Puerto Rico Banking Industry Report

Issue XVII | January to June 2013

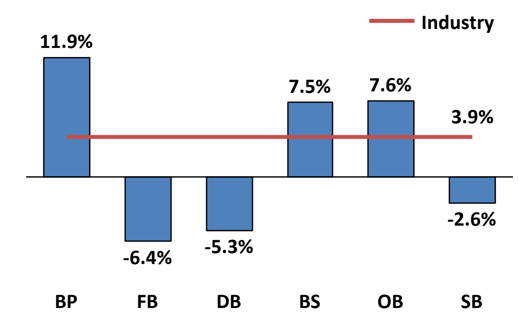
EXECUTIVE SUMMARY: the banking industry's YTD 2013 pre-tax ROE(1) adjusted for the sale of NPLs portfolios by Popular and FirstBank was 3.9%. The industry delinquency levels continue to improve and solvency ratios remain very solid. In this banking report we are taking a closer look at the mortgage business which represents 37% of the industry's total loan portfolio. As we will see, mortgage margins may reduce in the short/medium term driven by low originations in the context of rate increases, the implementation of new federal regulations and the recent and future repurchases of recourse portfolios. Both in the mortgage business and at the total bank level, workout efforts will need to be combined with cost reductions in order to boost profitability.

PROFITABILITY: "YTD 2013 ROE marked by unusual negative items; after adjusting for NPLs sales, ROE is still low (3.9%)"

During the second quarter of 2013, the two largest banks in Puerto Rico, Popular and FirstBank, sold a total of S658M in non performing residential mortgage loans (NPLs) book value balances. In the case of Popular, the $435M NPLs portfolio was sold at a discount to the unpaid principal balance (UPB) of 52% and generated a loss of $107M. In the case of FirstBank, the $223M NPLs portfolio was sold at a discount to UPB of 50% and generated a loss of $73M.

The Q1 and Q2 losses from NPLs portfolio sales from Popular and FirstBank, drove the –11.4% pre-tax loss experienced by the local banking industry in the first half of 2013 (see Annex 1). If we excluded the impact of the NPLs portfolio sales, the adjusted pre-tax ROE would have been 3.9% (see Figure 1).

Figure 1: Pre-Tax ROE by Bank YTD 2013*



*Adjusted for the sale of NPL portfolios, ratio is annualized

These bulk sales and the adjusted profitability figures confirm two trends that we have been observing in the local banking sector. First is the reduction in total banking assets, which have dropped by 31% since they reached a peak in 2006. Second, its return to positive profitability despite remaining at significantly below pre-crisis levels.

When we look at the adjusted profitability during the first half of 2013 we can see that Popular reached the highest pre-tax ROE with 11.9% driven by larger fee income and lower interest expense. The dominance of Popular in terms of fee income is reflected in the fact that all the other banks compare negatively against the industry as a whole (see Figure 2).

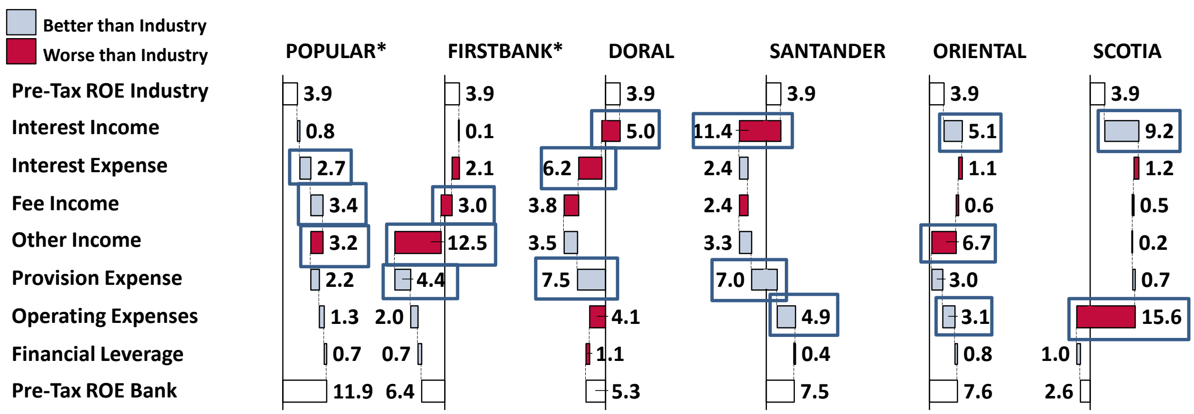
Oriental reached a YTD 2013 pre-tax ROE of 7.6% thanks to its higher interest income and lower provision and operating expenses. While the interest income has the noise of the covered portfolio accounting, we can start seeing the impact of the acquired BBVA individual portfolio (mainly Auto) which has a higher yield than, for instance, the commercial segments.

In third place came Santander with a pre-tax ROE of 7.5%. Santander showed lower provision and operating expenses when compared to the industry. However, the interest income came below the rest of the industry.

