Puerto Rico Banking Industry Report

Issue XXII | **January to September 2014**

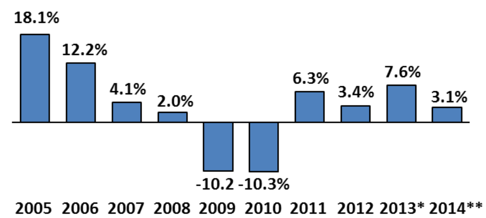
EXECUTIVE SUMMARY: The local banking sector reached positive returns in 2014 YTD, registering a pre-tax ROE of 3.1% (8.3% excluding Doral), despite the ongoing acute fiscal and economic challenges. Economic activity continues to contract according to the GDB's Economic Activity Index and job numbers remain at historically low levels. Falling oil prices should provide a much needed, although limited, positive impact on the Island's economy, increasing consumers' disposable income. Still high credit provision levels and decreasing leverage continue to adversely affect profitability of banks. Capitalization levels continue to be strengthened for all banks except Doral, which is now considered "significantly undercapitalized" by the FDIC. Delinquent loans have been creeping up in recent quarters, trend that should be closely monitored.

PROFITABILITY: "Oriental and Popular obtained the highest Pre-Tax ROE during 2014 YTD, 14.0% and 8.3%, respectively"

Puerto Rico's local banking industry on a consolidated basis registered positive profitability during the first three quarters of 2014, reaching a pre-tax ROE of 3.1% (see Figure 1), despite operating in a context characterized by continued economic contraction², prolonged loss of population³, and a cash-strapped public sector facing unsettling liquidity issues. The pre-tax ROE of the industry, when excluding Doral, amounted to 8.3%. Doral was the only bank to register negative earnings and is confronting difficulties in presenting a capital restoration plan that will appease federal regulators.

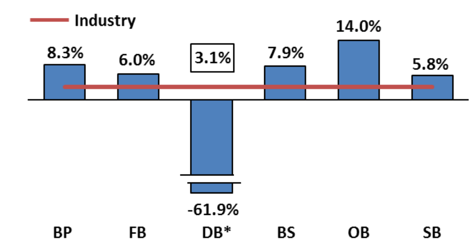
When examining profitability by bank, Oriental leads the industry with an annualized 2014 YTD pre-tax ROE of 14.0% (see Figure 2), its highest profitability since 2007. The bank's superior profitability performance in 2014 YTD in relation to 2013 was due primarily to higher interest income and higher other income, which more than offset higher operational expenses (see Figure 3). It should be noted that OFG Bancorp, the PR-based financial holding company of Oriental Bank, was added to Barron's 2014 Index in Nov. 2014 and Standard & Poor's SmallCap 600 Index in Dec. 2014. OFG Bancorp was also ranked 39th among the 100 largest publicly traded banks and thrifts by Forbes in 2014. Popular obtained the second highest pre-tax ROE. Popular saw a slight dip in its profitability in 2014 YTD with respect to 2013 because of higher operational and credit provision expenses, lower financial leverage, and lower fees and commissions income.

Figure 1: Industry Pre-Tax ROE Trend (2005-2014)(1)



*Adjusted for the sale of NPAs. (-2.3% unadjusted pre-tax ROE)
**2014 is January 1 to September 30, 2014 annualized.

