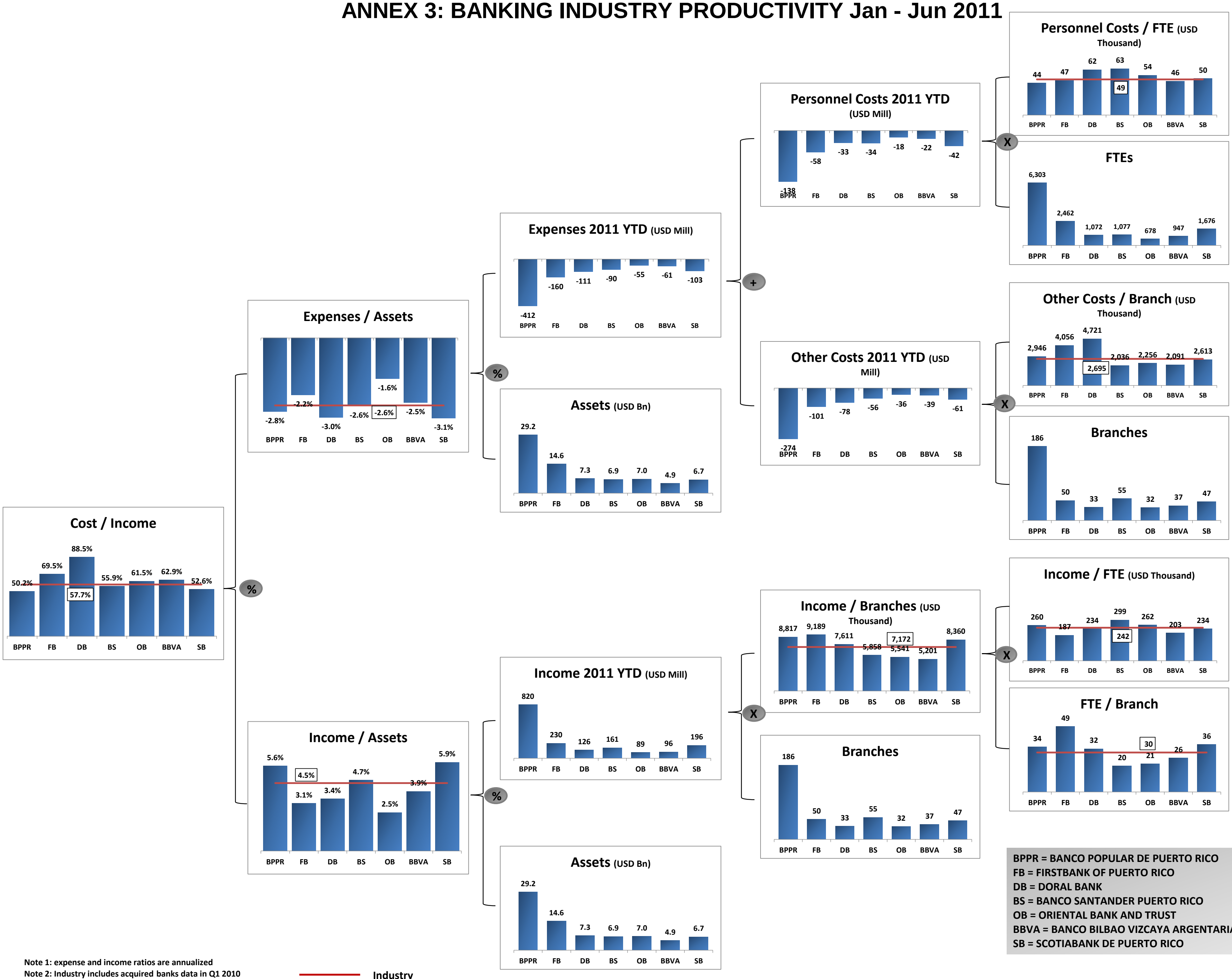


BPPR = BANCO POPULAR DE PUERTO RICO
FB = FIRSTBANK OF PUERTO RICO
DB = DORAL BANK
BS = BANCO SANTANDER PUERTO RICO
OB = ORIENTAL BANK AND TRUST
BBVA = BANCO BILBAO VIZCAYA ARGENTARIA PUERTO RICO
SB = SCOTIABANK DE PUERTO RICO

Industry

* Also referred to as Core Capital (leverage) Ratio by the FDIC
Note: Asset quality ratios are not adjusted for FDIC covered and available for sale portfolios
Source: Federal Deposit Insurance Corporation (FDIC)

ANNEX 3: BANKING INDUSTRY PRODUCTIVITY Jan - Jun 2011



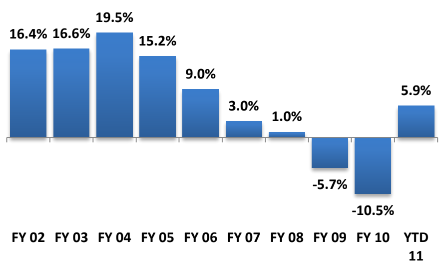
BPPR = BANCO POPULAR DE PUERTO RICO
FB = FIRSTBANK OF PUERTO RICO
DB = DORAL BANK
BS = BANCO SANTANDER PUERTO RICO
OB = ORIENTAL BANK AND TRUST
BBVA = BANCO BILBAO VIZCAYA ARGENTARIA PUERTO RICO
SB = SCOTIABANK DE PUERTO RICO

Note 1: expense and income ratios are annualized
Note 2: Industry includes acquired banks data in Q1 2010
Source: Federal Deposit Insurance Corporation (FDIC)