Scotia's YTD 2013 pre-tax ROE of –2.6% was impacted by an impairment of the FDIC indemnification asset of $40M. If we adjust the numbers for this one time effect, Scotia's pre-tax ROE increases to 6.6%.

FirstBank and Doral reached the lowest pre-tax ROEs in the industry with –6.4% and –5.3%, respectively. FirstBank's numbers were impacted by a $67M loss from the write off of an impaired asset posted as collateral with Lehman Brothers. If we adjust for this unusual item, the pre-tax ROE increases to 2.2%. Doral's negative pre-tax ROE is the reflection of its low productivity levels, with a cost to income ratio of 96%, compared to the industry level of 75% (see Annex 2).

Figure 2: Reconciliation of the Industry's Pre-Tax ROE and each bank's Pre-Tax ROE by income-expense category (YTD 2013)(1)



*Adjusted for the sale of NPL portfolios, ratios are annualized

Inside this issue:

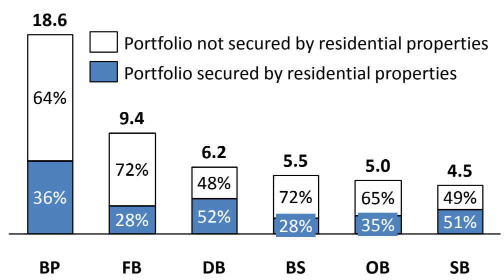
Source: Federal Deposit Insurance Corporation (FDIC), "Call Reports", 10-Q SEC filings, quarterly results calls, analysis by "Financial Institutions Practice" V2A.
(1) Citibank Puerto Rico financial data is not reported separately from Citibank US and, consequently, the bank is not included in the report analyses.

MORTGAGE BUSINESS PERSPECTIVES: "Not likely to drive an increase in profitability for the local banking sector in the short term"

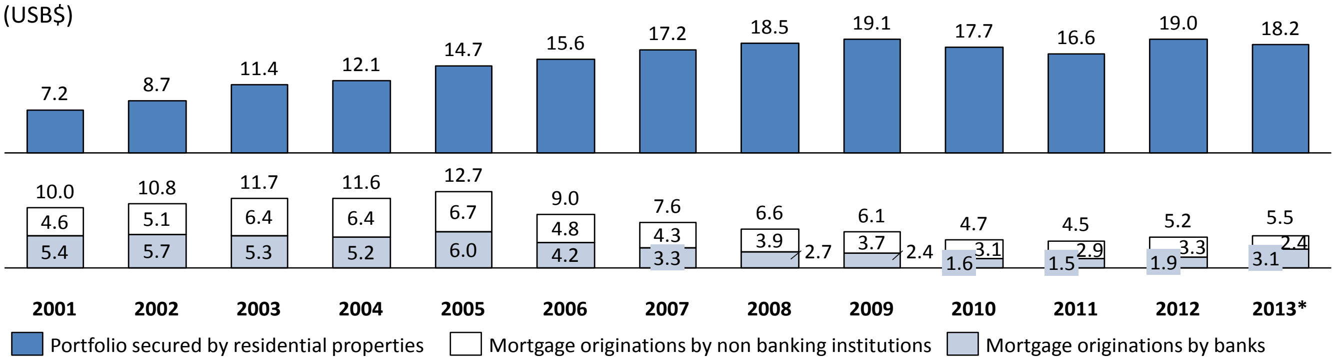
The profitability of local banks will be driven, among other things, by the profitability of one of their main sources of income which is the mortgage business. The residential loan portfolio represents 37% of the Puerto Rico banking sector total loan portfolio. For Doral and Scotia, the residential loan portfolio represents more than half of the total loan portfolio (see Figure 3). Even the banks that are more focused on other lending businesses like FirstBank and Santander, have a loan portfolio secured by residential properties that represents more than 25% of the total portfolio.

Additionally, some banks originate or acquire mortgage loans that they sell in the secondary market and which they continue to serve. This generally profitable business (particularly when loans are sold without recourse) contributes to the importance of the mortgage business for local banks.

Figure 3: Residential & total loan balances
(YTD 2013, USB$)



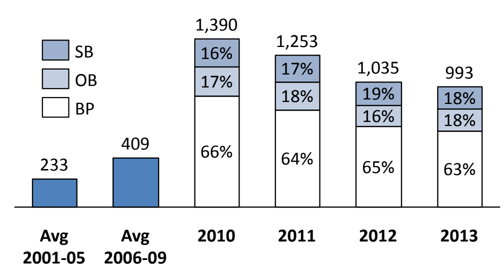
Figures 4-5: banking sector ending loan balances secured by 1-4 family residential properties and mortgage originations
(USB$)



*2013 originations are Jan.-Jun. annualized

After confirming the relevance of the mortgage business it is important to understand what can be expected from this business going forward. In this sense we foresee the following trends:

