Puerto Rico Banking Industry Report

Issue XII — January to March 2012

Vision To Action — Strategic Management Consultants

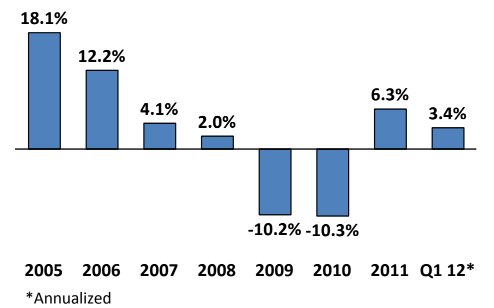
PROFITABILITY: "Fifth consecutive quarter with positive ROE confirms the recovery of the banking sector"

The first quarter of 2012 started with positive profitability for the Puerto Rico banking sector despite showing a decrease in the Pre-Tax ROE from 6.3% in 2011 to 3.4% in Q1 2012 (see Figure 1). The fact that the total pre-tax income for the industry remained positive is another sign that the banking crisis is over and that the banking industry in general is in a much better position compared to previous years.

The reduction in the provision expense was the main factor behind the improved profitability after 2010. 54% of the ROA improvement between 2010 and Q1 2012 is explained by the reduction in the provision expense. We should expect lower provision expenses to continue driving profitability during 2012. As toxic loan portfolios and net charge offs (NCOs) continue to decrease banks will continue releasing loan reserves. The reduction in charge offs and the excess reserves in the banking system is clearly reflected in the NCOs to allowance for loan losses which dropped from 146% in 2010 to 41% in Q1 2012 (see Figure 2).

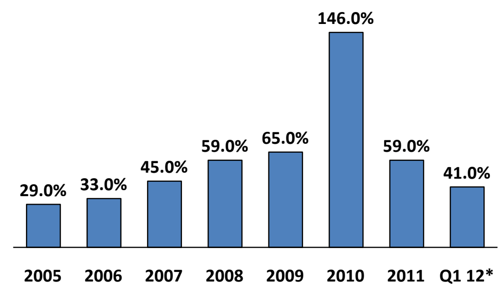
At some point charge off levels will stabilize and reserve releases will stop fuelling banks' profitability. When this happens, the banking context will be very different from the pre-crisis one. Income generating assets will be much lower and the prospects for growing them locally will be moderate at best. Thus, unless banks reduce their cost structure accordingly, profitability will remain below historical levels.

Figure 1: Industry Pre-Tax ROE Trend (2004-2012) (1)



*Annualized

Figure 2: NCOs to Allowance for Loan Losses



*Annualized

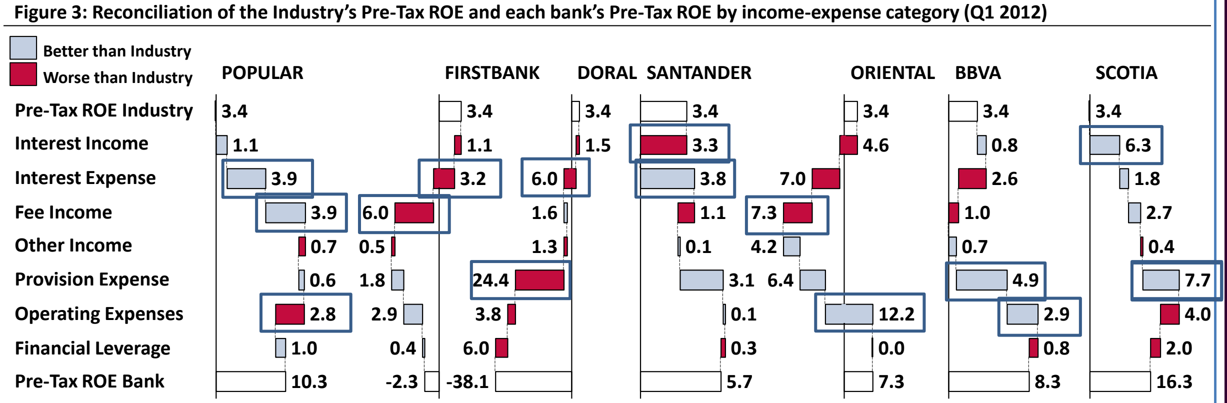
When looking at profitability by bank, Scotia and Popular reached the highest Pre-Tax ROEs in the industry in Q1 2012 with 16.3% and 10.3% respectively (see Figure 3). When compared to the rest of the industry, both Scotia and Popular showed a much higher revenue generating ability which drove their superior profitability in the first quarter of 2012. Additionally, Scotia booked much lower provision expenses compared to the industry. BBVA, Oriental and Santander reached Pre-Tax ROEs of 8.3%, 7.3% and 5.7% respectively in Q1 2012. BBVA's and Oriental's profitability remained above the industry level thanks to their lower provision and operating expenses.

FirstBank and Doral continued to show negative profitability with their Pre-Tax ROEs reaching –2.3% and –38.1% respectively. If this trend continues in 2012, it will be the 4th and 6th consecutive year with negative Pre-Tax ROE for FirstBank and Doral. Doral's Q1 2012 numbers were highly impacted by a provision expense of $71M, which was 23% larger than the 2011 full year provision. The bank was able to compensate for this expense with the recognition of an income tax benefit of $62M, leaving the After-Tax ROE close to 0.