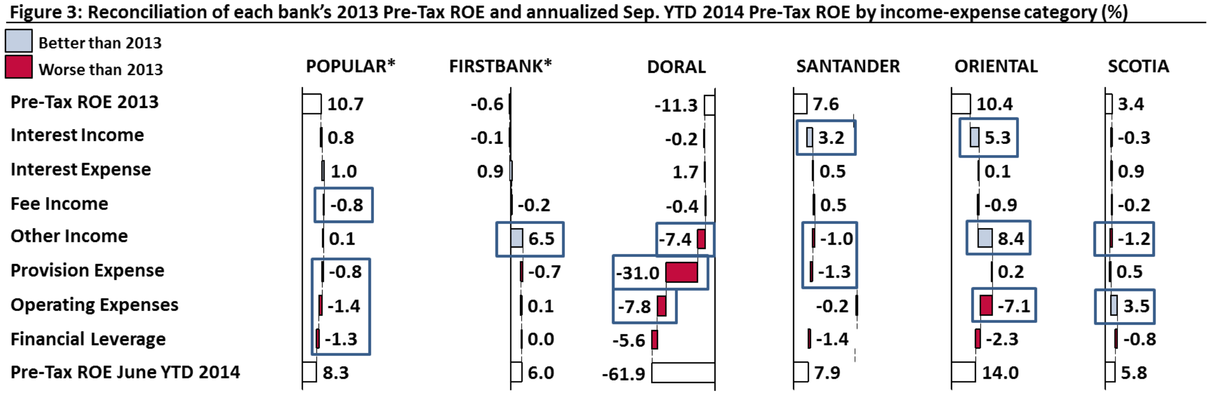
Figure 2: Pre-Tax ROE by Bank Q3 2014



*Doral's Pre-Tax ROE was not adjusted for the sale of delinquent portfolios due to insufficient data provided by public documents.

During the quarter ended September 30, 2014 Popular completed the repayment of $935 million in TARP Capital Purchase Program funds and Popular Inc. continued the reorganization of its U.S. banking subsidiary by selling assets in Central Florida and Illinois to centralize certain back office operations in Puerto Rico and New York. Moreover, Popular received the Bank of the Year Puerto Rico for 2014 award from The Banker. Santander obtained the third highest pre-tax ROE, reaching 7.9%. Santander shows a razor-thin improvement in 2014 YTD vs. 2013 due to substantially higher interest income which more than offset higher credit provision expenses and lower other income. FirstBank and Scotia obtained similar levels of profitability with pre-tax ROEs of 6.0% and 5.8%, respectively. FirstBank in 2014 YTD experienced a big jump in profitability due to higher other income while Scotia saw an improvement due to lower interest, operational and provision expenses. Doral was the only bank with negative returns, registering a pre-tax ROE of -61.9%, a clear outlier of the industry. Materially higher credit provision expenses caused the bank to go much deeper in the red in 2014 YTD.

Figure 3: Reconciliation of each bank's 2013 Pre-Tax ROE and annualized Sep. YTD 2014 Pre-Tax ROE by income-expense category (%)



*Adjusted for the sale of NPL portfolios in 2013

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. (2) As of November 2014, the GDB's Economic Activity Index has registered 23 consecutive months of YoY decreases. (3) According to the latest U.S. Census estimates, the Island's population dropped into the 3.5 million range in 2014 (3,548,397), a reduction of close to 300,000 when compared to the peak level reached in 2004 (3,826,878).

PRODUCTIVITY: "Controlling OPEX remains critical given context of tepid loan growth, still high credit provision levels and low leverage"

The Puerto Rico banking sector showed a cost to income ratio of 67.4% in Q3 2014. This productivity level compares favorably with 2012 and 2013 but remains well above the 60.7% cost to income ratio reached in 2011 (see Figure 4). If Doral is excluded, the cost to income ratio reaches 61.8%. In an environment characterized by tepid loan growth and asset reduction, controlling expenses is crucial for banks to obtain improved returns.

Although revising current cost structures and implementing other productivity enhancing measures will continue being critical moving forward, there are two other key factors that continue to exert a downward pressure on profitability levels: (1) credit provision levels and (2) financial leverage. Credit provision levels to average assets, although having decreased from the 2010 peak of 2.2%, remain at high levels. The annualized YTD 2014 provision expense to average assets was 1.3% (see Annex 4), compared to the 0.4% experienced in the 2002-2006 period. Moreover, the local banking industry has seen a dramatic decrease in financial leverage levels. The assets to equity ratio stood at 8.5 in Q3 2014 (see Annex 4) compared to an average of 14.5 in the 2002-2006 period.