Figure 6: Mortgage loan balances sold with recourse
(off balance sheet, USM$)



1– **Reduction in mortgage portfolio balances as a result of low originations levels.** Banks' mortgage loan originations have reduced from an average of $5.5B in the 2001-2005 period to an average of $2.0B in the 2010-13 period (see Figure 5). Low origination volumes are likely to continue due to the following:

- Interest rates have been at historically low levels for a long period of time. Consequently, most customers interested in refinancing have probably done so already. In fact, long term rates are starting to rise which, if anything, may reduce the number of mortgage transactions.
- Local and federal programs to stimulate or subsidize the mortgage loan business are likely to decrease. In the case of local programs this is due to the government fiscal crisis. In the case of Federal programs, there is less social pressure now to provide some sort of relief to highly indebted households.
- The local economy is not likely to show a solid recovery in the coming years.

In general, the mortgage loan originations structure is complex and it is difficult for banks to make adjustments to that structure. If, as expected, mortgage originations remain soft or fall even further, banks will need to rescale their operations. If they don't, they are likely to see their margins decrease.

2– **Increase in the participation of repurchased recourse portfolios within the mortgage portfolio mix.** While originations have reduced in recent years, the total mortgage loan balances have remained stable in the 2009-13 period (see Figure 4). This may be the result of some banks having to repurchase conforming mortgage loans they had previously sold with recourse. Local banks still have $993M in mortgage loans off balance sheet that they sold with recourse despite the reduction experienced since 2010 (see Figure 6). If they are required to continue repurchasing delinquent recourse portfolios, their loan mix will deteriorate impacting their margins.

3– **Weakening in the natural hedge from the mortgage servicing business.** In general, interest rate increases result in lower refinancing activity and longer mortgage durations. As a result, projected cash flows from mortgage servicing increase driving a higher servicing rights' valuation. However, under the current environment this benefit may the partially offset by the larger costs involved in servicing a mortgage portfolio which credit quality has deteriorated in recent years.

4– **Implementation of new regulation by the Consumer Finance Protection Bureau (CFPB) in January 2014.** Among other things, the new regulation will involve a more strict mortgage qualification criteria (for instance, a lower debt to income requirement), a cap in the originations fees of 3%, a more frequent communication with the customer and a more robust management of customer complaints.

In summary, several industry trends point to a deterioration in the mortgage business margins in the short term. Considering the relevance of this business for the banking industry, banks will need to find offsetting mechanisms to enhance their overall profitability levels.

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:

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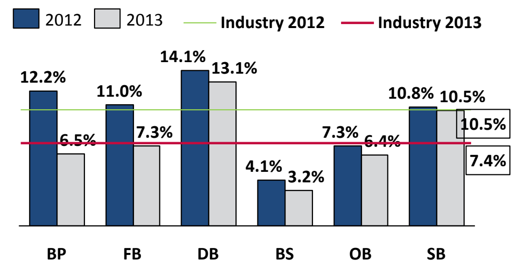
ASSET QUALITY: "The sale of NPLs by Popular and FirstBank results in a 30% reduction in the industry's NPLs ratio"

With the sale of delinquent portfolios by Popular and FirstBank during 2013, the asset quality ratios have improved substantially. The 90 days + and still accruing plus non accruing portfolios (NPLs) to total loan balances for the industry has reduced from 10.5% in December 2012 to 7.4% in June 2013 (see Figure 7). The NPLs inflows trend in the coming periods will dictate whether the industry's asset quality continues to improve or not.

As expected, the reduction has been driven by Popular and FirstBank, which ratios have decreased from 12.2% and 11.0% in December 2012 to 6.5% and 7.3% in June 2013, respectively. Doral continues to show the highest NPLs ratio (13.1%) while Santander presents the lowest ratio at 3.2%.

Figure 7: NPLs to Total Loans*

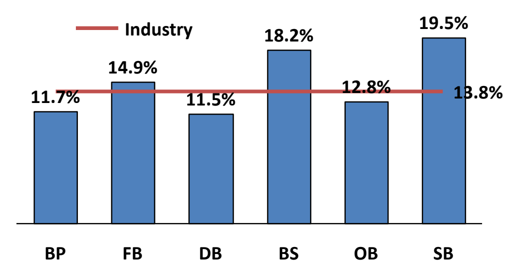


*Exclude FDIC covered portfolios and NPLs protected by FDIC

CAPITAL ADEQUACY: "Despite losses from NPLs sales, capital adequacy levels are still very solid"

Despite the losses incurred with the sale of NPLs, the capital adequacy ratios remain at solid levels (tier 1 risk based capital ratio of 13.8%, see Figure 8). All banks show above well capitalized levels based on the capital ratios used by the FDIC (see Annex 2). However, as we saw in previous reports these ratios may not be capturing the inherent risk in Doral's balance sheet. Doral has the highest NPLs ratio and the lowest NPLs coverage ratio in the industry (see Annex 2) and has shown after tax losses for the past six years. The rest of the banks seem to have spare capital to make opportunistic acquisitions, return capital through dividends or repay TARP when applicable.