Aside from Doral and Oriental, all banks are benefiting from lower provision expenses thanks to lower charge offs and the reserves built up during the past difficult years. This benefit should not distract banks from improving their productivity levels by either enhancing revenues or cutting expenses. Otherwise, when reserve releases stop, lower revenue generating assets will hurt productivity levels and the banks' cost structure will be put into question.

Inside this issue:

Figure 3: Reconciliation of the Industry's Pre-Tax ROE and each bank's Pre-Tax ROE by income-expense category (Q1 2012)



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.

PRODUCTIVITY: "It is key that banks revise their current cost structure to reach pre-crisis profitability levels"

Since the local economy entered a long period of stagnation in 2005, total banking assets have decreased steadily. Total assets dropped from $104B in 2005 to $73B in Q1 2012, an annual compounded decrease of 6%. In the meantime, total operating expenses reduced at a lower pace, which translated into an increase of the operating expenses to total assets from 1.7% in 2005 to 2.8% in Q1 2012 (see Figure 4). Similarly, the cost to income ratio increased from 55.5% in 2005 to 63.8% in Q1 2012 (see Figure 5). As a consequence, it is hard to imagine the local banking sector returning to the pre-crisis profitability unless its cost structure is brought down to levels consistent with the reduction in income generating assets.

When we look at productivity by bank, Scotia and Popular continue to show the lowest cost to income ratios with 57.5% and 58.6% in Q1 2012 respectively. Not surprisingly, these two banks were also the most profitable in Q1 2012 as well as in 2011. In the case of Scotia it is worth mentioning that, compared to the industry, it has lower data processing costs, which is an important driver when explaining its lower cost to income ratio (see Figure 6). In the case of Popular, the lower cost to income ratio compared to the industry is mainly driven by relatively lower salaries and expenses related to premises and fixed assets. While Popular has by far the largest branch network, when measured against its revenue generating capacity, the network cost does not seem to be high compared to the rest of the industry. However, the data processing costs of Popular do compare unfavorably against the industry.

The productivity of BBVA, Oriental and Santander, measured on a cost to income basis, was close to the industry level in Q1 2012 reaching 61.2%, 62.2% and 63.8% respectively.

Figure 4: Operating expenses to total assets

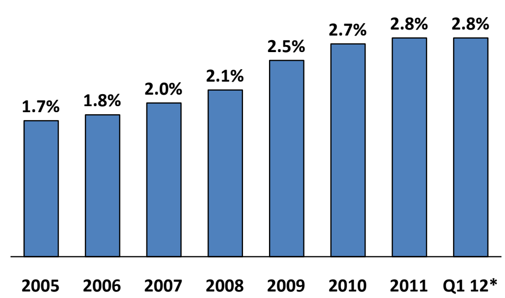


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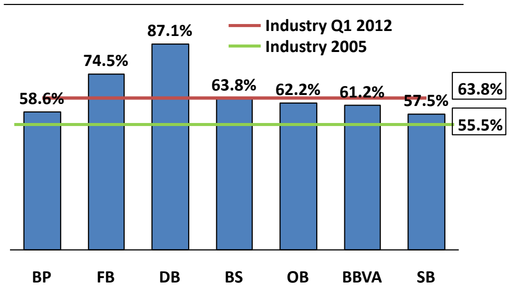
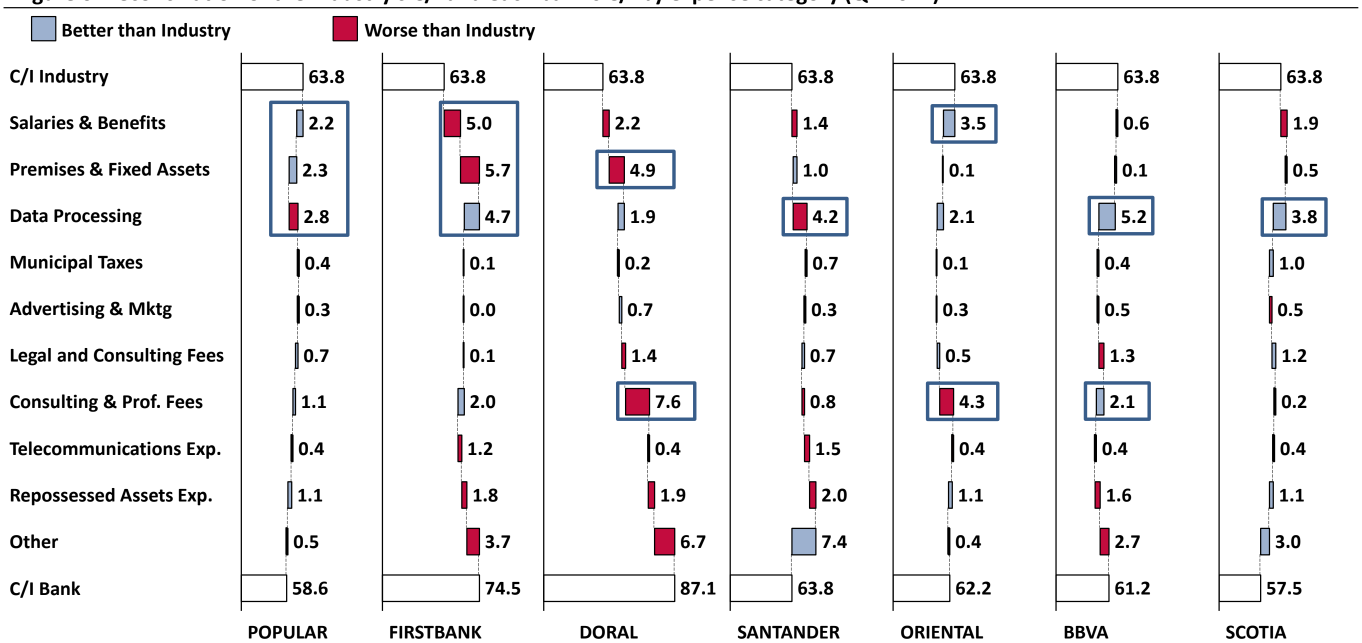
Figure 5: Cost to Income by Bank



