Puerto Rico Banking Industry Report

Issue X | **January to September 2011**

EXECUTIVE SUMMARY: The Puerto Rico banking industry achieved a Pre-Tax ROE of 7.9% in the first nine months of 2011 after two years of negative bottom line. The improvement in the banking system profitability coincides with a period of weak economic activity and decreasing total assets. As a result, banks are facing the need to rationalize their expense structure locally to cope with increasing fixed costs relative to productive assets. Additionally they are finding themselves with excess capital after a period when they had to strengthen their capital levels to face large credit losses. With limited opportunities to invest in the local market, banks are looking at alternatives to use their spare capital, like investing in existing outside operations, repaying debt or returning capital to their shareholders.

2011 RESULTS: BACK TO THE PATH OF PROFITABILITY

For the third consecutive quarter, the Puerto Rico banking sector remained profitable in Q3 of 2011. The efforts done by most banks to reduce their exposure to non performing assets seem to be paying off. The Q3 2011 Pre-Tax ROE remained in the positive area (4.4%) despite the reduction experienced against the Q1 and Q2 2011 profitability levels (see Figure 1). This decline in Pre-Tax ROE was mainly caused by an increase in the credit provision of Popular and Doral, explaining approximately half of the total reduction.

Despite the increase in the commercial credit provision in Q3, Popular still showed a healthy 13.1% Pre-Tax ROE, only below the 16.1% of Scotia (see Figure 2). Popular and Scotia continued to have the largest net interest income relative to assets in the Jan-Sep 2011 period reaching 4.3% and 4.5%, respectively compared to the industry average of 3.6% (see Annex 1). The other bank that participated in the 2010 consolidation process, Oriental, experienced the third highest Pre-Tax ROE in the Jan-Sep 2011 period (10.2%). The bank is trying to boost its profitability by maintaining its healthy credit performance while rebalancing its assets mix towards the commercial loan portfolio.

On the opposite side, Doral and FirstBank had negative profitability in the first nine months of 2011. The Pre-Tax ROE of these two banks were negatively impacted by low productivity levels. The cost to income (C/I) of Doral and FirstBank reached 90.4% and 73.1% respectively in the Jan-Sep 2011 period compared to the industry average of 59.4% (see Annex 2). Additionally, FirstBank suffered the largest credit provision expense relative to total assets reaching 1.9% in the first nine months of the year compared to the industry average of 1.3% (see Annex 1).

Despite the negative net income of these two banks, the banking industry as a whole was able to return to the path of profitability in a context of sharp contraction. Total banking assets declined by 8% from September of 2010 to September of 2011 (see Figure 3). Only Santander grew total assets thanks to a 10% increase in the commercial loan portfolio, while Doral and FirstBank suffered the largest decreases (13% and 19% year on year respectively). While loan originations reached their highest level during the Q2-Q3 2011 period when compared to the three previous six months periods (see Figure 4), the increase was not large enough to offset the decrease in other banking assets.

Looking into the future, the combination of profitability and contraction is likely to have two important consequences:

1. Increased pressure on banks to improve productivity. There will be questions around the size of banks' infrastructure as fixed costs to total productive assets continue to grow. The need for greater efficiency will be even more relevant after observing that the recent growth in loan originations was driven by large new commercial loans which, in general, are not serviced through the banks' branch network (see Figure 4).
2. Excess liquidity as retained earnings continue to grow and there are less assets for an increasing amount of capital.

In summary, we should expect banks to continue focusing on cost reduction as total assets remain at historical lows. Also, we will see top management developing strategies to use the banks' excess capital by either returning it to the shareholders or by investing in new growth opportunities.

Figure 1: Industry Pre-Tax ROE Trend (Q309-Q311)

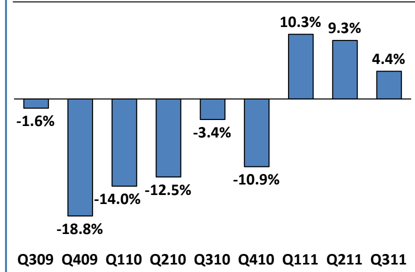


Figure 2: Pre-Tax ROE by Bank (YTD 2011) (1)

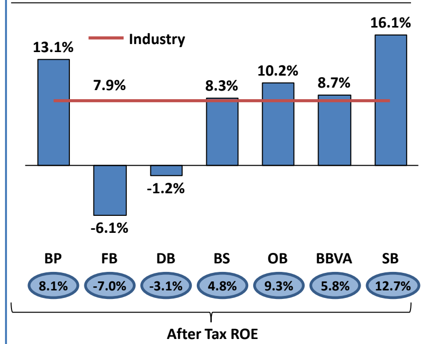


Figure 3: Total Assets ($B)