Figure 8: Tier 1 Risk-based Capital Ratio YTD 2013



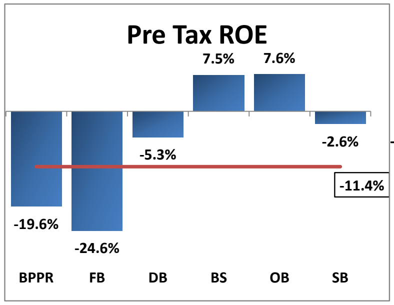
In summary, the Puerto Rico banking sector continued to show positive profitability in the first half of 2013 after adjusting the pre-tax net income for the losses related to the sale of non performing loan portfolios by Popular and FirstBank. However, the adjusted pre-tax ROE of 3.9% in the first half of 2013 is still low compared to the average 18% reached in the pre-crisis period of 2002-06. This is not surprising considering the current environment of economic stagnation, limited credit activity and still high delinquency levels.

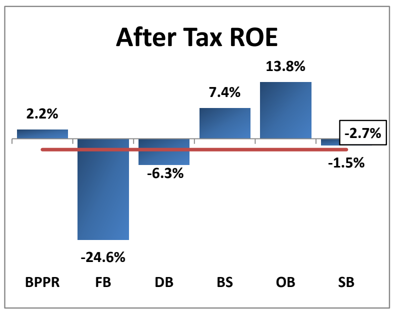
One of the most important local banking businesses is the mortgage business which represents more than 25% of every banking institution's total loan portfolio. Our perspective is that the profitability of this business in the coming years may deteriorate, making it more difficult for the local banks to reach pre crisis profitability levels. Low mortgage originations, portfolio mix deterioration and more expensive service operations may drive a reduction in the mortgage margins unless the banks come up with initiatives to reduce costs, be more efficient and find alternative ways to grow healthy portfolio volumes.

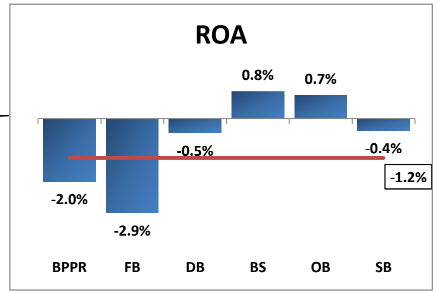
Finally, despite the difficulties to reach high profitability levels, the industry continues to improve the quality of its asset base through work out initiatives including the sale of NPL portfolios. These initiatives have driven the industry NPLs ratio down to 2008 levels (see Annex 4). Additionally, capital levels are very solid and most banks are presented with different alternatives to make use of their spare capital. They can either invest in opportunistic inorganic growth acquisitions locally, in expanding their continental presence, in repaying TARP in the case of Popular or simply in returning capital to shareholders.

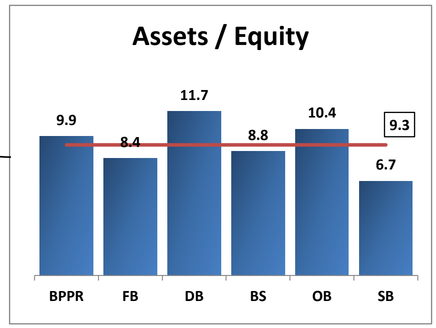
Source: Federal Deposit Insurance Corporation (FDIC), 10-Q SEC filings, analysis by "Financial Institutions Practice" V2A.

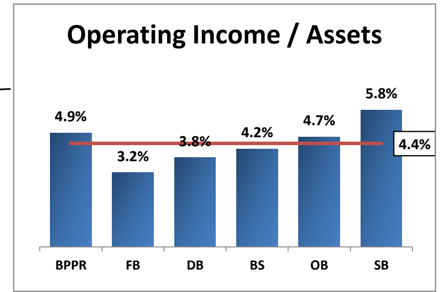
ANNEX 1: BANKING INDUSTRY PROFITABILITY Jan - Jun 2013