BBVA's higher profitability compared to the industry was mainly driven by lower data processing costs and consulting and professional fees. Oriental benefitted from lower salaries and benefits and data processing expenses partially offset by higher consulting and professional fees. Finally, it is worth mentioning that Santander suffered higher data processing costs compared to the rest of the industry in Q1 2012. However, the bank experienced lower miscellaneous costs that offset the higher data processing expenses and left the bank at par with the industry on a cost to income basis.

FirstBank and Doral showed the highest cost to income ratios in Q1 2012 with 74.5% and 87.1% respectively. In the case of FirstBank, the larger costs were the result of higher salaries and branch network expenses, partially offset by lower data processing costs. The higher level of salaries seems to be the result of a larger number of employees rather than higher salaries per employee. This is reflected in the net margin per employee of $131k compared to the industry level of $176k in Q1 2012 (see Annex 2). Finally, Doral's higher cost to income ratio in Q1 2012 was driven by higher premises and fixed assets expenses and, especially, by higher consulting and professional fees.

Figure 6: Reconciliation of the Industry's C/I and each bank's C/I by expense category (Q1 2012)



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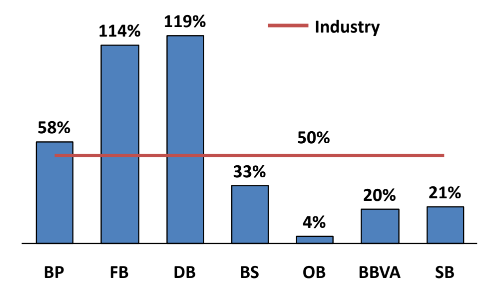
LIQUIDITY: "Brokered deposits are still large for some banks; interest rate risk should be monitored"

The historical dependency on brokered deposits to fund credit activities by the local banking entities has reduced substantially in recent years. The ratio of brokered deposits to total deposits dropped from 43.8% in 2008 to 20.3% in Q1 2012 (see Annex 4). The reduction was mainly driven by the pressure from the financial regulator due to the volatility of this type of deposits. Brokered deposits switch banks based on price and consequently are not as "sticky" as regular individual and commercial deposits.

However, there are still two banks with substantial amounts of brokered deposits in their balance sheets, Doral and FirstBank. The ratio of brokered deposits maturing in less than a year to total liquid assets was 119% and 114% for Doral and FirstBank respectively in Q1 2012.

Figure 7: Brokered dep. < 1Y to liquid assets Q12012



Additionally, the recent environment of low or negative profitability in the banking sector has pushed banks globally to enhance profitability by buying funds short term in the market at historical low levels to fund their longer term credit activities. These positions are risky when not properly hedged if short term rates start to increase. Non parallel shifts in the yield curve could hurt banks with large duration mismatches between assets and liabilities and this is something local banks should keep in mind before the FED starts increasing short term rates.

CAPITAL ADEQUACY: "Banks look for opportunities to deploy their excess capital"

As we saw in 2011, capital levels in the banking sector have continued to strengthen. The tier 1 risk based capital ratio increased from 9.4% in 2007 to 14.3% in 2011 and 14.6% in Q1 2012 (see Figure 8). Other capital adequacy ratios like the leverage and the total risk based capital ratios have shown similar trends during the same period.

When looking at capital adequacy levels by bank, we observe that all banks present capital ratios above the "well capitalized level" (see Figure 9 and Annex 2). The capital levels of Oriental and Scotia are particularly high with the tier 1 risk based capital ratio reaching 29.4% and 17.7% in Q1 2012 respectively.

At this moment most banks have excess capital and are looking for alternatives to make use of it. Considering the limited organic growth opportunities in Puerto Rico, the alternatives include the purchase of local asset portfolios, growing outside business operations, repaying TARP funds and returning capital to shareholders.