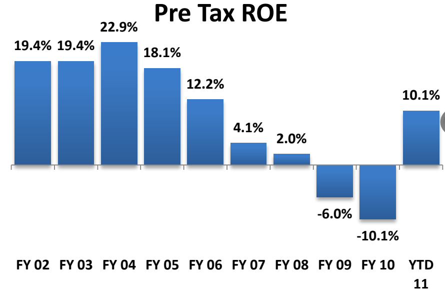
ANNEX 4: INDUSTRY TRENDS - SELECTED METRICS

PROFITABILITY

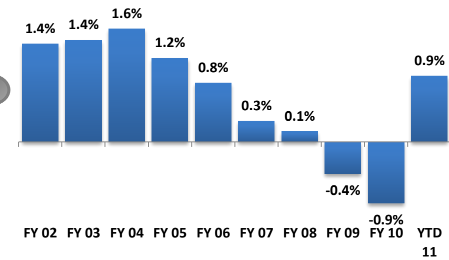
After Tax ROE



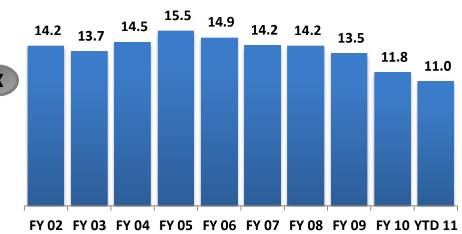
Pre Tax ROE



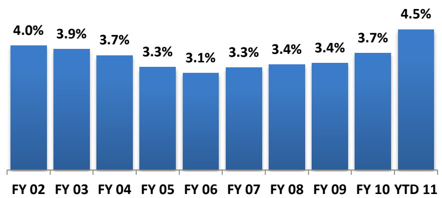
Pre Tax ROA



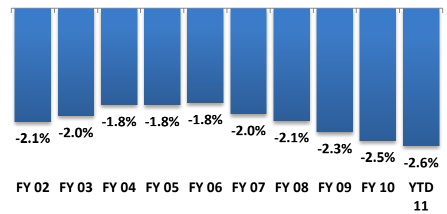
Assets / Equity



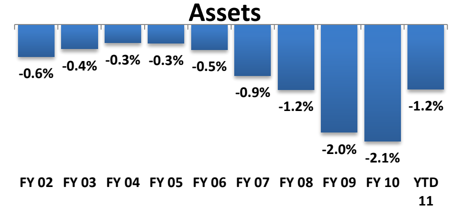
Operating Income / Assets



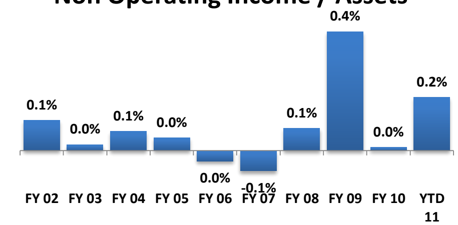
Operational Expenses / Assets



Loan Impairment Provision / Assets

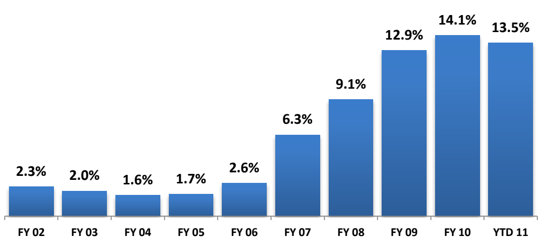


Non Operating Income / Assets

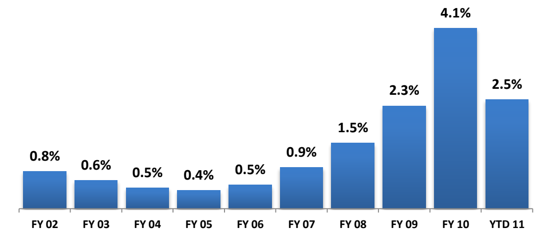


ASSET QUALITY

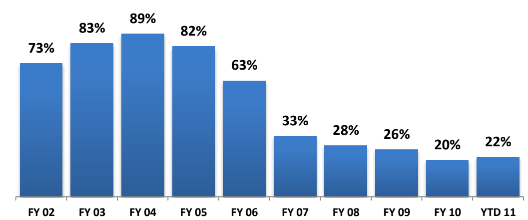
Noncurrent Loans / Loans



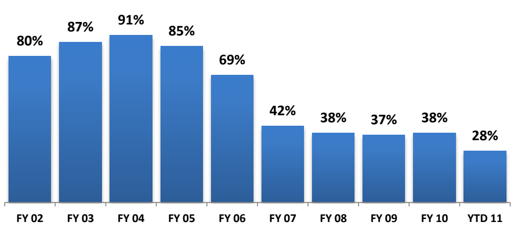
Charge-Off (Loss) Ratio



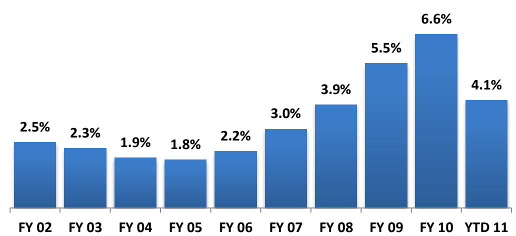
Reserve / NPL



(Reserve+NCO)/(NPL+NCO)



(Reserve+NCO)/(L&L+NCO)



Note: Asset quality ratios are not adjusted for FDIC covered and available for sale portfolios
Source: Federal Deposit Insurance Corporation (FDIC)