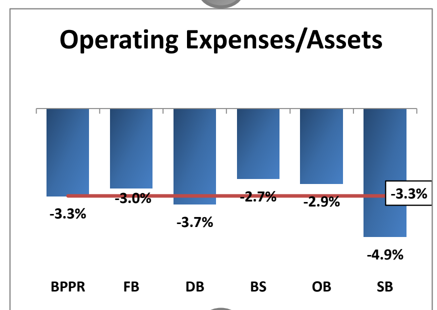


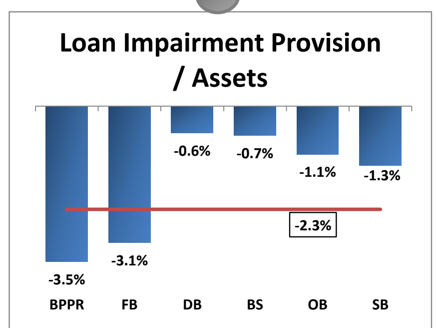


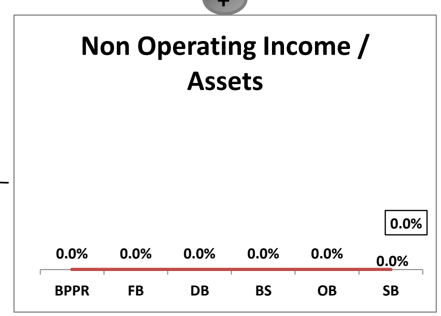


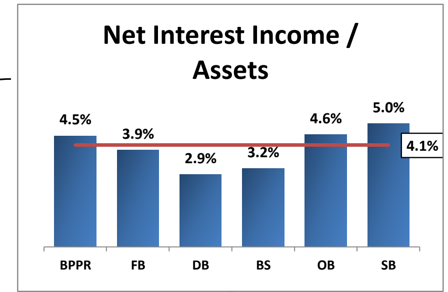


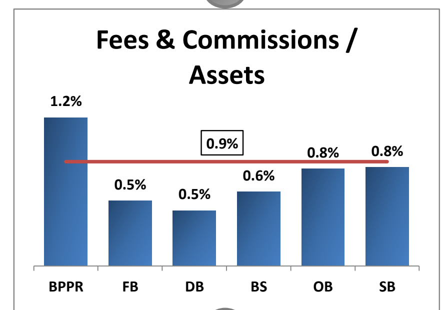


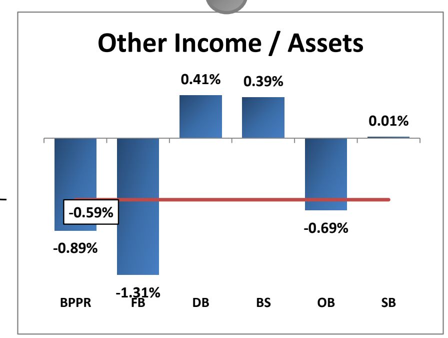












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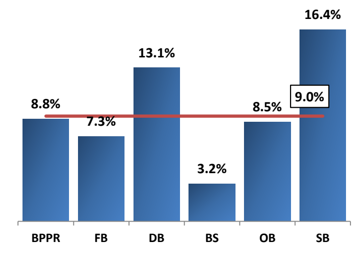
Note: Income and expense ratios are annualized
Source: Federal Deposit Insurance Corporation (FDIC)

Industry

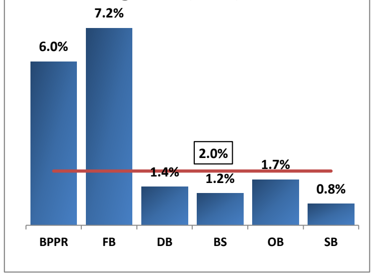
ANNEX 2: BANKING INDUSTRY PERFORMANCE RATIOS Jan - Jun 2013

ASSET QUALITY

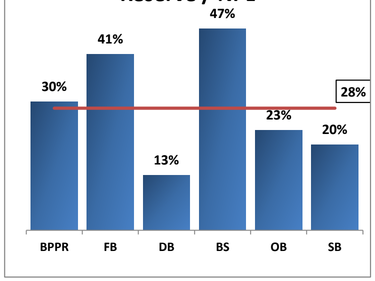
Nonperforming Loans Ratio



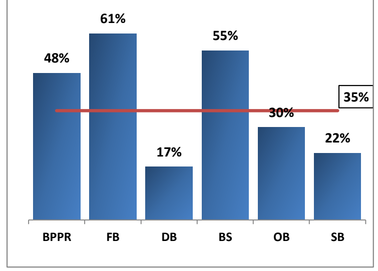
Charge-Off (Loss) Ratio



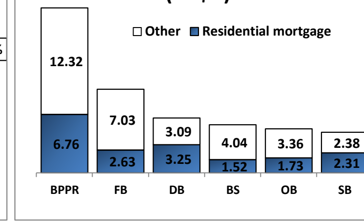
Reserve / NPL



(Reserve+NCO)/(NPL+NCO)

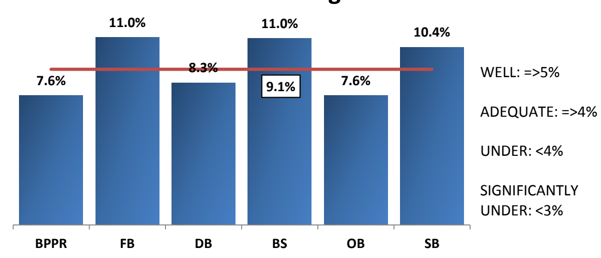


Total L&Ls & Residential Mortgage Participation (US$B)