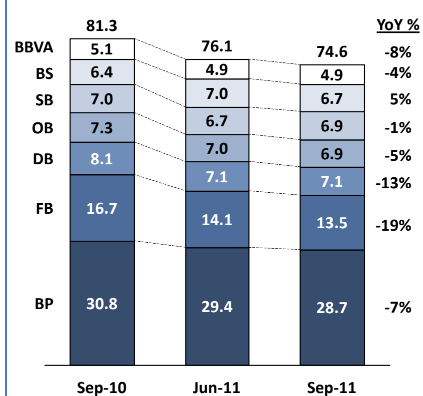
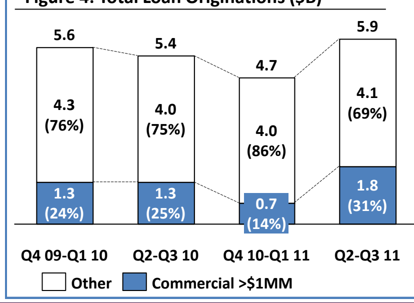


Figure 4: Total Loan Originations ($B)



Inside this issue:

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.

LOOKING AT THE BANKS' EXPENSE STRUCTURE

One of the consequences of the current environment of slow credit activity and assets reduction is the need to rationalize the current banking expense structure. Otherwise, the banks' productivity will drop as revenues decline and the cost structure remains the same. In fact, this is what happened in the 2005-2009 period, when credit activity declined as Puerto Rico entered a prolonged economic recession. The banking sector C/I increased from 55.5% in 2005 to 68.2% in 2009 (see Figure 5). With the banking consolidation in 2010 and the increased focus on containing expenses by local banks, productivity levels improved and the C/I ratio dropped from 68.2% in 2009 to 59.4% in the first 9 month of 2011. However, the industry is still far from the average of 51.9% experienced in the 2002-2004 pre-recession period.

As long as the local economy continues to falter, banks are likely to keep reducing their cost structure. However, there are marked differences in the banks' productivity levels, and the areas of opportunity differ among them. In 2011, FirstBank and Doral showed C/I ratios of 73.1% and 90.4% respectively, well above the industry level of 59.4% (see Figure 6). On the opposite side, Popular, Santander and Scotia experienced the lowest C/I ratios in the industry. In order to understand which costs are likely to be tackled by banks to increase productivity we can look at Figure 7. Figure 7 reconciles each bank's C/I with the industry's C/I based on the size of different expense categories for the amount of income generated.

FirstBank and Doral show relatively higher personnel and branch infrastructure expenses than the rest of the industry (see Figure 7). Regarding personnel costs, FirstBank seems to have a larger amount of employees for the income generated, which is reflected in the net margin per employee of $130k compared to the industry average of $186k (see Annex 2). In the case of Doral, the net margin per employee is close to the industry level, which suggests that the bank pays higher salaries than the rest of the industry. It is also worth mentioning Doral's consulting and advisory fees which explain 26% of the bank's C/I variance against the industry.

Figure 5: Cost to Income 2005-YTD 2011

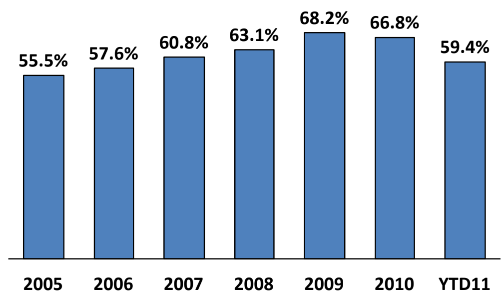
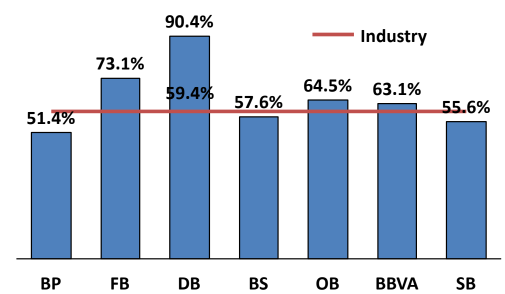