The projected profitability of the alternative investment opportunities will dictate whether banks decide to grow their banking operations or return capital to shareholders.

Figure 8: Tier 1 Risk Based Capital Ratio 2007-2012

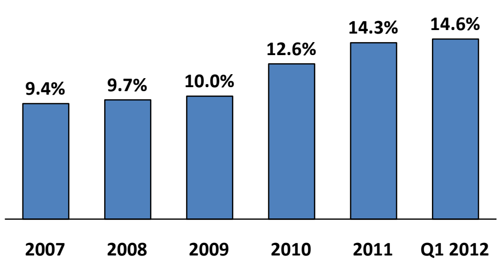
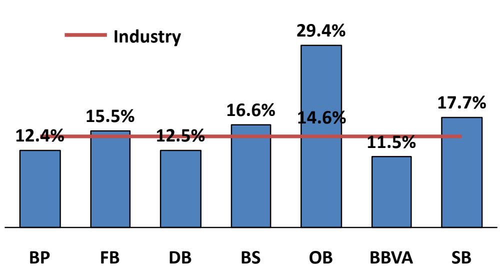


Figure 9: Tier 1 Risk-based Capital Ratio Q1 2012



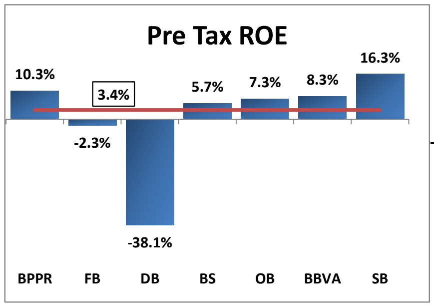
In summary, we welcome the positive Pre-Tax ROE in Q1 2012 which confirms the recovery of the local banking sector. However, we have to reiterate the need for banks to enhance revenue streams and/or reduce their cost structure to return to historical profitability levels. Finally, banks should keep an eye on their exposure to interest rate risk now and anticipate the increase in short term interest rates that sooner or later will materialize.

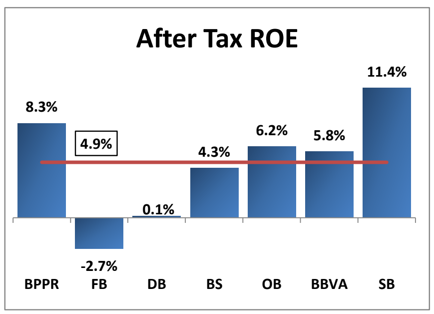
Note: Just before finalizing this issue, Oriental announced its intention to buy BBVA Puerto Rico's operation for $500M*. This acquisition will transform the current banking landscape. Oriental will become the 2nd largest bank in terms of deposits and total branches and the 3rd in total assets. In the next issue we will analyze in detail the impact of this acquisition in the banking sector.

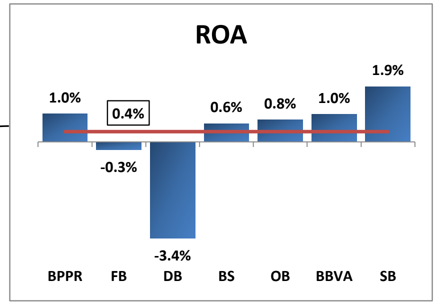
Source: Federal Deposit Insurance Corporation (FDIC), local media, analysis by "Financial Institutions Practice" V2A.

*See also our Puerto Rico Banking Industry Report Issue VII where we classified local banks in terms of the likelihood of participating in hypothetical consolidation events

ANNEX 1: BANKING INDUSTRY PROFITABILITY January - March 2012







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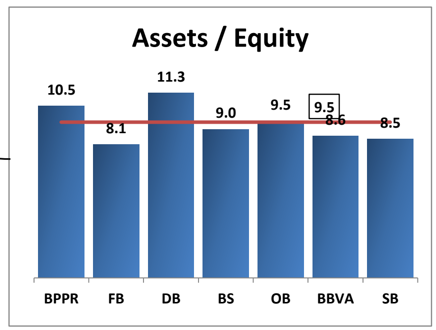

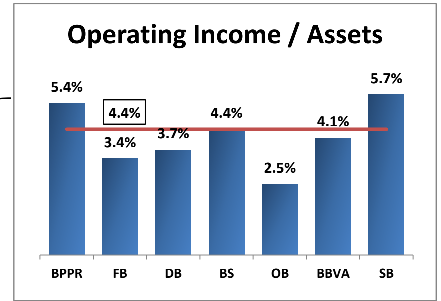

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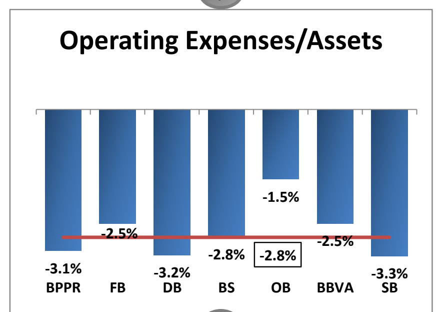