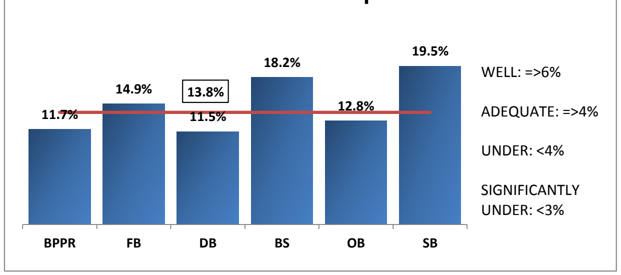


CAPITAL ADEQUACY

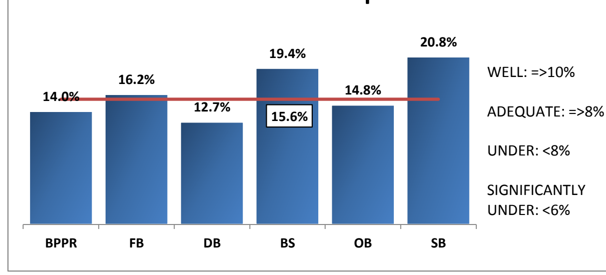
Tier 1 Leverage Ratio *



Tier 1 Risk-based Capital Ratio

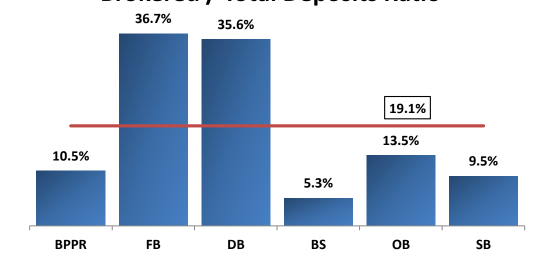


Total Risk-based Capital Ratio

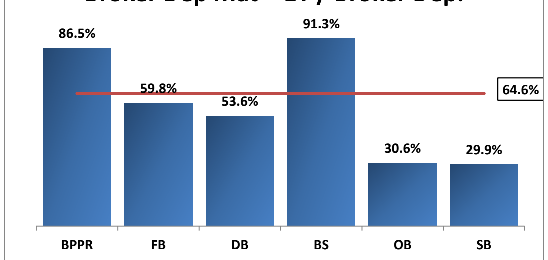


LIQUIDITY

Brokered / Total Deposits Ratio

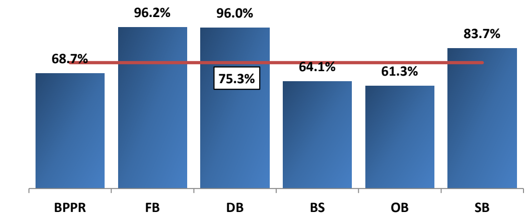


Broker Dep Mat < 1Y / Broker Dep.

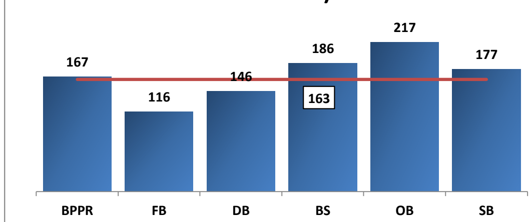


PRODUCTIVITY

Efficiency Ratio (Cost / Income)



Net Margin per Employee (USD Thousand)