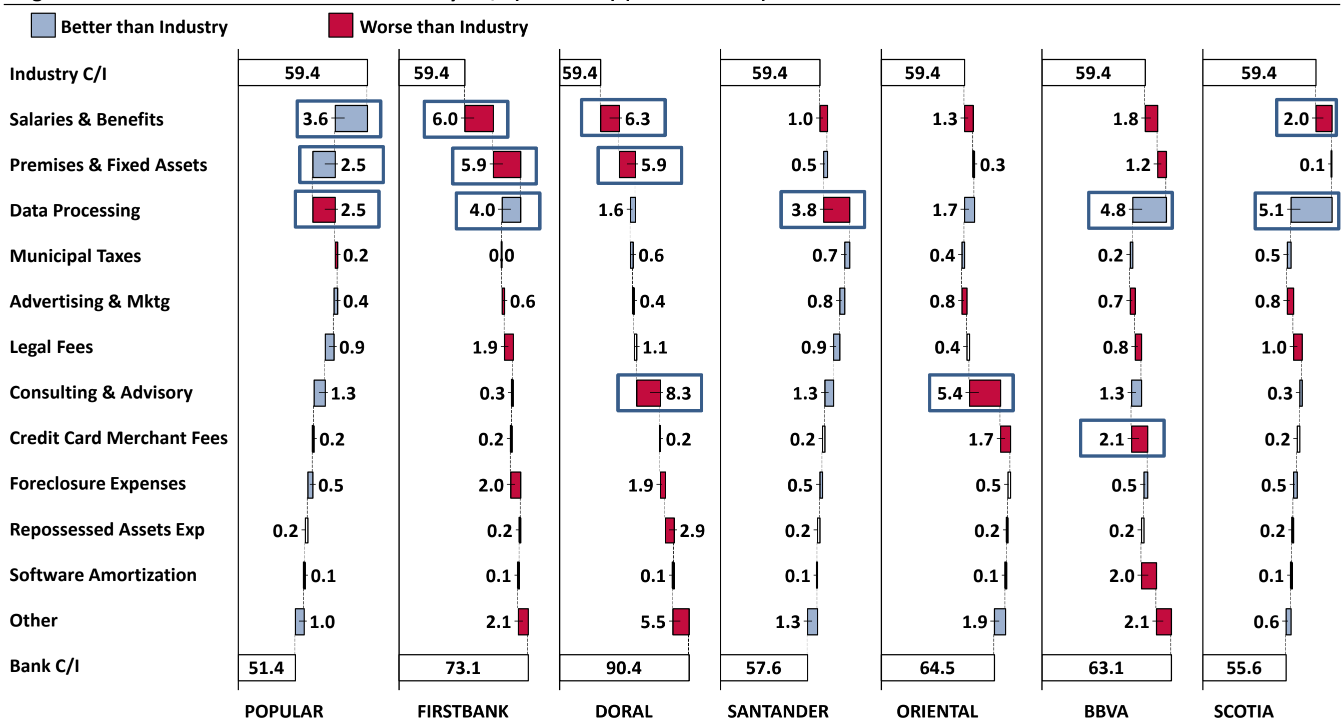
Figure 6: Cost to Income by Bank YTD 2011



Oriental, like Doral, seems to have consulting and advisory fees above the rest of the banking sector explaining most of the difference between the bank's C/I and the industry's C/I. On the contrary, BBVA's higher C/I is caused by the smaller impact of several expense categories like credit card merchant fees, software amortization expenses and personnel costs.

In the case of Scotia, salaries and benefits, advertising and marketing costs and legal fees are slightly above the industry levels. Finally, both Santander and Popular seem to fare better than other banks in most expense categories, but share an area of opportunity for cost efficiency in their large data processing costs.

Figure 7: Reconciliation of Banks' and Industry's C/I (YTD 2011) (numbers in %)



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LOOKING FOR ALTERNATIVES TO INVEST SPARE CAPITAL

The second consequence of the current banking sector environment is a situation of excess capital. This is clearly reflected in the Tier 1 risk-based capital ratio of all banks being above the well capitalized level of 6% (see Figure 8). The other two key capital ratios, the Tier 1 leverage ratio and the Total risk based capital ratio are also above the well capitalized levels for all banks (see Annex 2).

With limited opportunities for growth locally, where there is fierce competition for a shrinking market, banking institutions need to look at alternative strategies to invest their excess capital.

One alternative is redirecting resources to other markets. This alternative is best suited for institutions with corporate headquarters outside Puerto Rico like Santander, BBVA and Scotia. For these banks it should be relatively easy to move resources to markets with higher growth potential.

Among local banks, Popular, FirstBank and Doral already have sizeable business activities in the US and the Virgin Islands. Gross revenues from outside business units represent between 16% and 18% of total gross revenues for these banks (see Figure 9). Increasing their presence in those markets is a possible alternative to invest spare capital. In fact, one of Popular's strategic pillars is to continue implementing its community bank strategy in the US. Similarly, in the last FirstBank investor presentation, expansion prospects in Florida were a key part of the bank's strategy for growth.

Finally, Oriental has its banking activity fully concentrated in Puerto Rico. As long as no opportunities for growth show up in the local market, Oriental will need to continue returning capital to its shareholders. The bank has been implementing share repurchase initiatives and, most importantly, recently announced that it would increase its regular quarterly cash dividend by 20%.

For local banks that consider that their stock is undervalued, buying back shares could make sense, as long as it does not violate agreements with the federal authorities. As reflected in Figure 10, the price to tangible book value is substantially below 100% for all local banking institutions.