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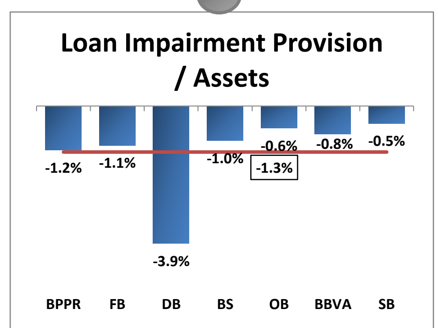

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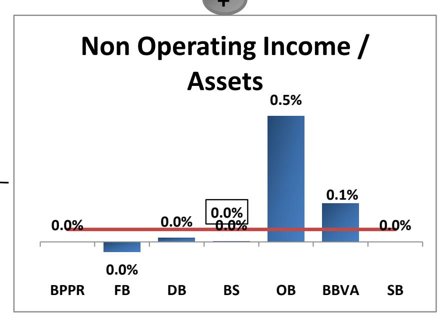

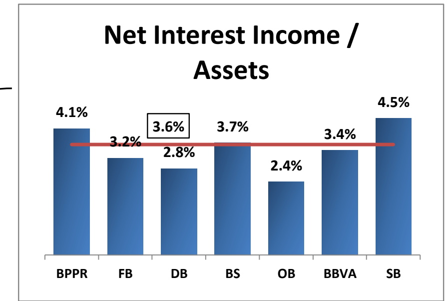

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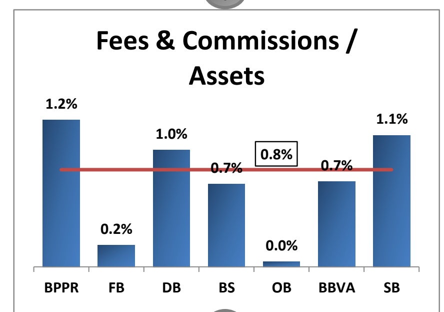

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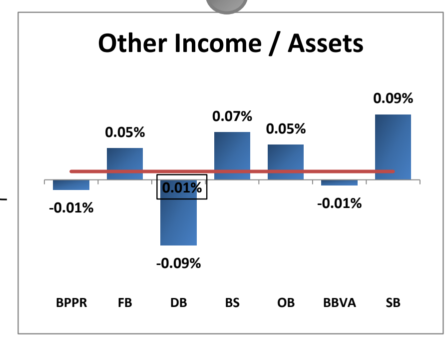

BPPR = BANCO POPULAR DE PUERTO RICO
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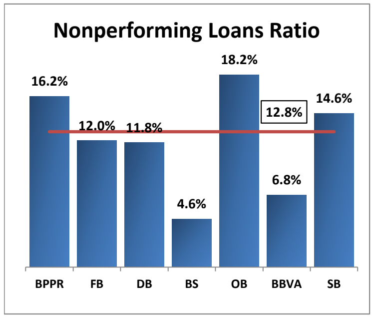
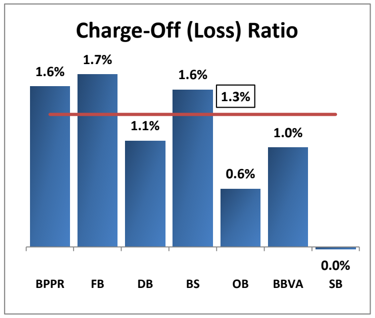
Note: Income and expense ratios are annualized
Source: Federal Deposit Insurance Corporation (FDIC)

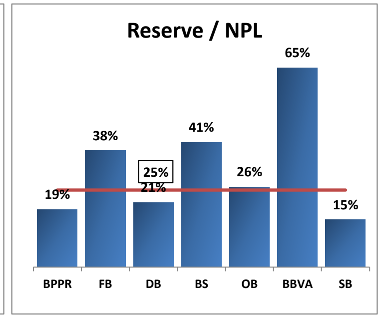
Industry

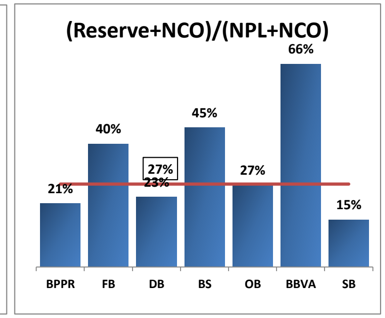
ANNEX 2: BANKING INDUSTRY PERFORMANCE RATIOS January - March 2012