When looking at productivity by bank, Santander, Oriental and Popular achieved the lowest cost to income ratios with 58.4%, 59.2% and 61.2%, respectively (see Figure 5). FirstBank and Scotia reached slightly higher cost to income ratios with 65.1% and 65.9%, respectively. In terms of productivity, as well as other performance and condition indicators, Doral is anomalous among its peers. Doral's cost to income ratio was 146.0%, largely exceeding the industry level of 67.4%. The bank's personnel costs per FTE and other costs per branch have been persistently higher than the industry level (see Annex 3).

Figure 4: Cost to Income Trend 2009-2014 (%)

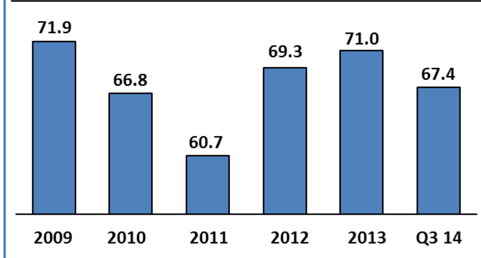
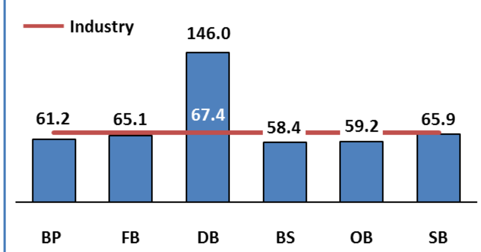


Figure 5: Cost to Income by Bank (%)



CAPITAL ADEQUACY: "Solvency remains robust; Doral: 'significantly undercapitalized'"

The local banking industry continues to maintain historically high capital adequacy ratios. The Tier 1 risk based capital ratio for the industry as a whole stood at 15.5%, close to 10 percentage points above the regulatory minimum of 6% established by the FDIC. Other capital ratios, including the Tier 1 leverage ratio (10.3%) and the Total risk-based capital ratio (16.8%), also remain well above the well capitalized thresholds.

When analyzing capital adequacy by bank, Scotia and Santander continue to lead the industry. Scotia's Tier 1 risk based capital ratio more than quadrupled the regulatory minimum, standing at 26.2% while Santander's reached 23.3%, almost four times the minimum (see Figure 7). FirstBank had the third highest Tier 1 risk based capital ratio, standing at 16.9%, followed by Popular and Oriental, both with ratios of 15.1%.

While most banks continue to see an increase in their capitalization levels, Doral has been deemed "significantly undercapitalized" by the FDIC. Doral's Tier 1 risk based capital ratio has been quickly deteriorating in the first three quarters of 2014, reaching 3.2% at the end of Q3 2014, close to half of the regulatory minimum. Doral, in an attempt to appease federal regulators and continue operations, has been aggressively selling assets to improve its capitalization but has so far fallen short of FDIC's demands. Moreover, it must resubmit a capital restoration plan since the one submitted was "inadequate."

Figure 6: Tier 1 Risk Based Capital Ratio Trend (%)

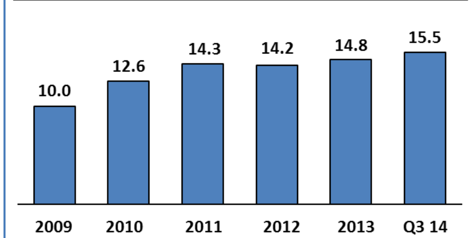
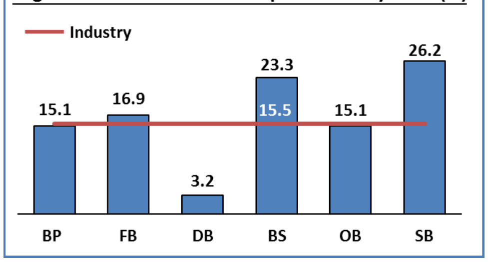


Figure 7: Tier 1 Risk Based Capital Ratio by Bank (%)



LIQUIDITY: "Brokered to total deposits ratio remains high for FirstBank and Doral"

