Puerto Rico Banking Industry Report

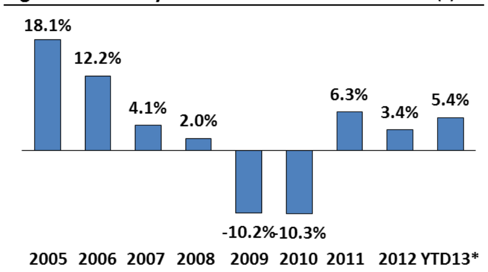
Issue XVIII **January to September 2013**

EXECUTIVE SUMMARY: the local banking sector reached an adjusted pre-tax ROE of 5.4% in 2013 YTD, an improvement when compared to 2012 but still very far from reaching pre-crisis levels of profitability. This adjusted rate does not include the adverse effects the sale of non performing loan (NPL) portfolios had on the sector's bottom line. The Island's current economic outlook characterized by a protracted contraction, low aggregate demand, no clear growth drivers in the short-term, warnings from credit agencies of a potential downgrade to Puerto Rico's general obligation bonds, a housing market that still faces steep challenges and disconcerting labor market indicators, presents few opportunities domestically for the local banking industry to perform at levels prior to 2007 when it reached double digit rates of profitability.

PROFITABILITY: "After adjusting for NPL sales, the annualized YTD 2013 pre-tax ROE reached 5.4%, 200bps above 2012"

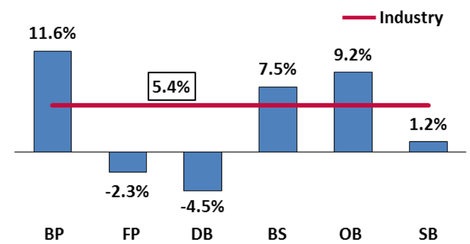
The consolidated profitability level of Puerto Rico's banking industry during the first three quarters of 2013 was impacted by the sale of NPL portfolios by Popular and FirstBank during Q1 and Q2 which resulted in a combined loss of $180M. These transactions kept the annualized YTD 2013 profitability in negative territory at –4.8% (see Annexes 1 and 4). Once these unusual negative events are netted out from the industry's profitability, the pre-tax ROE increases by more than 10 percentage points to 5.4%, 200 bps higher than in 2012 (see Figure 1). Although the sale of $658M in NPL book value balances by Popular and FirstBank during Q1 and Q2 decreased their delinquency levels, these transactions adversely impacted the bottom line of the industry as a whole, as was explained in the previous issue.

Figure 1: Industry Pre-Tax ROE Trend 2005-2013 (1)



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

Figure 2: Pre-Tax ROE by Bank YTD 2013*



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

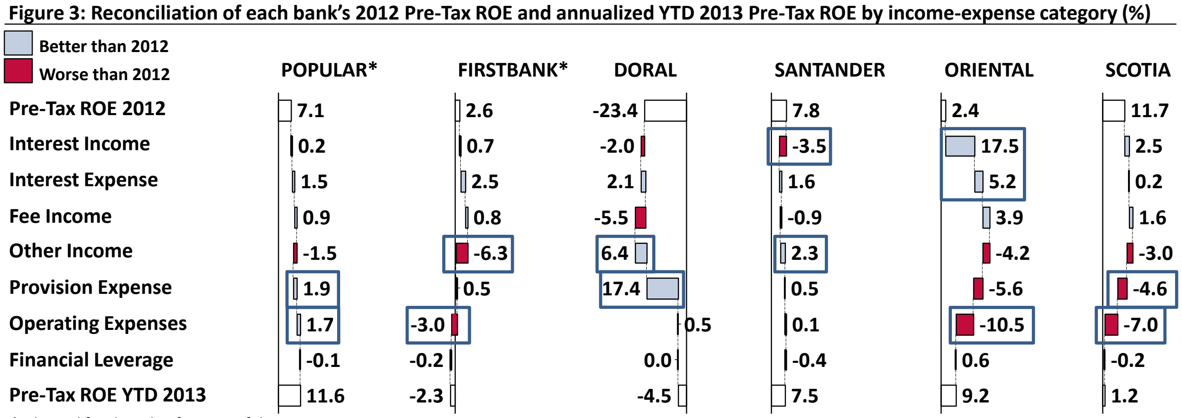
When looking at profitability by bank and adjusting for the sale of the NPL portfolios, Popular leads the industry with an annualized YTD 2013 pre-tax ROE of 11.6% (see Figure 2), its highest profitability since 2007. The improvement against the 2012 ROE levels (7.1%) was obtained through lower provision and operating expenses which more than compensated the lower other income (see Figure 3). Popular maintains its dominance in terms of fee income generation among local banks (see Annex 1). Oriental follows Popular with a YTD 2013 ROE of 9.2%, a sizable improvement when compared to 2012 (2.4%). This improvement was driven by significantly higher interest income and lower interest expense which more than offset higher provision and operating expenses (see Figure 3).

Santander came in third place with an annualized pre-tax ROE of 7.5% in YTD 2013, followed by Scotia with a pre-tax ROE of 1.2%. When compared to 2012, Santander experimented a slight decrease in its profitability due to a reduction in the interest income level partially compensated by higher other income. Scotia's pre-tax ROE decreased from 11.7% to 1.2%, a reduction of over 10 percentage points, due to higher provision and operating expenses and lower other income.

FirstBank and Doral obtained the lowest pre-tax ROEs with –2.3% (adjusted for the sale of the NPL portfolio) and –4.5%, respectively. The non-adjusted pre-tax ROE of FirstBank was much lower than the adjusted rate, reaching a dismal –14.7%.

Doral's profitability will continue to suffer until it achieves greater control of its cost structure. Doral's productivity level compares unfavorably against the industry measured by the cost/income ratio (96.7% DB vs. 72.0% IND) (see Annex 2).

Figure 3: Reconciliation of each bank's 2012 Pre-Tax ROE and annualized YTD 2013 Pre-Tax ROE by income-expense category (%)



	POPULAR*	FIRSTBANK*	DORAL	SANTANDER	ORIENTAL	SCOTIA
Pre-Tax ROE 2012	7.1	2.6	-23.4	7.8	2.4	11.7
Interest Income	0.2	0.7	-2.0	-3.5	17.5	2.5
Interest Expense	1.5	2.5	2.1	1.6	5.2	0.2
Fee Income	0.9	0.8	-5.5	-0.9	3.9	1.6
Other Income	-1.5	-6.3	6.4	2.3	-4.2	-3.0
Provision Expense	1.9	0.5	17.4	0.5	-5.6	-4.6
Operating Expenses	1.7	-3.0	0.5	0.1	-10.5	-7.0
Financial Leverage	-0.1	-0.2	0.0	-0.4	0.6	-0.2
Pre-Tax ROE YTD 2013	11.6	-2.3	-4.5	7.5	9.2	1.2

*Adjusted for the sale of NPL portfolios

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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.