Figure 8: Tier 1 Risk-based Capital Ratio YTD 2011

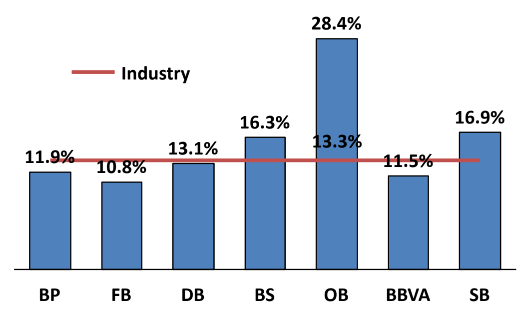


Figure 9: % Revenues generated outside Puerto Rico

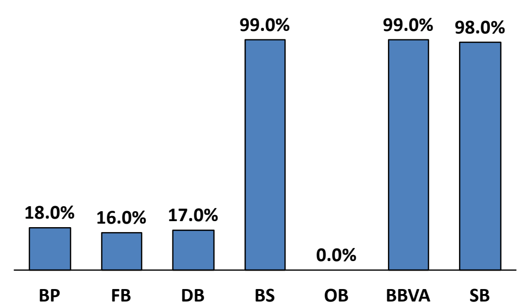
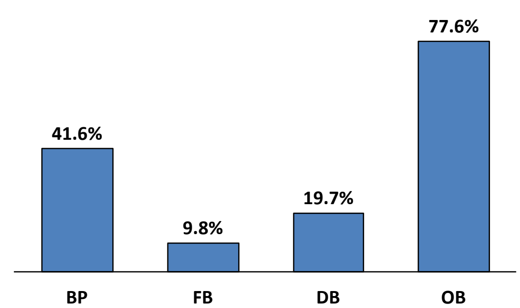
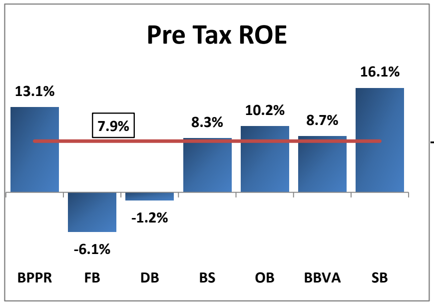


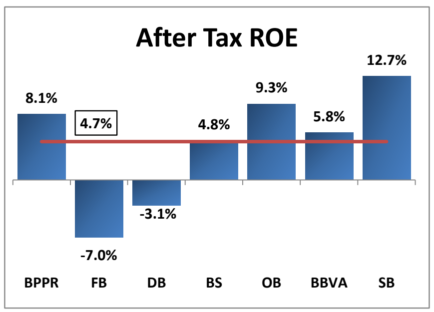
Figure 10: Price to Tangible Book Value

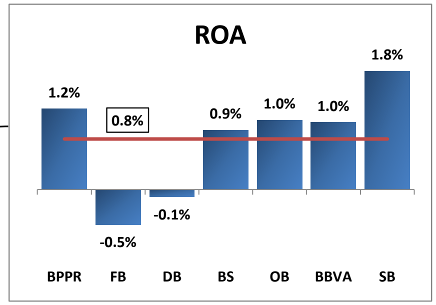


In summary, we continue to see a stagnant or low credit growth environment in the short term in Puerto Rico. With balance sheets in a much healthier position and with banks back in the track of profitability, the focus will be concentrated on improving productivity locally while looking for the best alternatives to invest excess capital. These alternatives mainly include growing organically in the US and returning capital to shareholders. However, if the global economic instability continues, particularly in the financial sector, we cannot discard opportunities for inorganic growth in outside markets.

ANNEX 1: BANKING INDUSTRY PROFITABILITY January - September 2011







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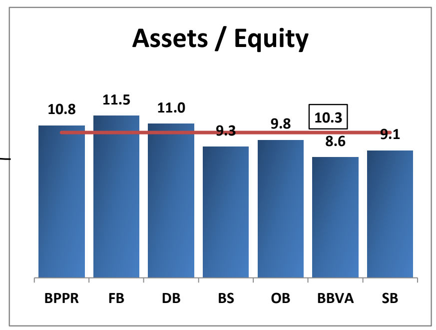

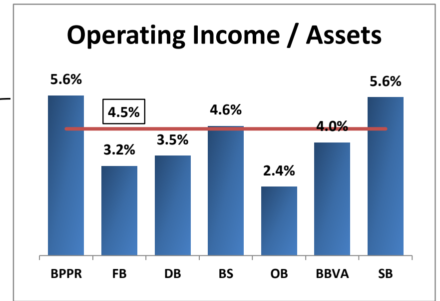

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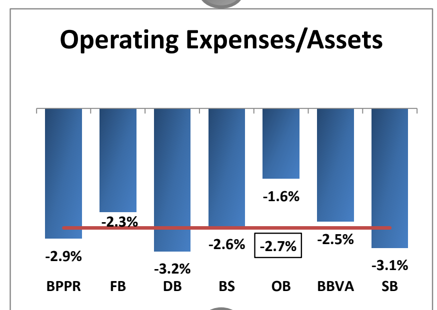