Historically, the local banking industry has been highly dependent on brokered deposits and other non-core funding sources, although there has been a gradual and notable decrease since 2009. Federal regulators have exerted pressure on banks to reduce reliance on brokered deposits since they are more volatile and to a certain extent threaten the stability of the banking industry. The brokered deposit to total deposits ratio stood at 37.2% in 2009, decreasing to 15.1% in YTD 2014 (see Figure 8). Deposit generation has been a challenge for some local banks given the limited size of the market. The net loss of population trend that has characterized the Island in recent years will further hinder deposit generation. It should be noted that traditionally wholesale funds have been used not only to fund loan origination but also to fund large securities portfolios.

There are large differences between banks operating in Puerto Rico in terms of their reliance on brokered deposits for their funding needs. Although local banks have aggressively substituted brokered deposits with core deposits, FirstBank and Doral continue to show substantially above industry brokered to total deposits ratios (35.0% and 21.4% in YTD 2014, respectively vs industry ratio of 15.1%, see Figure 9). FirstBank's ratio peaked at 71.5% in 2005 while Doral's peaked in 2008 at 60.0%. Oriental has the third highest dependence of brokered deposits, with a brokered to total deposits ratio of 13.2%. Popular, Scotia and Santander all have ratios below 10% (9.6%, 5.5%, and 2.4%, respectively).

Figure 8: Brokered deposits/ total deposits trend

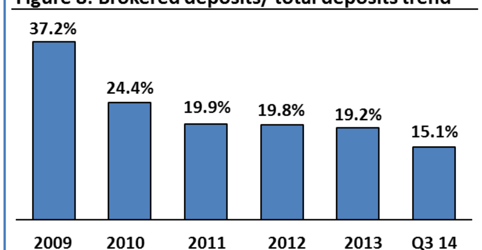
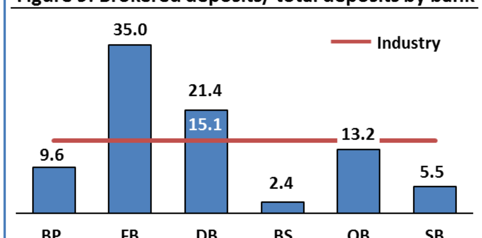


Figure 9: Brokered deposits/ total deposits by bank



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

Roberto Jiménez
Director, V2A
(robertojimenez@v-2-a.com)

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

Olivier Perrinjaquet
Analyst, V2A
(olivierperrinjaquet@v-2-a.com)

V2A, Inc.

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

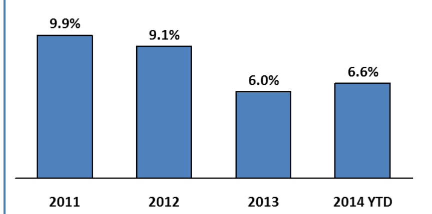
Miami
20801 Biscayne Blvd (Suite 403)
Aventura, FL 33180

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

ASSET QUALITY: *"The rise in delinquency in 2014 combined with the expiration of some LSA in 2015 raise concerns"*

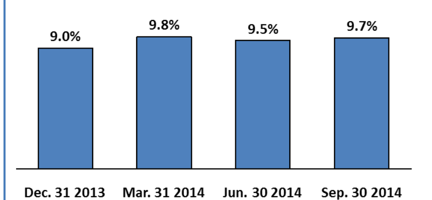
Local banks in the last five years have taken bold steps in order to materially reduce their delinquency levels and have a "cleaner" asset base. Actions include the sale of delinquent and non-delinquent portfolios (e.g. FirstBank and Popular, Puerto Rico's largest banks, sold large loan portfolios involving NPLs or adversely classified assets while Doral has executed various asset sales including $429MM in mortgage assets to Barclays), renegotiation of loan terms, cancellations or write-offs on delinquent loans, among other initiatives. Furthermore, the 2010 FDIC-assisted consolidation resulted in loss-share agreements (LSA) between the federal regulator and acquiring banks (i.e. Popular, Scotia and Oriental) covering 80% of loan losses. It should be noted that a significant portion of loss-sharing agreements will expire on April 30, 2015, putting pressure on the aforementioned banks to remove these toxic assets from their balance sheets.