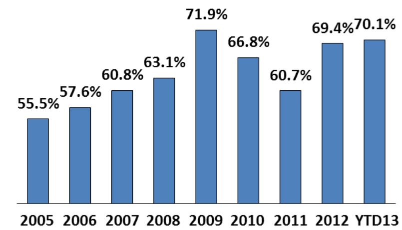
PRODUCTIVITY: "Productivity enhancing and cost restructuring measures remain fundamental to reach pre-crisis levels of profitability"

The local banking industry in YTD 2013, even after adjusting for the NPL portfolio sales carried out by Popular and FirstBank, showed the second lowest productivity level in the 2005-2013 period with a cost/income of 70.1%, only after 2009 when it reached 71.9% (see Figure 4). While there is certainly room for improvement on the productivity front, it is important to mention that the currently low profitability rates are due in a great degree to still high credit provision levels and low financial leverage.

When analyzing the productivity performance by individual banks and adjusting for the sale of NPL portfolios, Popular and Oriental obtained the highest productivity levels with cost to income ratios of 58.4% and 60.8%, respectively (see Figure 5). Popular, Puerto Rico's largest bank, has been able to effectively take advantage of economies of scale, while Oriental has managed to integrate BBVA's operations while maintaining control of its cost structure. They are followed by Santander (63.4%), Scotia (78.5%) and FirstBank (83.6%). Doral has not been able to substantially improve its productivity, reaching a cost/income ratio of 96.7%, a clear outlier in the local banking industry.

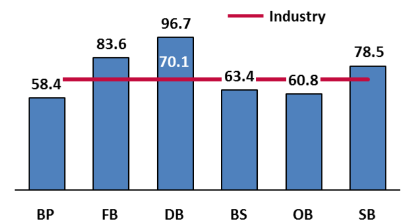
Since 2006, when Puerto Rico entered one of its deepest and longest contractionary periods, total assets have experienced a sharp downward trend, reaching $66.3B in Q3 2013, from $104B in 2005, a decrease of 36%. Operational expenses have not kept in line with the reduction in income generating assets, which has hurt the banking industry's capacity to generate profit. Continuing efforts to control expenses and revise cost structures will be fundamental to reach higher levels of profitability.

Figure 4: Cost to Income Trend 2005-2013*



* Adjusted for the sale of NPL portfolios

Figure 5: Cost to Income YTD 2013 (%)*



*Adjusted for the sale of NPL portfolios

CAPITAL ADEQUACY: "Solvency ratios remain at historically high levels"

Capital adequacy ratios continue to strengthen, reaching historically high levels. The sale of NPL portfolios by Popular and FirstBank, which resulted in a combined loss of $180M, did not have a significant impact on capital ratios.

The Tier 1 risk based capital ratio of the local banking industry reached 13.8% in September 2013 (see Figure 6), slightly lower than 2012 but still more than double the well capitalized threshold established by the FDIC (6%).

When analyzing capitalization by bank, Scotia and Santander lead the industry with Tier 1 risk based capital ratios that more than triple the regulatory minimum and that stand significantly above the industry level (see Figure 7). These two banks have seen a gradual increase in their capitalization levels since 2009 when their ratios were close to 10%. FirstBank also has a high capital adequacy level when compared to the industry.

Although Popular and Oriental show a Tier 1 risk based capital ratio below the industry level, they still more than double the well capitalized threshold of 6% set by the FDIC.

Finally, Doral continues to see its Tier 1 risk based capital ratio decline, reaching 11.0% in YTD 2013. This ratio may not reflect the inherent risk in Doral's balance sheet, as mentioned in previous issues. Doral has the highest NPL ratio and the lowest NPLs coverage among local banks (see Annex 2).

Figure 6: Tier 1 Risk-based Capital Ratio 2005-2013 (%)

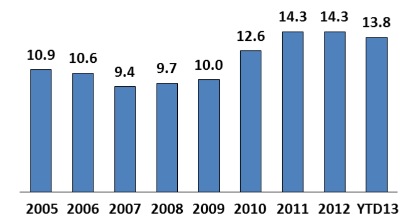
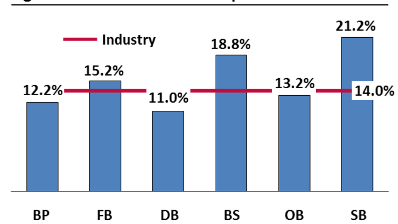


Figure 7: Tier 1 Risk-based Capital Ratio YTD 2013



ASSET QUALITY: "Delinquency reaches its lowest level since 2007"

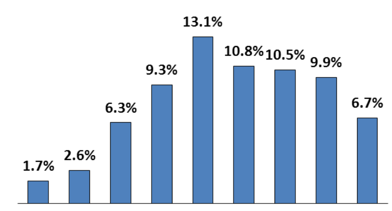
While the sale of NPL portfolios by Popular and FirstBank hurt profitability in YTD 2013, these transactions also resulted in a dramatic improvement in the asset quality indicators. The NPL ratio, excluding FDIC covered and held for sale portfolios, reached 6.7%, a drop of more than 3 percentage points when compared to 2012 and a decrease of more than 6 percentage points relative to 2009 when it peaked at 13.1% (see Figure 8). Although the YTD 2013 NPL ratio showed a substantial improvement, it was still far from the average 2.0% reached in the 2002-2006 period.

When analyzing asset quality by bank, Santander continues with the lowest NPL ratio in YTD 2013 (3.3%), followed by Oriental, Scotia, Popular and FirstBank (4.1%, 5.3%, 5.7% and 7.3%, respectively). Doral is struggling to have a "cleaner" asset base, showing the highest NPL ratio in YTD 2013 (13.7%, see Figure 9).

Given the still high delinquency levels, we expect banks to continue using different mechanisms to clean their books and return their asset quality to pre-crisis levels.

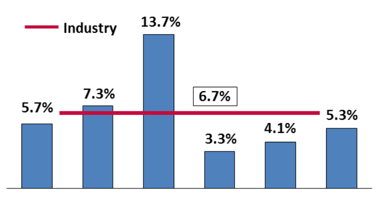
In summary, the Puerto Rico banking industry will need to continue rationalizing its cost structure to improve profitability considering the still high delinquency levels and the deleveraging environment. Given the solid capital position of the local banking industry, banks will continue to look for alternatives to deploy their spare capital.

Figure 8: NPL Ratio Trend 2005-2013*



*FDIC covered and held for sale portfolios are excluded

Figure 9: NPL Ratio by Bank YTD 2013*



*FDIC covered and held for sale portfolios are excluded

Source: FDIC, OCIF, 10-Q SEC filings, quarterly results calls, analysis by "Financial Institutions Practice" V2A. www.v-2-a.com / Tel. V2A (787) 919 7303

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DEPOSITS TRENDS: "Lower dependence on brokered deposits; Santander & Oriental core deposits winners in PR"

The FDIC assisted banking consolidation that took place in 2010 resulted in a sharp reduction in brokered deposits that drove the drop in total deposits from $60.5B in 2009 to $50.4B in 2010 (see Figure 10). Since then total deposits have remained stable. Banks in Puerto Rico, mostly responding to regulatory pressures, have been decreasing their dependence on brokered deposits. The brokered to total deposits ratio has shrunk from 40.0% in 2009 to 17.8% in 2013.

When looking at core deposits market share in Puerto Rico, Santander has experienced the largest increase (15.6% 2013 vs 12.2% 2009, see Figure 11). Regarding the three banks that participated in the 2010 consolidation, we see different trends by bank. The sum of Oriental, Eurobank and BBVA market shares in 2009 was 12.5% while in 2013 Oriental accumulated a 13.6% core deposits share. Scotia and RG had a combined share of 8.8% in 2009, exactly the same that Scotia held in 2013. Finally, the sum of Popular and Western market shares in 2009 was 51.3%, 320 bps above the share that Popular held in 2013.