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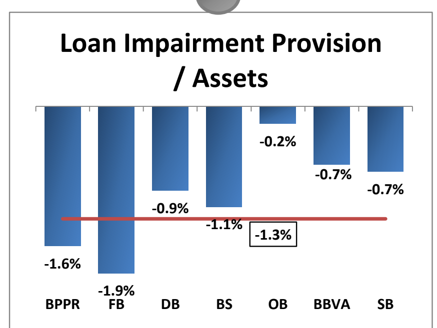

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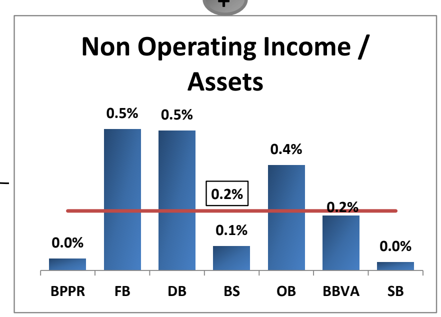

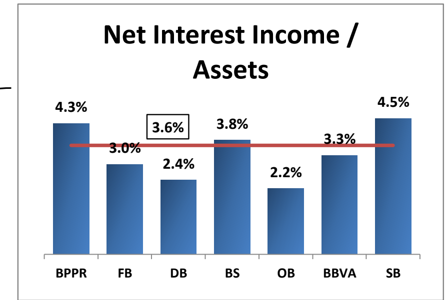

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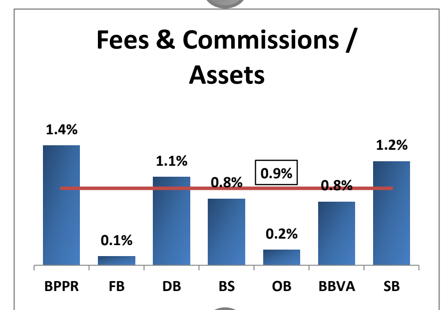

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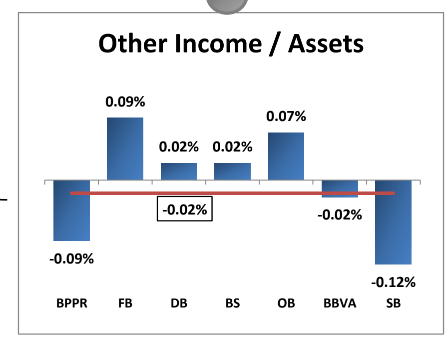

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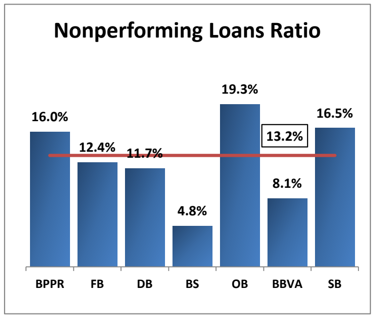
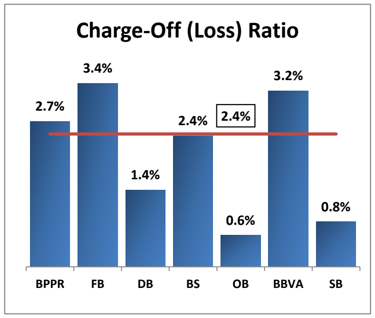
Note: Industry includes acquired banks data in Q1 2010
Source: Federal Deposit Insurance Corporation (FDIC)

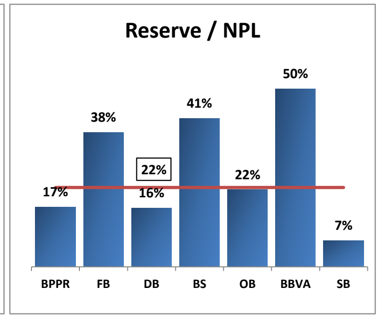
Industry

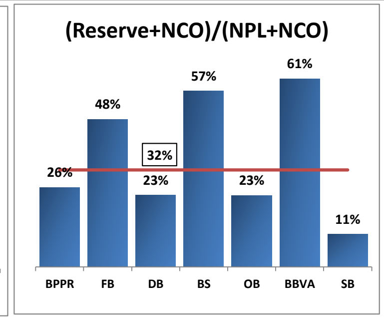
ANNEX 2: BANKING INDUSTRY PERFORMANCE RATIOS January - September 2011