Figure 10: 90+DPD & non accrual <90DPD to Total Loans*



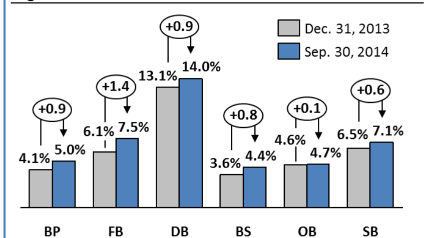
*Excludes FDIC covered portfolios, held for sale portfolios and guaranteed portion of portfolios insured by the U.S. Government

Figure 11: Residential 90+DPD & non accrual <90DPD (%)*



*Excludes FDIC covered portfolios, held for sale portfolios and guaranteed portion of portfolios insured by the U.S. Government

Figure 12: 90+DPD & non accrual <90DPD to Total Loans*



*Excludes FDIC covered portfolios, held for sale portfolios and guaranteed portion of portfolios insured by the U.S. Government

The 90+ days past due–non accruing ratio[4] stood at 9.9% in 2011 and decreased in both 2012 and 2013, reaching 6.0% in 2013 (see Figure 10). In the first three quarters of 2014 this downward trend was reverted. The delinquency ratio during the 2002-2006 period, period preceding the economic downturn, averaged 2.0%, substantially lower than current levels. Credit agencies which rate local banks have continually pointed to the significant discrepancy between delinquency levels in the Island and banks in the mainland U.S. According to the FDIC, the average noncurrent loans rate as of September 30, 2014 of all commercial banks in the U.S. was 2.1%. The data suggests that, as has occurred in terms of economic growth and performance in the U.S. municipal bond market, Puerto Rico has increasingly "decoupled" from the U.S. in terms of the performance and condition of banks.

As aforementioned, the unwelcomed trend of rising delinquent loan levels has emerged in the first three quarters of 2014. In 2013 the 90+ days past due–non accruing ratio for the industry stood at 6.0%, increasing to 6.6% as of Sep. 30, 2014, a 60 bps increase (see Figure 10).