Doral and FirstBank have experienced a decrease in core deposits' market share during this time period. However, when we include the core deposits that these two banks have in the continental US (mainly FL and NY) we observe a market share increase (see "Special Addendum 1").

Before the publication of this issue, a game-changing bill which will have significant ramifications in the local banking industry was passed by the PR Senate. Senate Bill 0857 (HB 1592), in an attempt to strengthen the GDB's liquidity position, would require the transfer of public sector deposits from private banks to the GDB. The imminent enactment of this law may exacerbate the slowdown in lending activity which is already 26% below the 2009 level. Deposits of government instrumentalities in the Island's private banks reached $3.1B in September 2013, representing 6.2% of the close to $50B of total deposits. If this law is ultimately passed, the banks will be affected in different degrees given their deposit composition. Public sector deposits represent a significant share of deposits in Santander (10.7%), FirstBank (7.3%), Oriental (7.1%), and Popular (6.1%) while only a small share in Doral (2.2%) and Scotia (0.6%) (see "Special Addendum 1").

Figure 10: Total Deposits 2009-2013 (US$B)

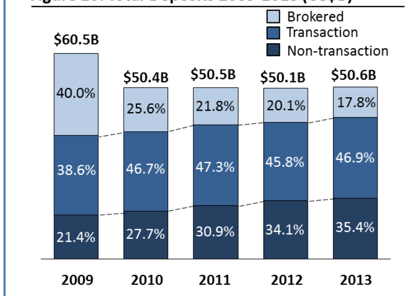
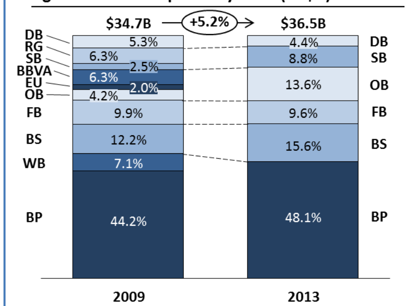


Figure 11: Core Deposits by Bank (US$B)



MORTGAGE ORIGINATIONS TRENDS: "Refinancing drives increase in mortgage origination from 2011 to 2012"

The profitability of the local banking industry relies heavily on the performance of the mortgage market. The residential loan portfolio represented 37% of the total loan portfolio in Q3 2013.

Total mortgage originations decreased by 15.1% from 2008 to 2012. In Figure 12 it can be observed that although mortgage originations increased by 19.5% from 2011 to 2012, the increase was mainly driven by the refinancing of mortgages due to historically low interest rates. We can also observe an increase in home purchase origination in 2011 due to a local housing stimulus program which provided incentives to both buyers and sellers. It is unlikely that we see the implementation of local and federal programs to stimulate or subsidize the mortgage loan business in the short-term, as was mentioned in the previous issue.

Popular dominates the local banking sector in terms of mortgage originations, capturing 31.8% of the market in 2012, followed by the mortgage bankers (22.6%), Scotia (12.6%), Doral (10.8%) and FirstBank (7.8%) (see Figure 13). Scotia acquired the second largest mortgage originating bank in 2010 but has lost mortgage origination market share since (from 19.7% Scotia+RG in 2008 to 12.6% in 2012). On the other hand, Popular and the mortgage bankers experienced the largest mortgage originations share increase (from 25.5% Popular+Western in 2009 to 31.8% in 2013, from 16.6% mortgage bankers in 2009 to 22.6% in 2013).

Figure 12: Mortgage Originations 2008-2012 (US$B)

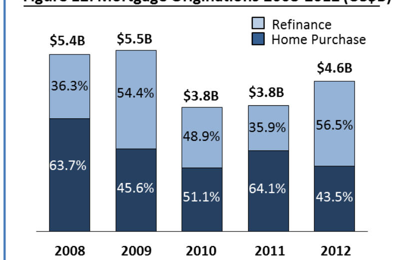
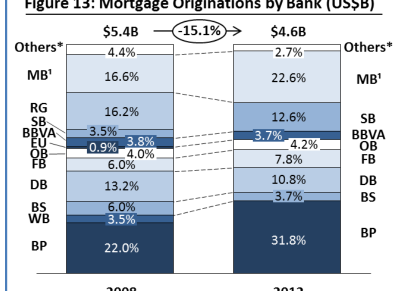


Figure 13: Mortgage Originations by Bank (US$B)

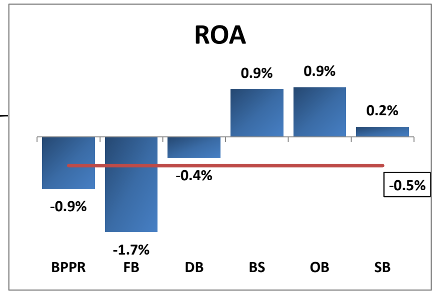


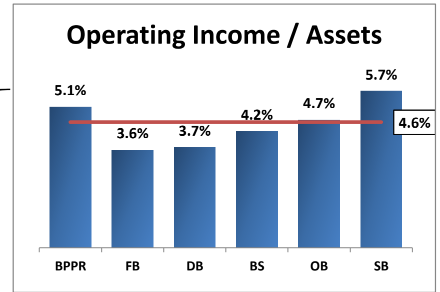
*Includes other banks, Reliable, credit unions and cooperatives
1. MB = Mortgage Bankers

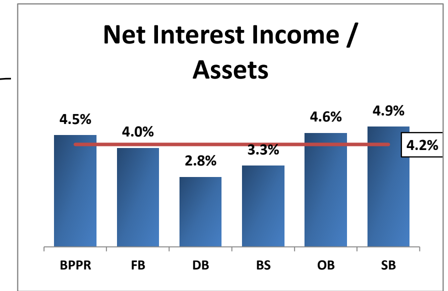
Disclaimer:

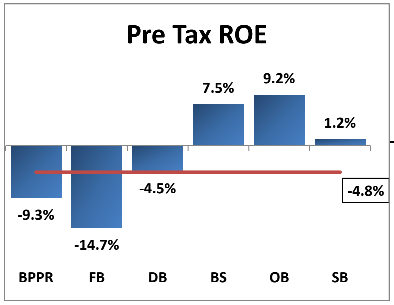
Source: Federal Deposit Insurance Corporation (FDIC), 10-Q SEC filings, analysis by "Financial Institutions Practice" V2A.