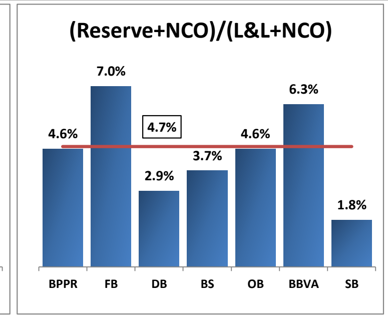
ASSET QUALITY



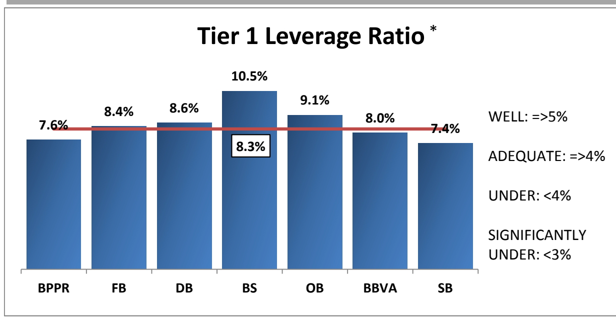


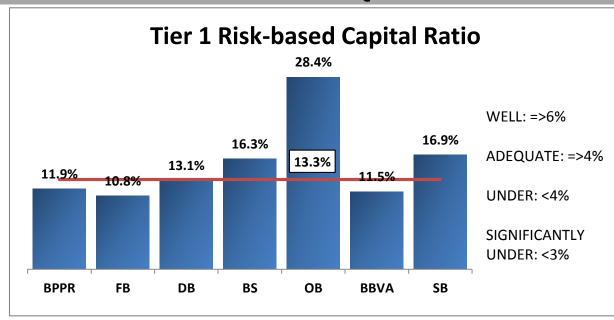


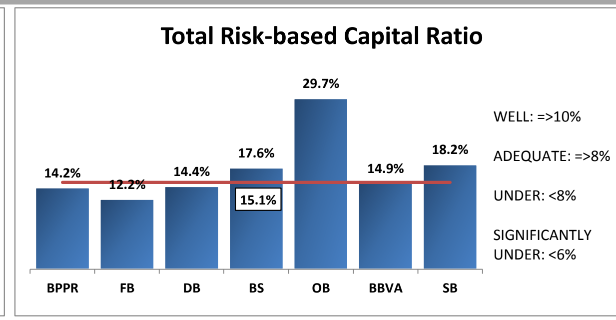




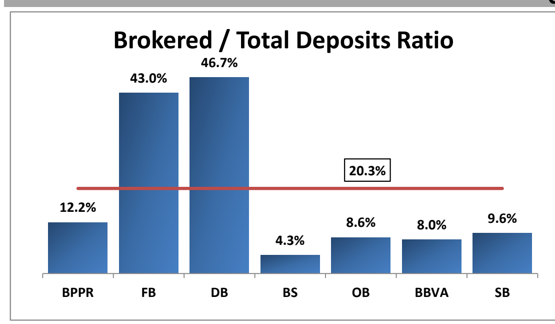
CAPITAL ADEQUACY

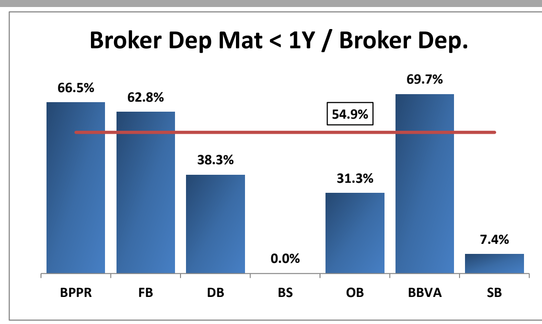




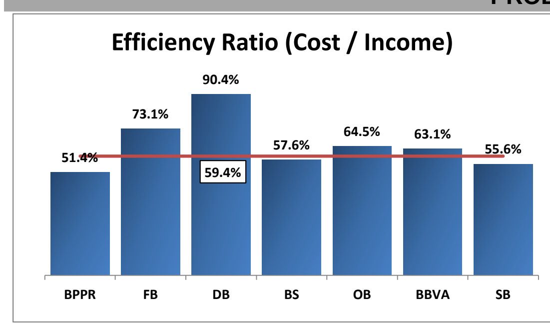


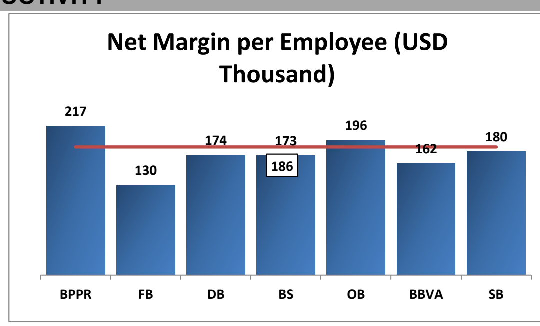
LIQUIDITY





PRODUCTIVITY