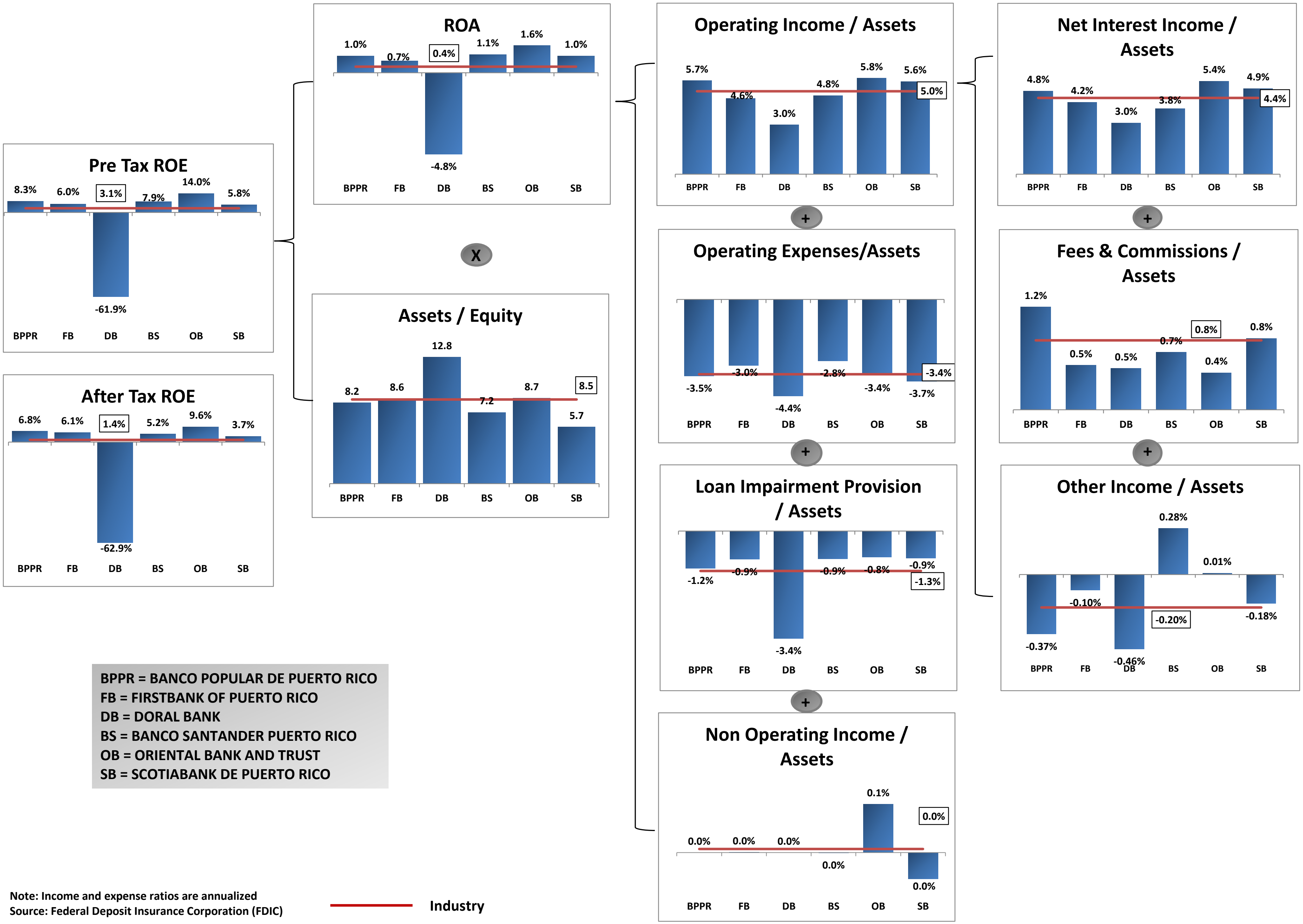
When looking at residential 90+ days past due–non accruing ratio for the industry, there was a 70 basis points increase from the ending balance of 2014 (9.0%) to the ending balance of Q3 2014 (9.7%) (see Figure 11). Considering that the mortgage business is one of the main sources of income of the local banking industry, addressing this issue is of paramount importance. The residential loan portfolio represents 36.8% of the banking sector's total loan portfolio. A number of factors will continue to weigh down on the real-estate market including stricter underwriting standards, still weak labor market, continued out-migration, excess in property inventory, lack of assistance programs for new homeowners, and the overall uncertainty of the macroeconomic environment. Without rising levels of employment and an increase in household formation, demand for new homes will remain low. Although there has been an increase in net private sector employment in recent months, total nonfarm employment remains at very low levels. In 2005 nonfarm employment peaked at 1,051,900 and during 2014 has averaged 924,700 (-127k). Moreover, the unemployment rate remains high (14.0% in Nov. 2014).

When analyzing asset quality by bank, all banks experienced an increase in their 90+ days past due–non accruing ratio from Dec. 31, 2013 to Sep. 30, 2014. FirstBank registered, within the aforementioned time period, an increase of 140 bps, followed by Popular (+90 bps), Doral (+90 bps), Santander (+80 bps) and Scotia (+60 bps) (see Figure 12). Oriental showed the lowest increase in its 90+ days past due–non accruing ratio (+10 bps). If the rise in delinquent loans continues, profitability levels will remain subdued in the short-term.

In summary, local banks continue to face considerable challenges due to profound structural weaknesses of the economy. Nevertheless, the robust capital levels of banks will help to absorb potential losses. Doral continues to confront consequential risks and uncertainties in the short-term. It will have to resubmit to the FDIC a capital restoration plan and a contingency plan for the sale, merger or liquidation of the bank and await a response from the federal regulator which might take additional regulatory action against the bank. Moving forward, rising delinquency levels should be closely monitored in subsequent quarters to determine if the trend persists or is of short duration.