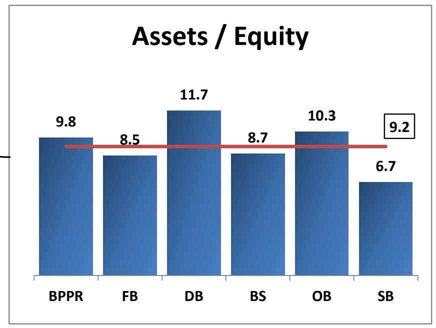
ANNEX 1: BANKING INDUSTRY PROFITABILITY Jan - Sep 2013

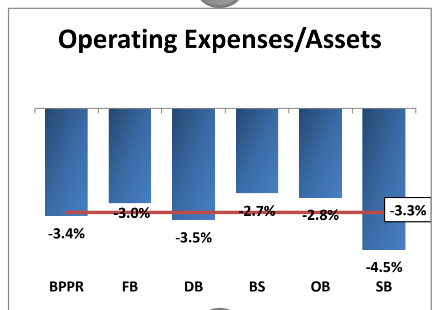


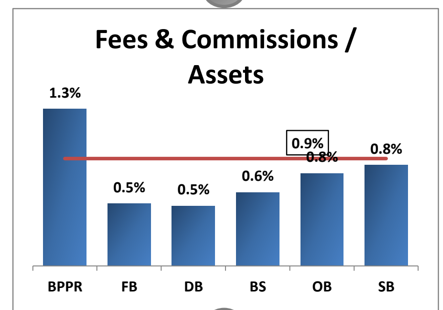


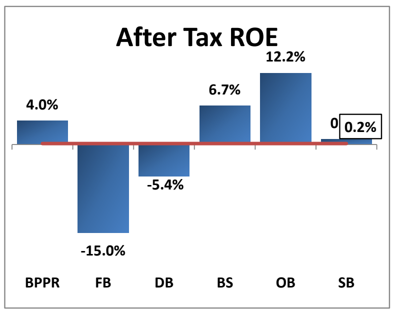


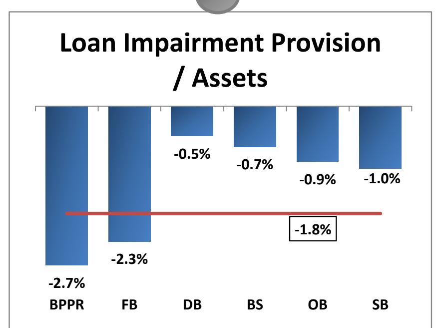


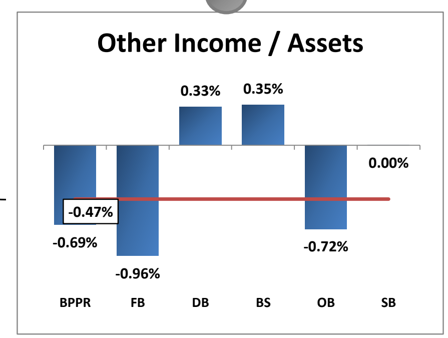


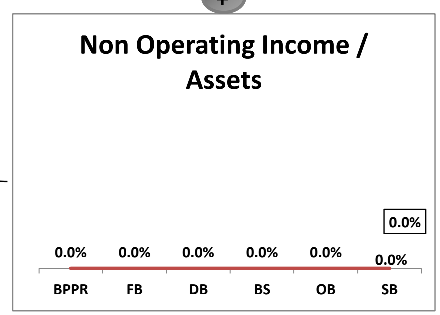












BPPR = BANCO POPULAR DE PUERTO RICO
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DB = DORAL BANK
BS = BANCO SANTANDER PUERTO RICO
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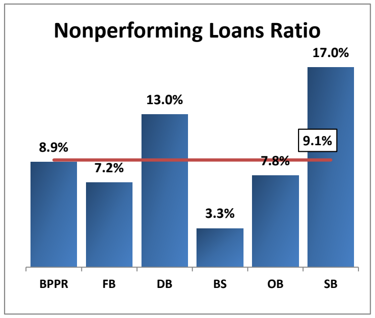
SB = SCOTIABANK DE PUERTO RICO

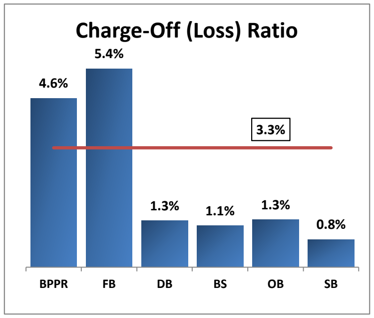
Note: Income and expense ratios are annualized
Source: Federal Deposit Insurance Corporation (FDIC)

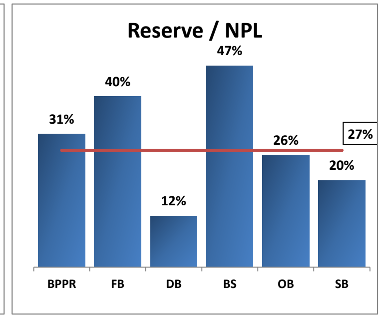
Industry

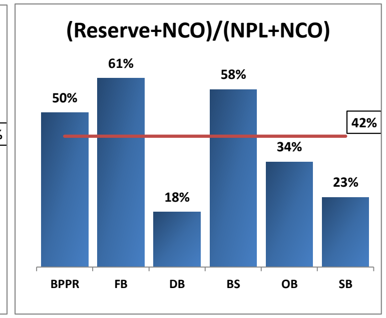
ANNEX 2: BANKING INDUSTRY PERFORMANCE RATIOS Jan - Sep 2013