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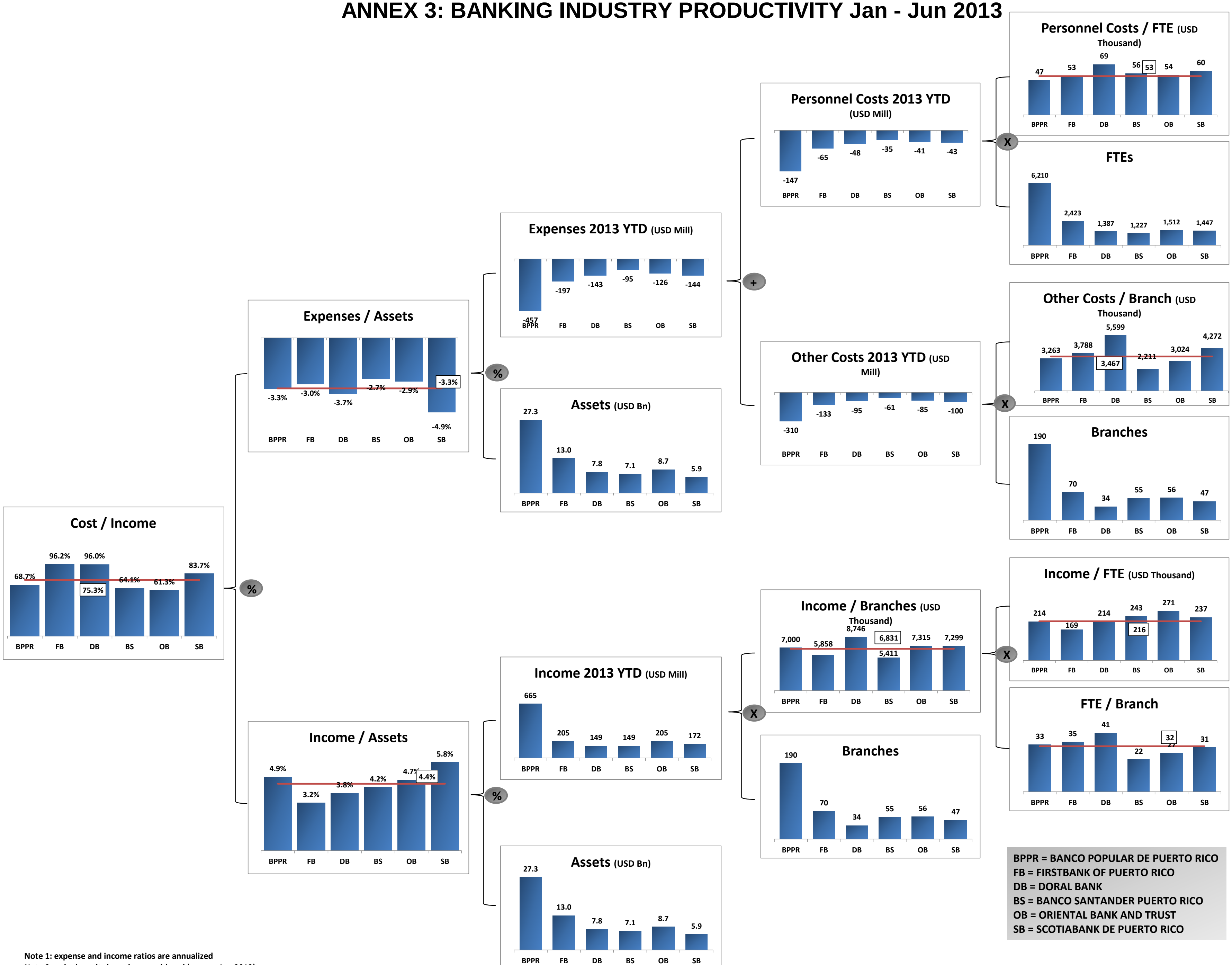
Industry

* 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 - Jun 2013



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Note 1: expense and income ratios are annualized
Note 2: only deposits branches considered (source: Jun 2012)
Source: Federal Deposit Insurance Corporation (FDIC)

Industry

V2A Vision To Action
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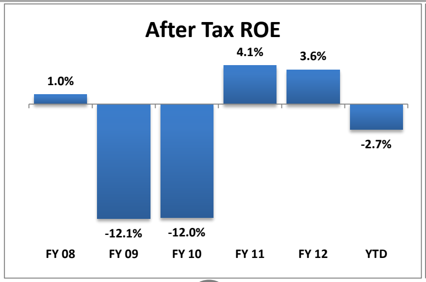
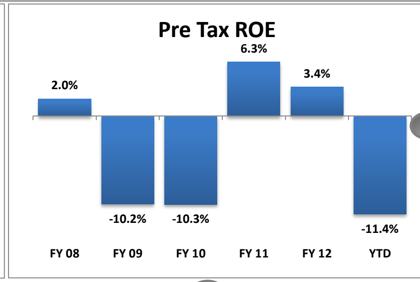
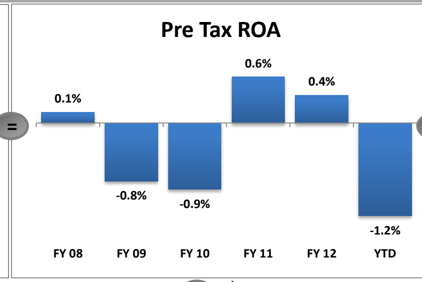
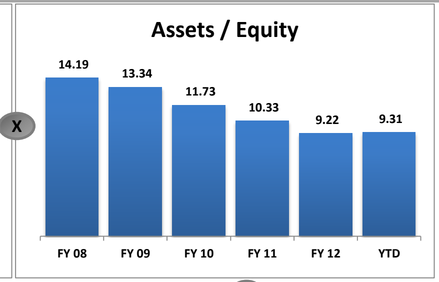
ANNEX 4: INDUSTRY TRENDS - SELECTED METRICS