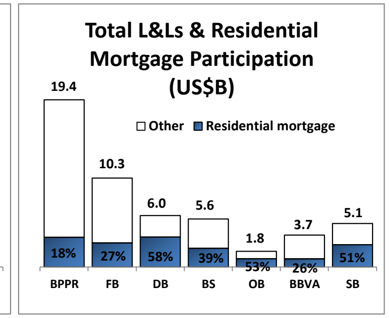
ASSET QUALITY



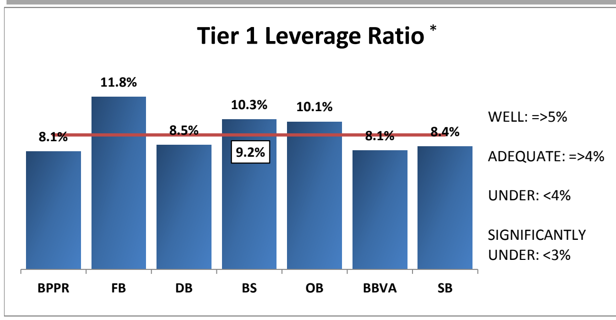


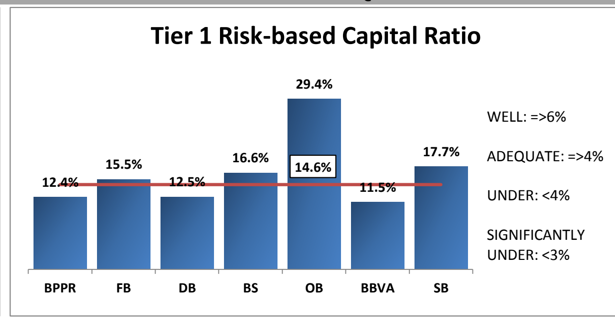


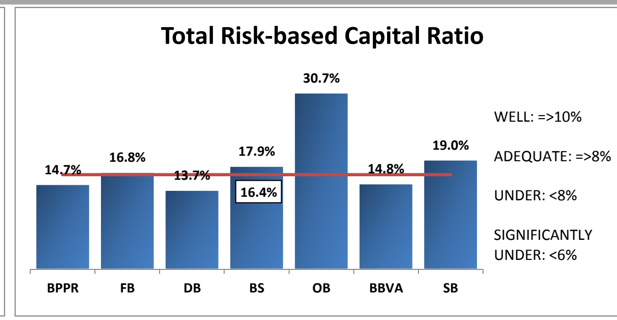




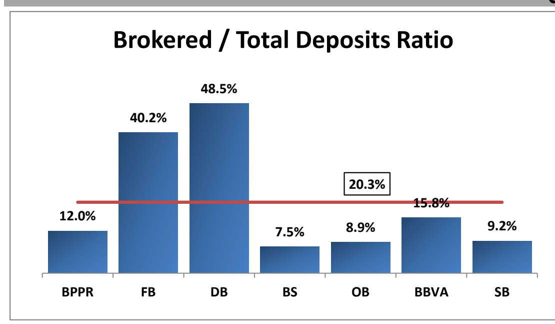
CAPITAL ADEQUACY

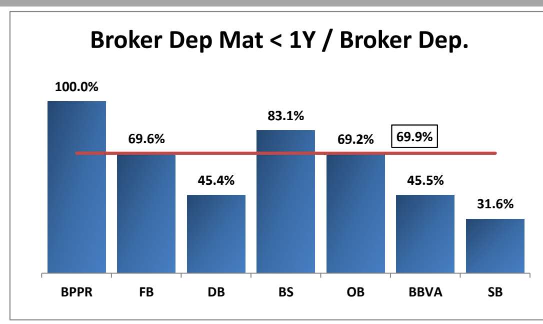




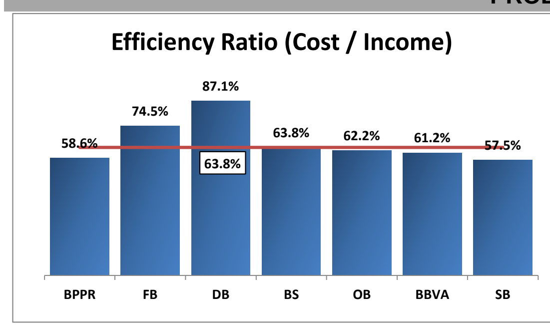


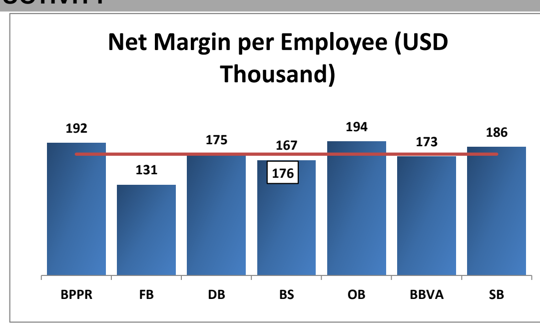
LIQUIDITY





PRODUCTIVITY





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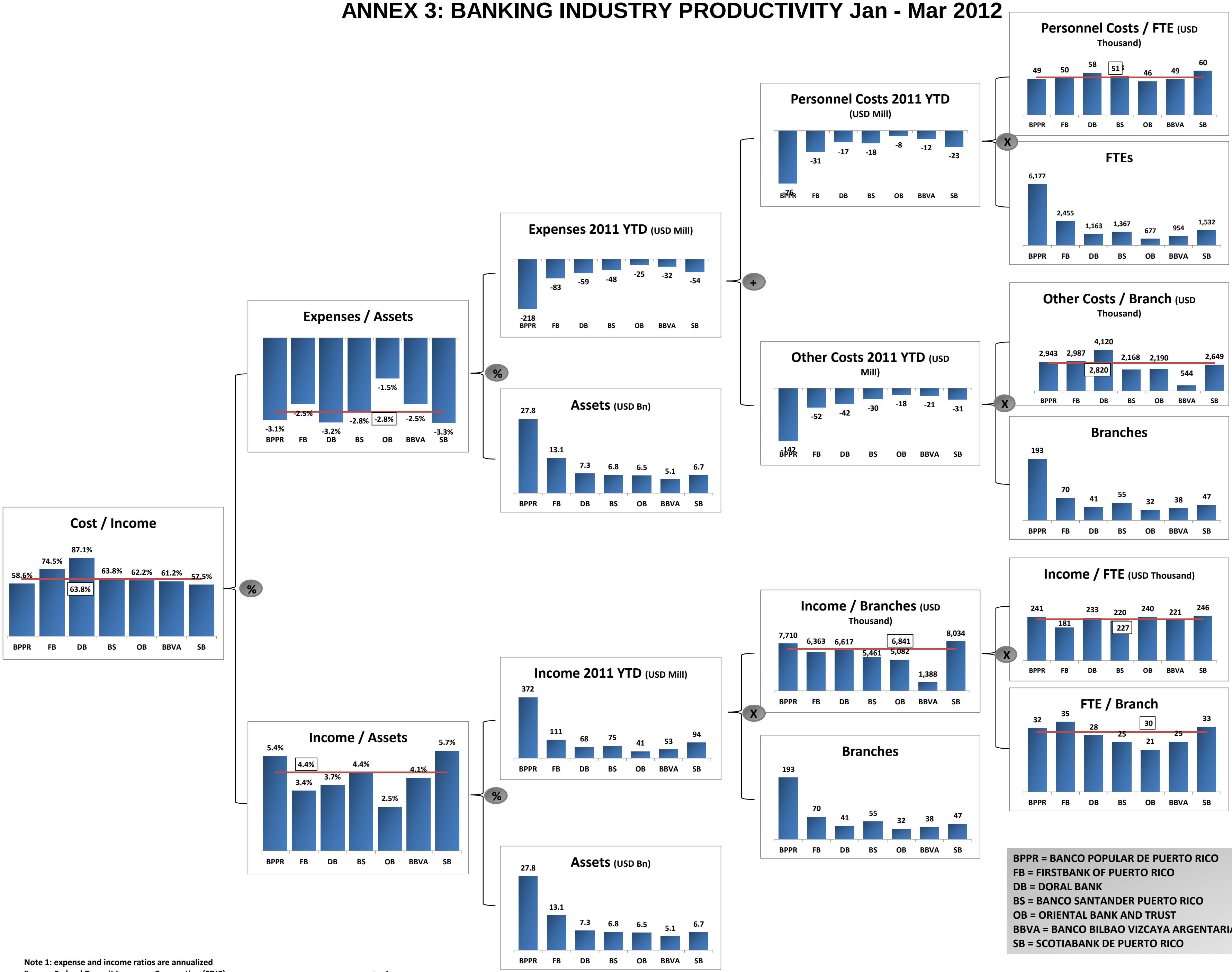
Industry