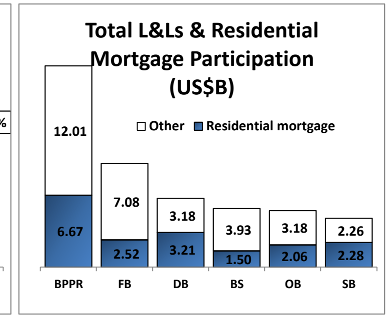
ASSET QUALITY



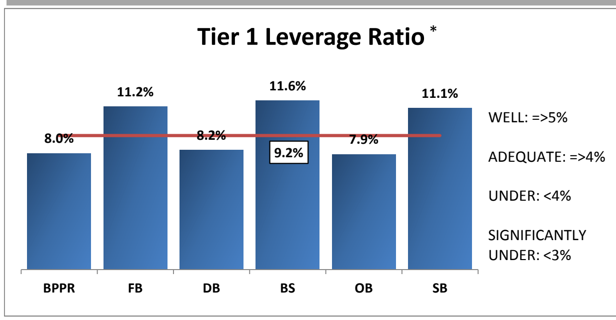


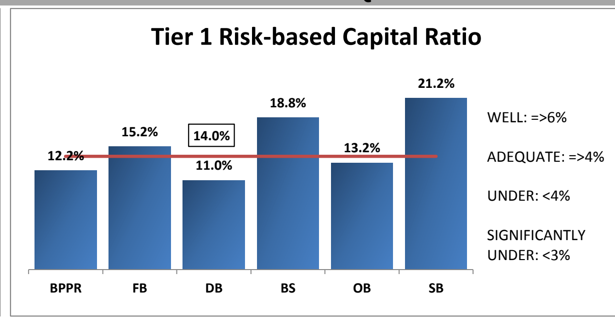


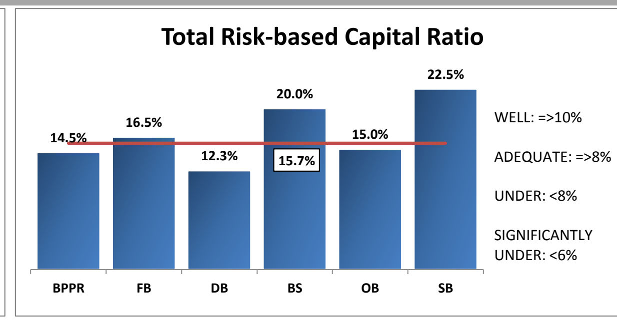




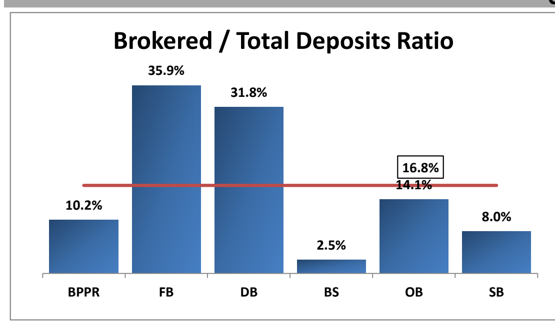
CAPITAL ADEQUACY

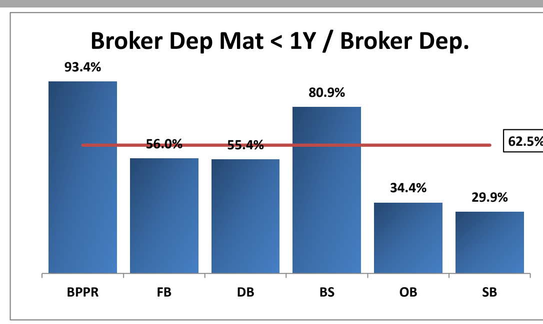




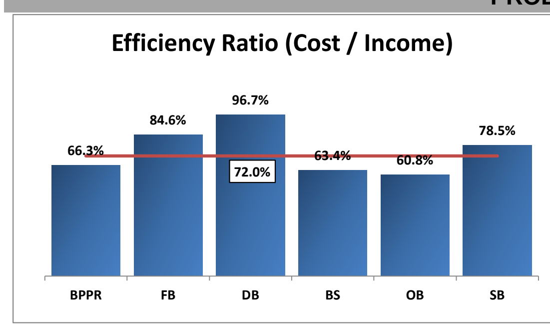


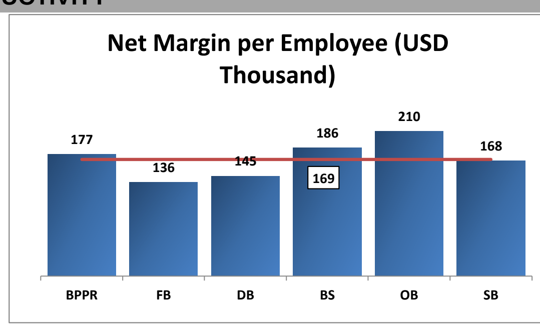
LIQUIDITY





PRODUCTIVITY





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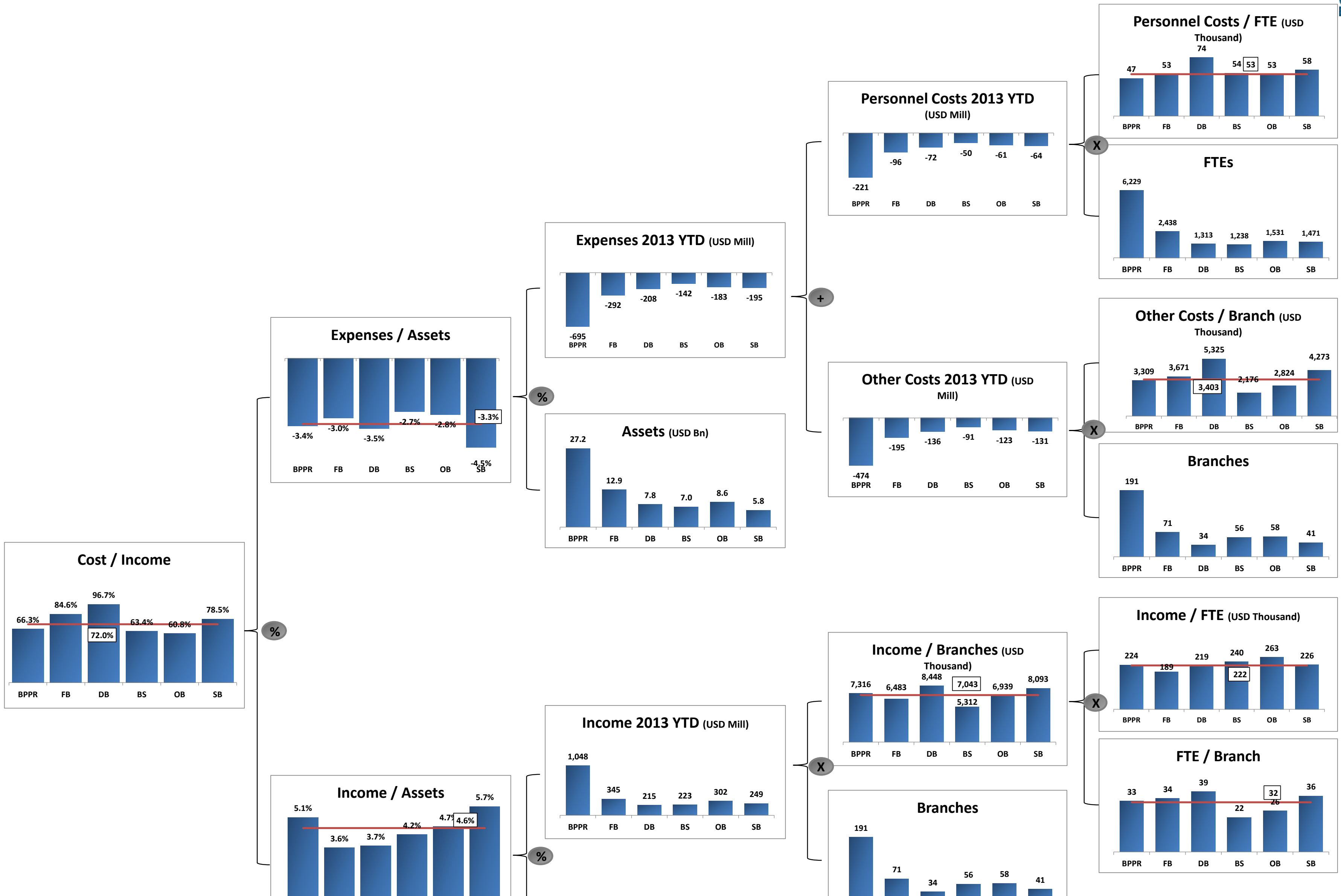
Industry

* 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 - Sep 2013



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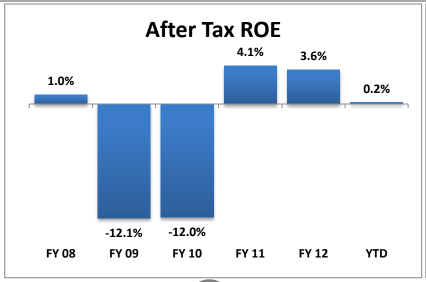
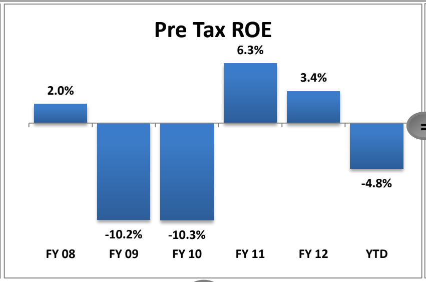
Note 1: expense and income ratios are annualized
Note 2: only deposits branches considered (source: Jun 2013)
Source: Federal Deposit Insurance Corporation (FDIC)