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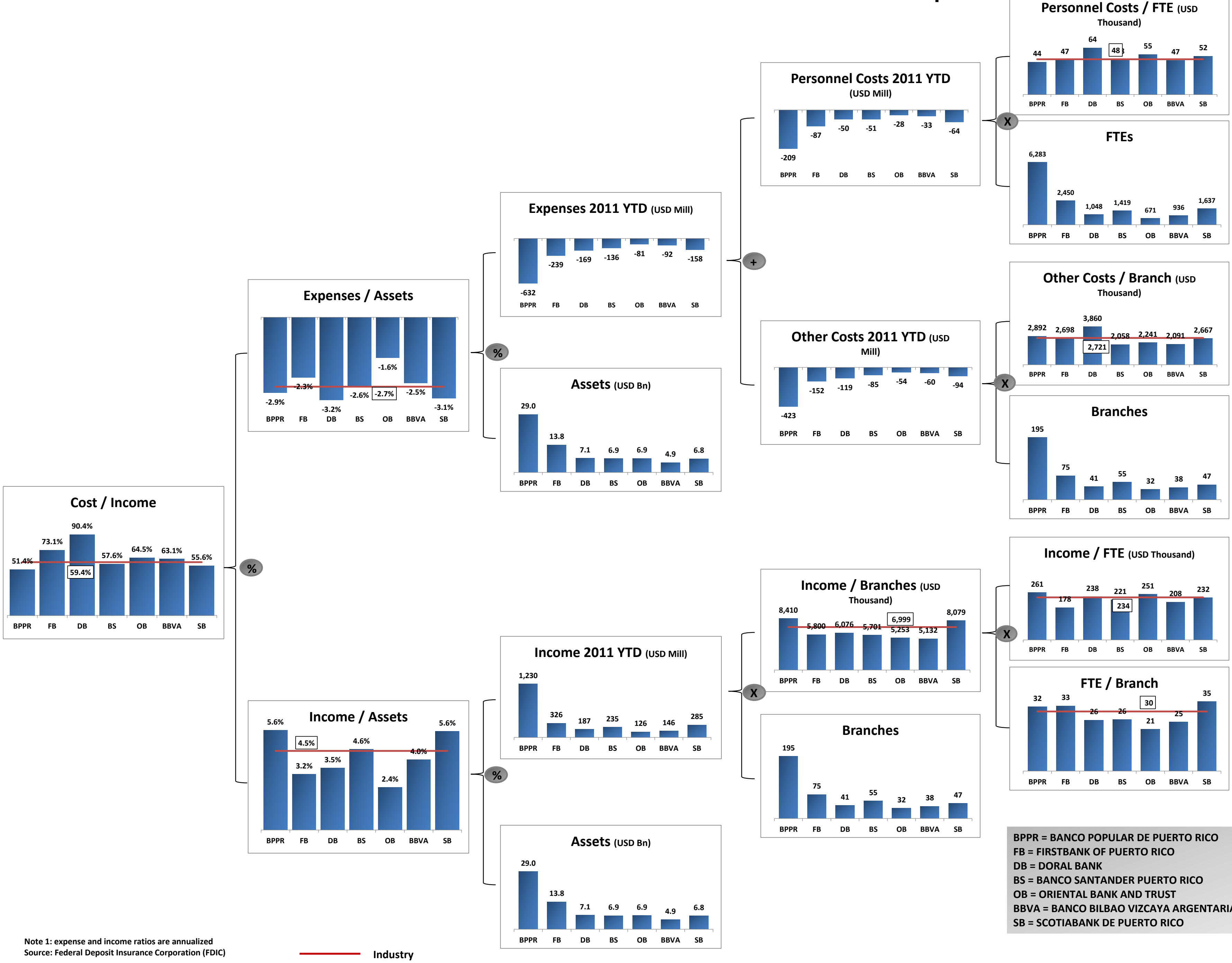
Industry

*** 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 - Sep 2011



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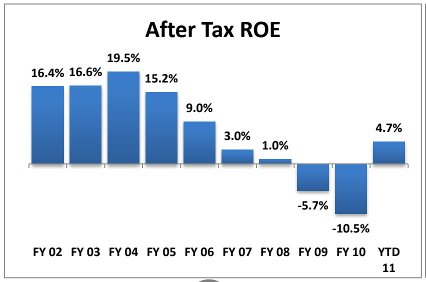
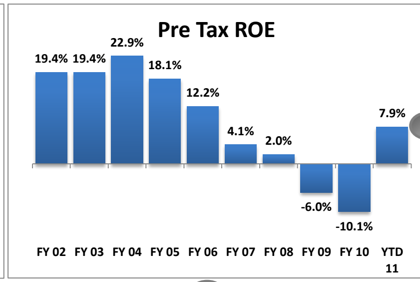
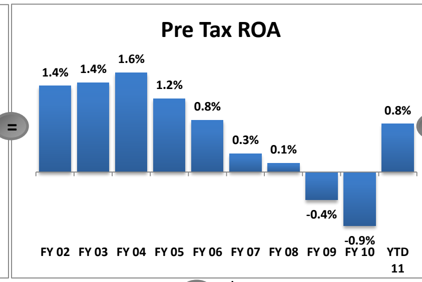
Note 1: expense and income ratios are annualized
Source: Federal Deposit Insurance Corporation (FDIC)