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

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

ANNEX 3: BANKING INDUSTRY PRODUCTIVITY Jan - Mar 2012



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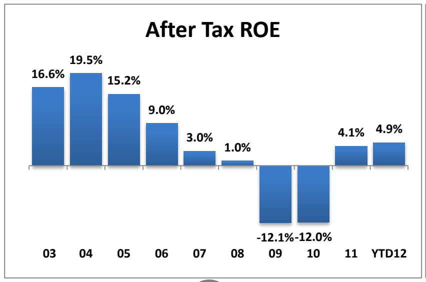
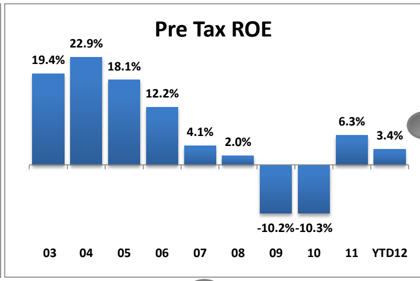
Note 1: expense and income ratios are annualized
Source: Federal Deposit Insurance Corporation (FDIC)

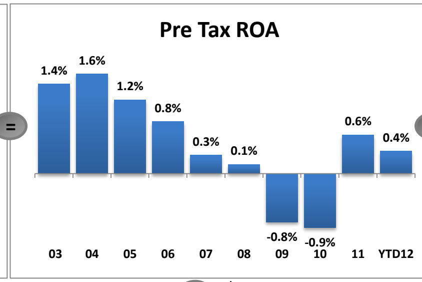
Industry

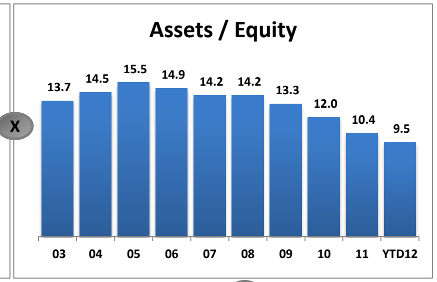
ANNEX 4: INDUSTRY TRENDS - SELECTED METRICS