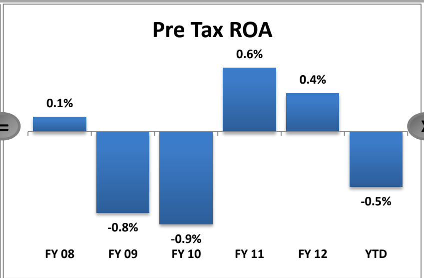
Industry

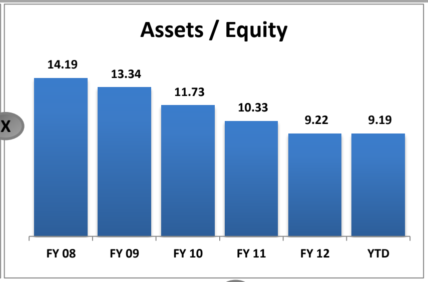
ANNEX 4: INDUSTRY TRENDS - SELECTED METRICS

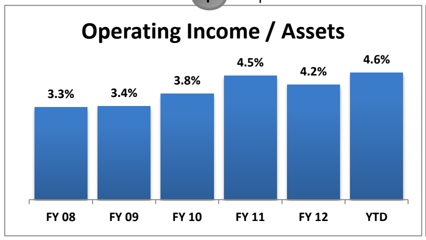
PROFITABILITY

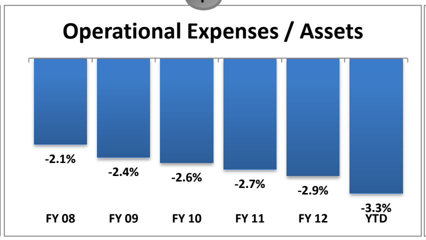


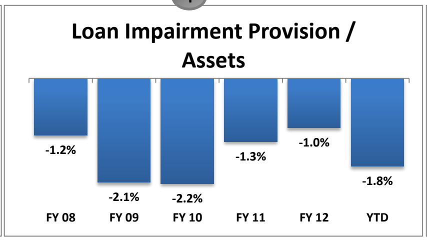


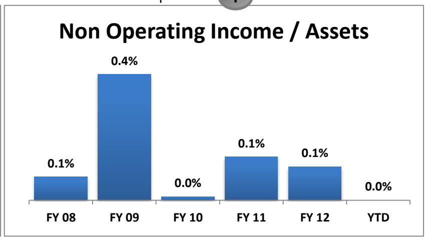




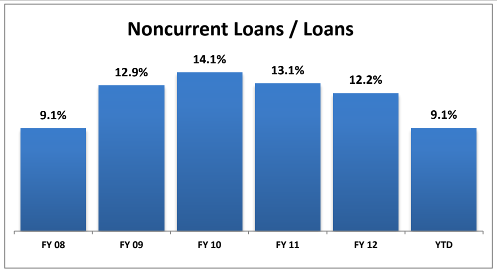


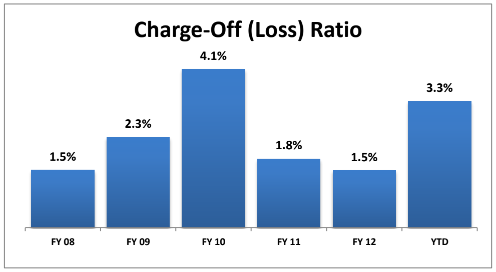


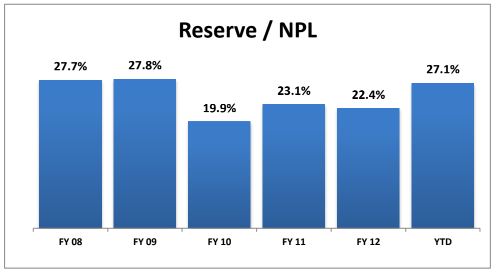


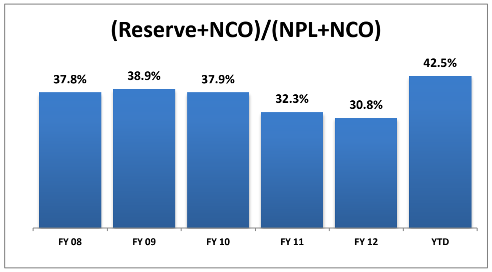


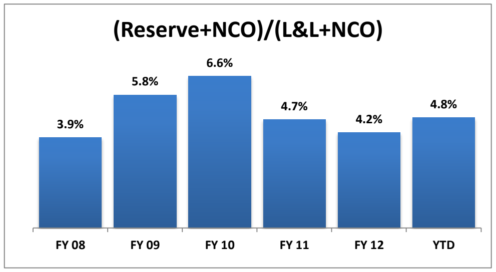
ASSET QUALITY







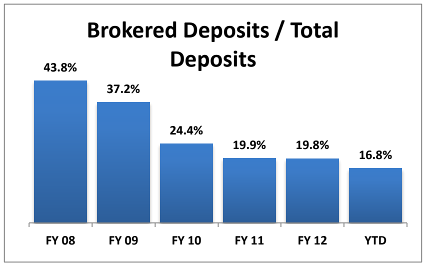




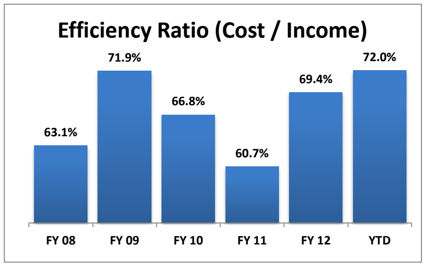
Notes:
- Asset quality ratios are not adjusted for FDIC covered and available for sale portfolios
- YTD numbers are annualized

Source: Federal Deposit Insurance Corporation (FDIC)