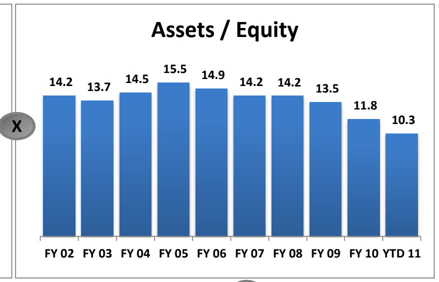
ANNEX 4: INDUSTRY TRENDS - SELECTED METRICS

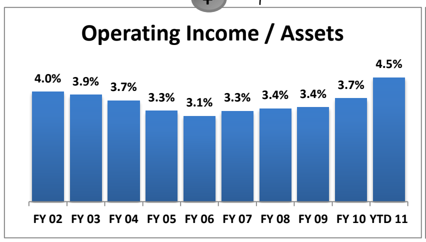
PROFITABILITY

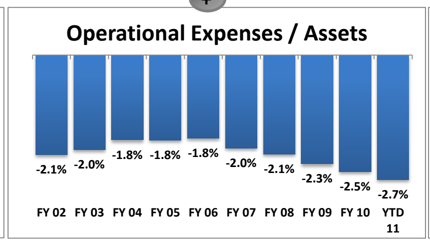


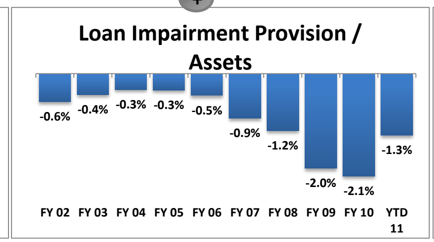


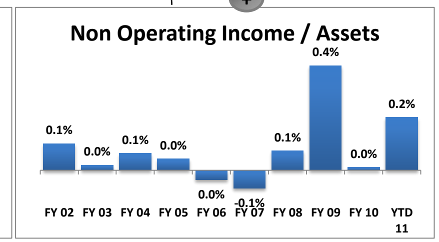




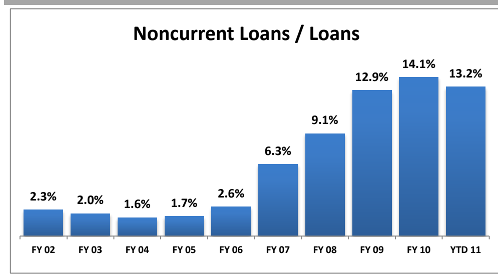


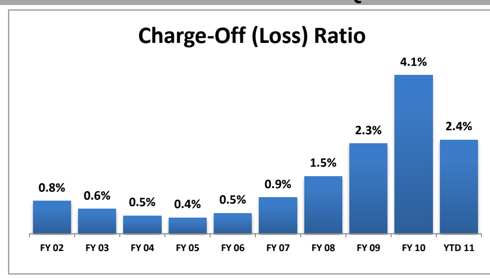


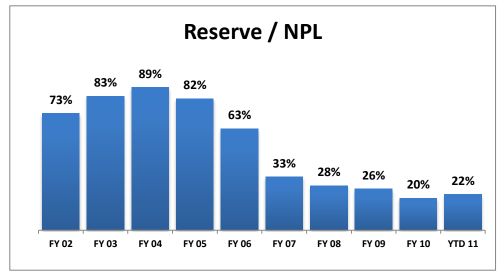


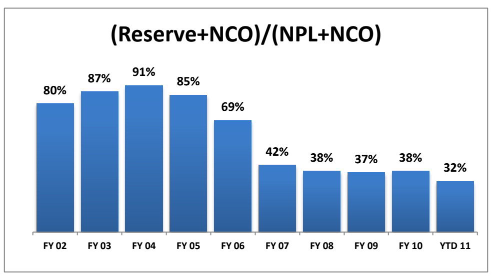


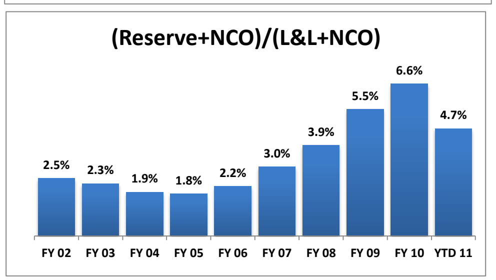
ASSET QUALITY











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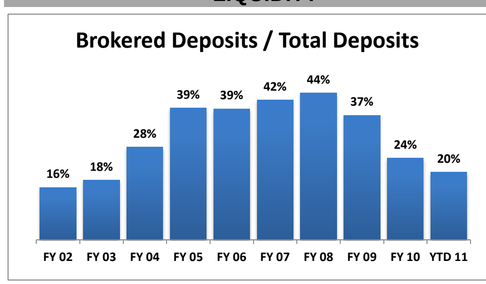
LIQUIDITY



PRODUCTIVITY