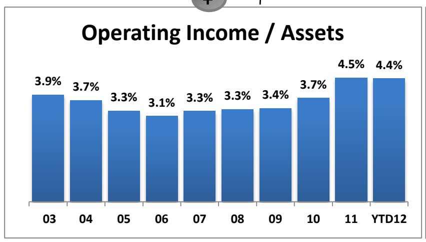
PROFITABILITY

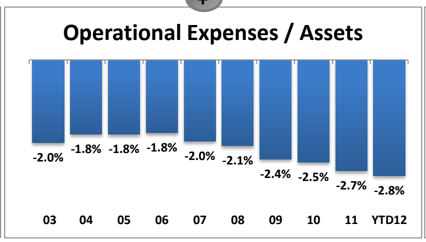


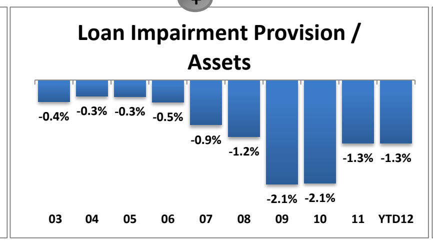


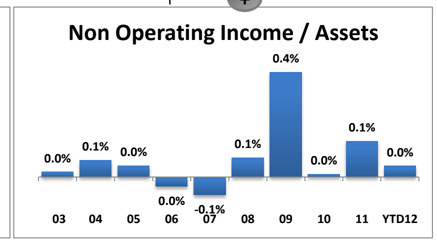




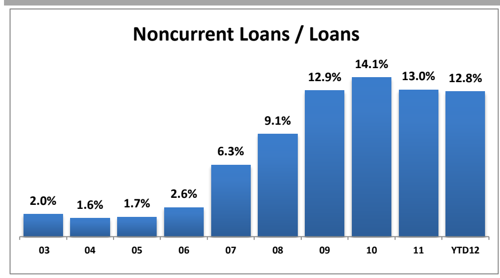


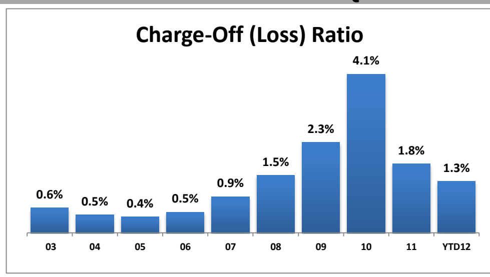


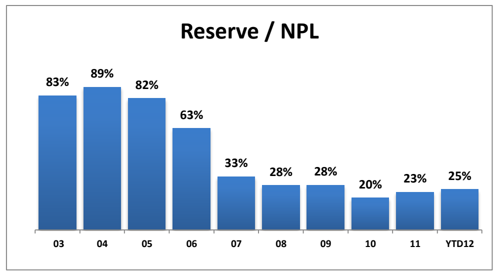


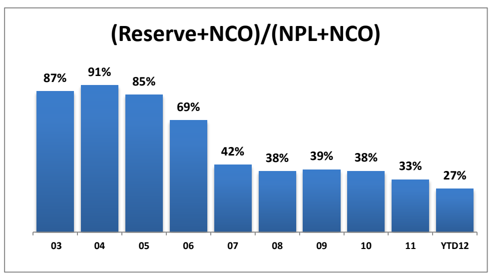


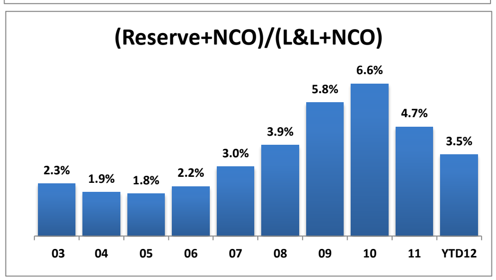
ASSET QUALITY





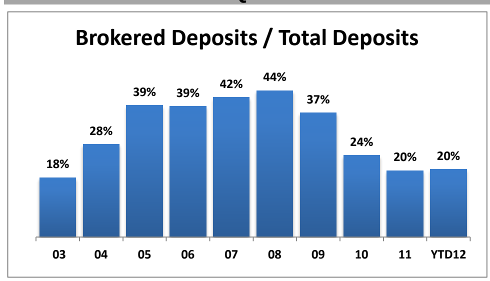




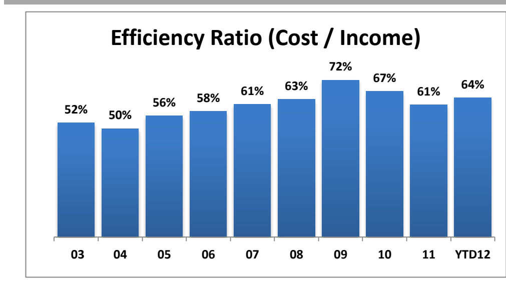


Notes:
Asset quality ratios are not adjusted for FDIC covered and available for sale portfolios
YTD numbers are annualized
Source: Federal Deposit Insurance Corporation (FDIC)

LIQUIDITY



PRODUCTIVITY



MARKET ORIGINATIONS