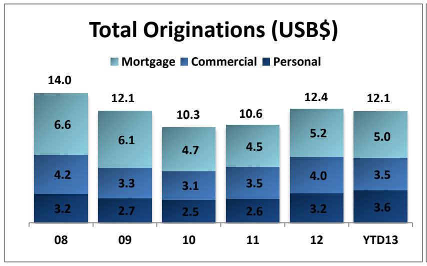
LIQUIDITY



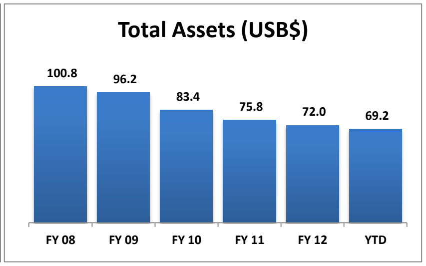
PRODUCTIVITY



MARKET ORIGINATIONS

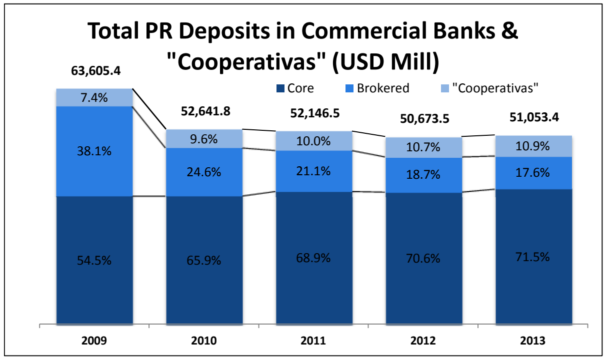


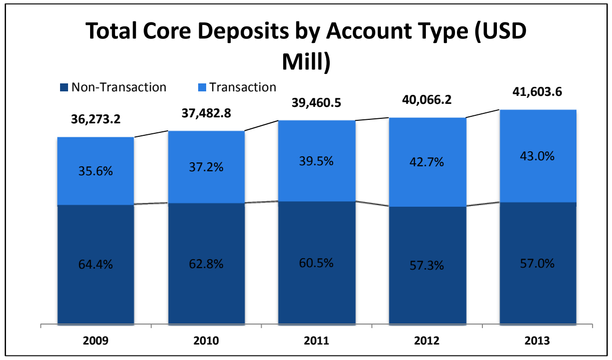
TOTAL ASSETS



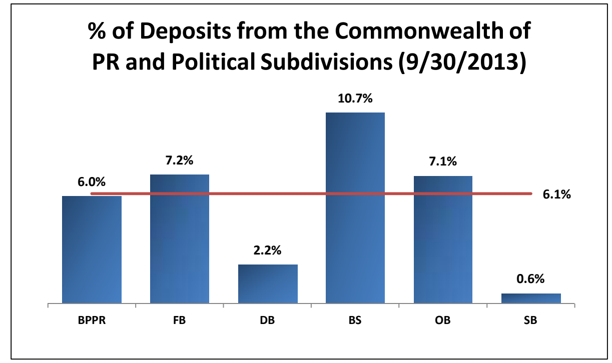
SPECIAL ADDENDUM 1: DEPOSIT TRENDS

TOTAL DEPOSITS

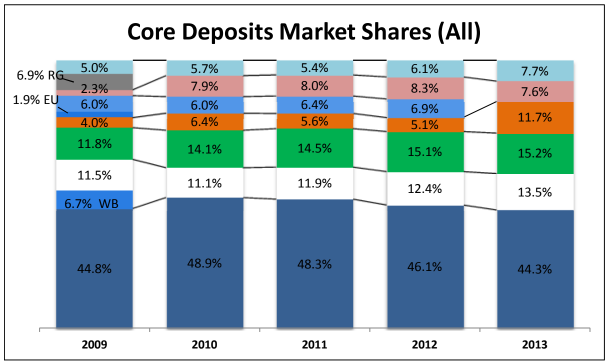


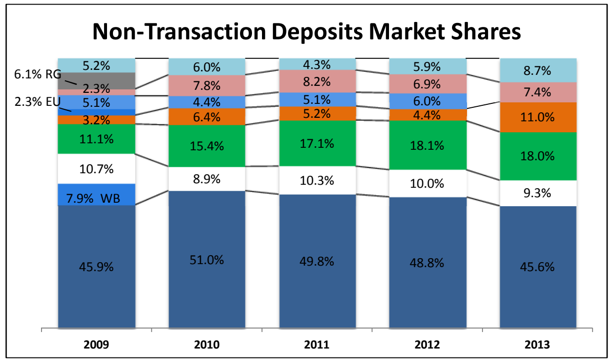


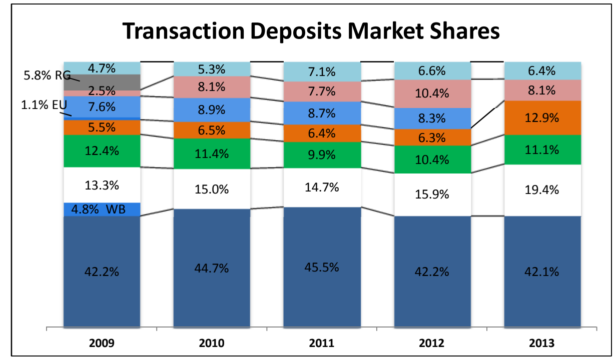
PUBLIC DEPOSITS EXPOSURE

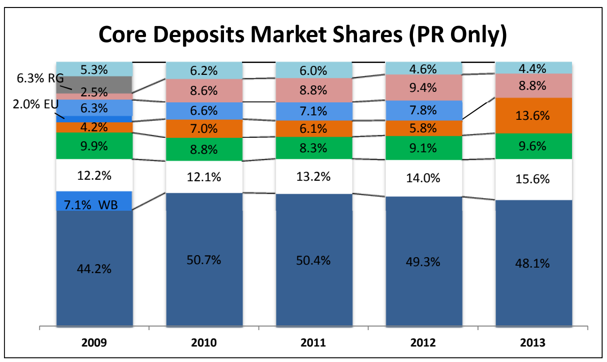


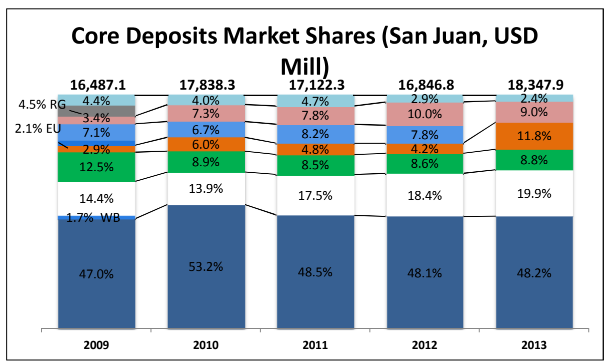
DEPOSIT MARKET SHARES

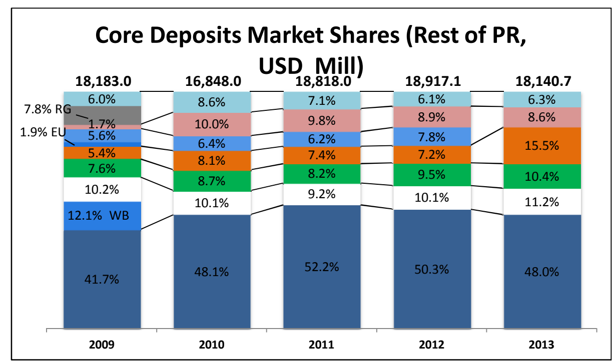












Legend:

- DB
- SB
- BBVA
- OB
- FB
- BS
- BPPR

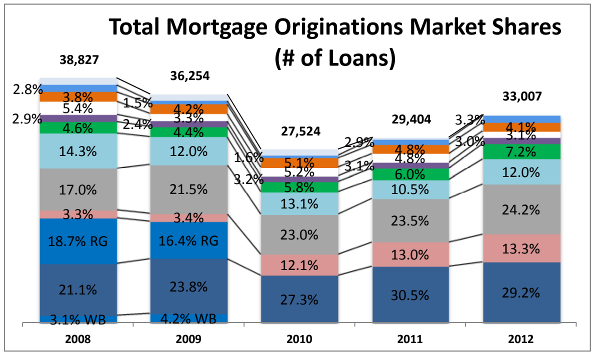
BPPR = BANCO POPULAR DE PUERTO RICO
FB = FIRSTBANK OF PUERTO RICO
DB = DORAL BANK
BS = BANCO SANTANDER PUERTO RICO
OB = ORIENTAL BANK AND TRUST
SB = SCOTIABANK DE PUERTO RICO
BBVA = BANCO BILBAO VIZCAYA ARGENTARIA PUERTO RICO
WB = WESTERNBANK PUERTO RICO
RG = R-G PREMIER BANK OF PUERTO RICO