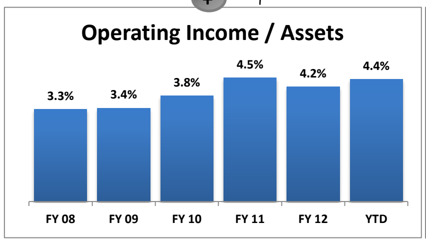
PROFITABILITY

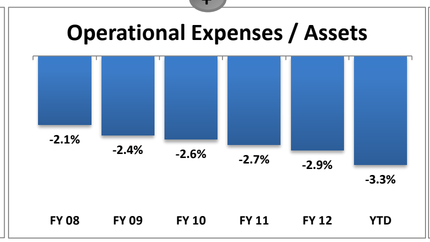


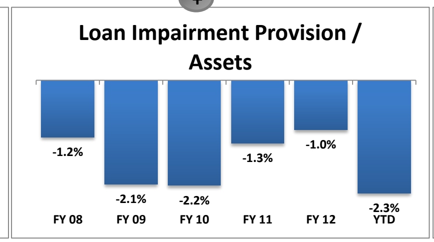


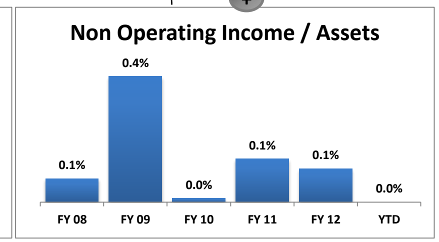




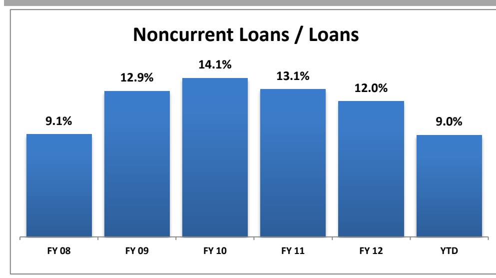


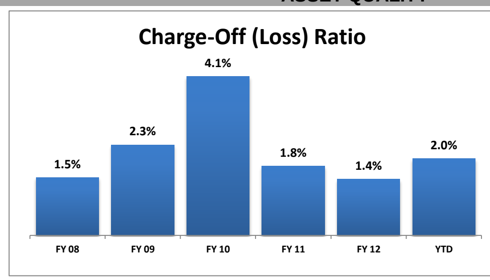


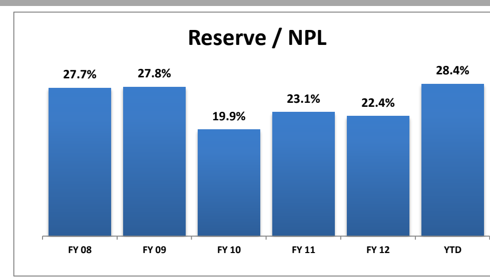


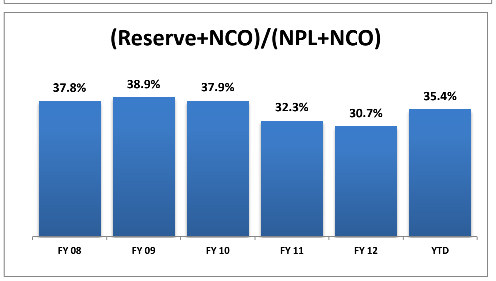


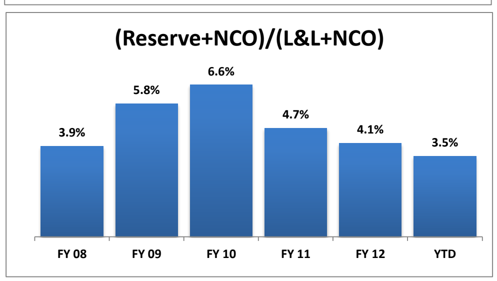
ASSET QUALITY





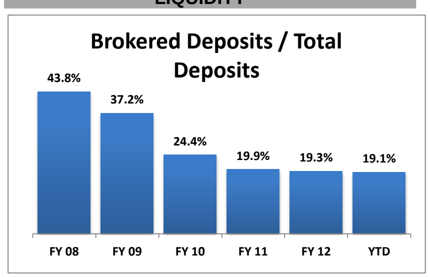




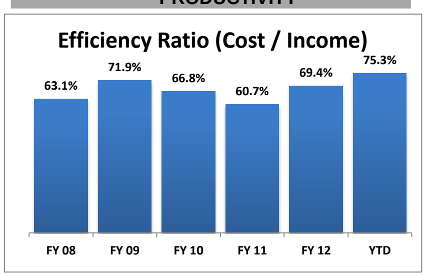


Notes:
Asset quality ratios are not adjusted for FDIC covered and available for sale portfolios
YTD numbers are annualized
Source: Federal Deposit Insurance Corporation (FDIC)

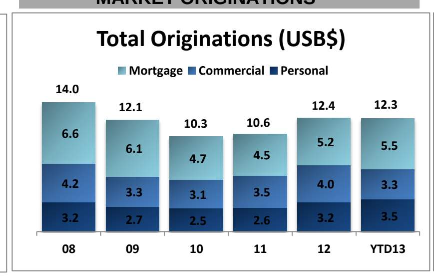
LIQUIDITY



PRODUCTIVITY



MARKET ORIGINATIONS



TOTAL ASSETS