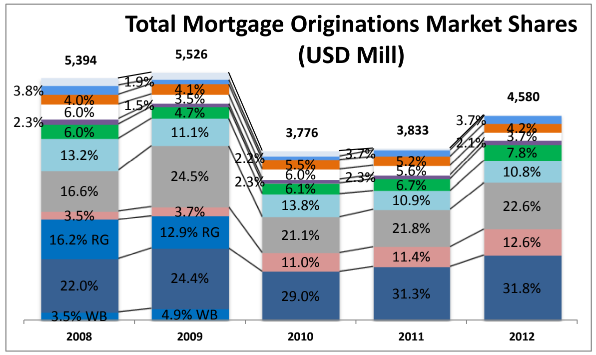
Note 1: Data as of June 30
Note 2: Deposits by account type include deposits in US branches
Note 3: Core deposits in main branches are estimates based on reported brokered deposits
Source: Federal Deposit Insurance Corporation (FDIC)

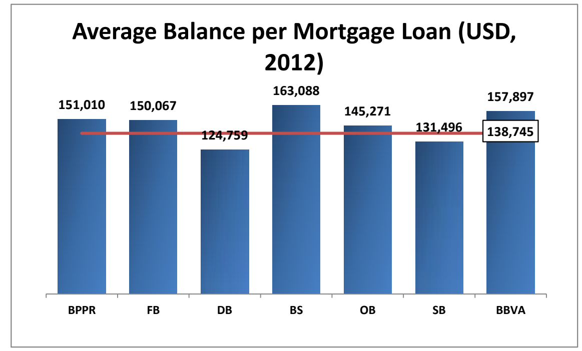
Industry

SPECIAL ADDENDUM 2: MORTGAGE LOANS TRENDS

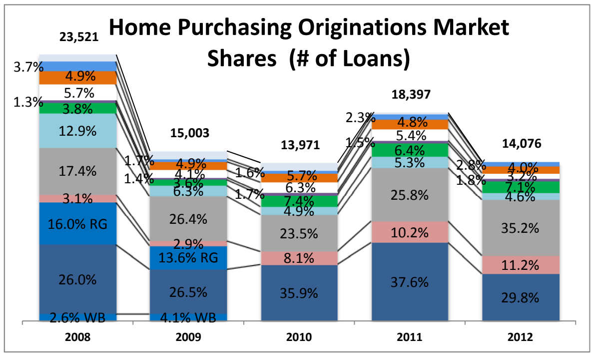
TOTAL MORTGAGE LOANS

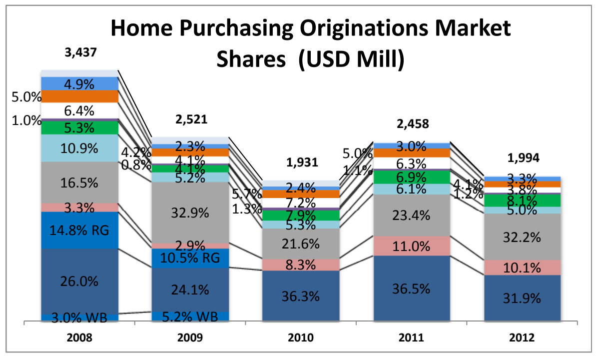


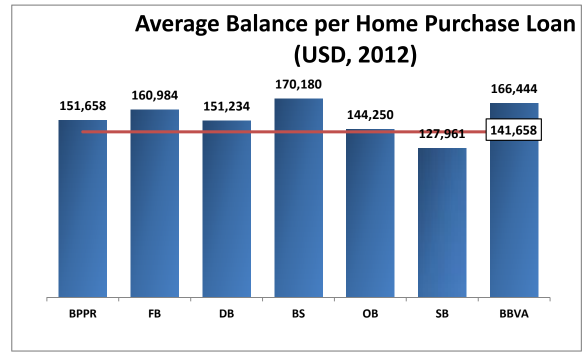




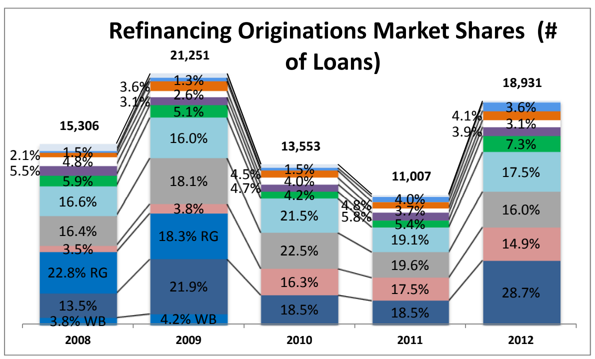
HOME PURCHASING LOANS

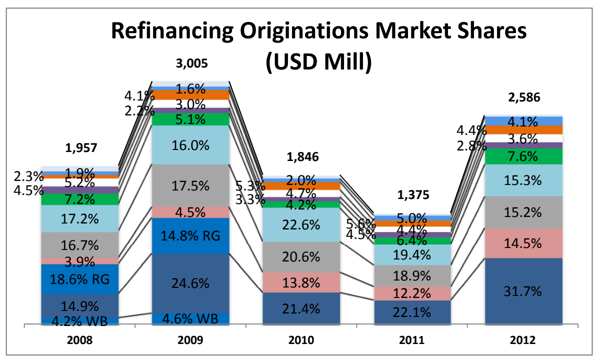


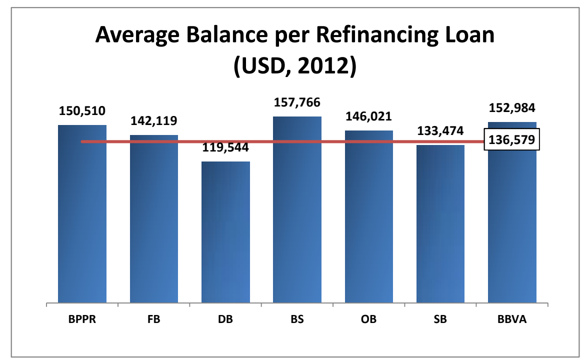




REFINANCING LOANS







Legend:

- Other
- BBVA
- OB
- BS
- "Cooperativas"
- FB
- DB
- Mortgage Bankers
- SB
- BPPR

BPPR = BANCO POPULAR DE PUERTO RICO
FB = FIRSTBANK OF PUERTO RICO
DB = DORAL BANK
BS = BANCO SANTANDER PUERTO RICO
OB = ORIENTAL BANK AND TRUST
SB = SCOTIABANK DE PUERTO RICO
BBVA = BANCO BILBAO VIZCAYA ARGENTARIA PUERTO RICO
WB = WESTERNBANK PUERTO RICO
RG = R-G PREMIER BANK OF PUERTO RICO

Industry

Note:
Excludes Home Improvement loans; includes all loans from all financial institutions with mortgage lending activity in PR
Source: Federal Financial Institutions Examination Council (FFIEC) via the Home Mortgage Disclosure Act (HMDA)