(4) The 90+ days past due–non accruing ratio includes: (1) past due 90 days or more, and (2) past due less than 90 days but nonaccruing, as the numerator and total loan balances as the denominator, excluding FDIC covered and held for sale portfolios and guaranteed portion of portfolios insured by the U.S. Government (e.g. HUD).

ANNEX 1: BANKING INDUSTRY PROFITABILITY 2014



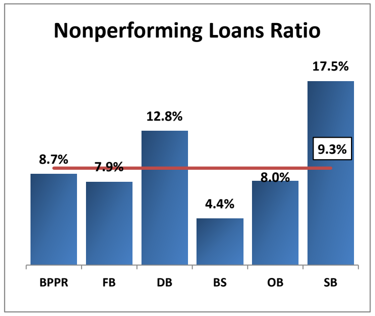
BPPR = BANCO POPULAR DE PUERTO RICO
FB = FIRSTBANK OF PUERTO RICO
DB = DORAL BANK
BS = BANCO SANTANDER PUERTO RICO
OB = ORIENTAL BANK AND TRUST
SB = SCOTIABANK DE PUERTO RICO

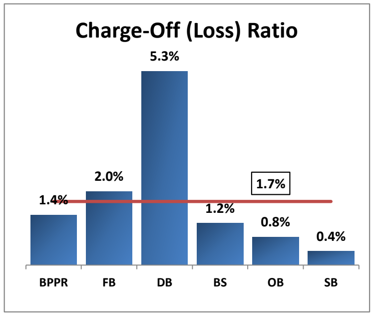
Note: Income and expense ratios are annualized
Source: Federal Deposit Insurance Corporation (FDIC)

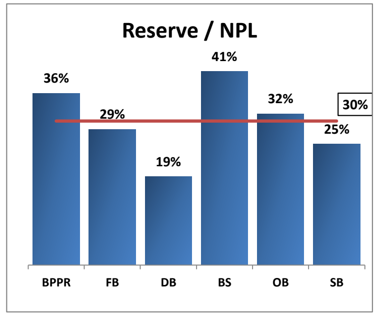
Industry

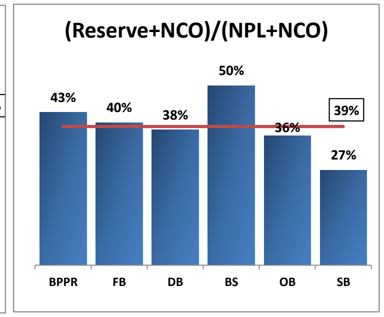
ANNEX 2: BANKING INDUSTRY PERFORMANCE RATIOS 2014

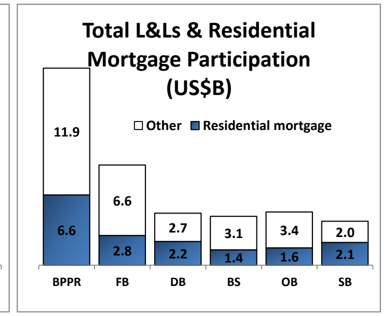
ASSET QUALITY



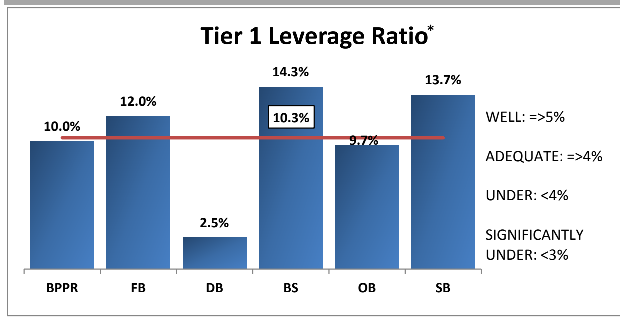


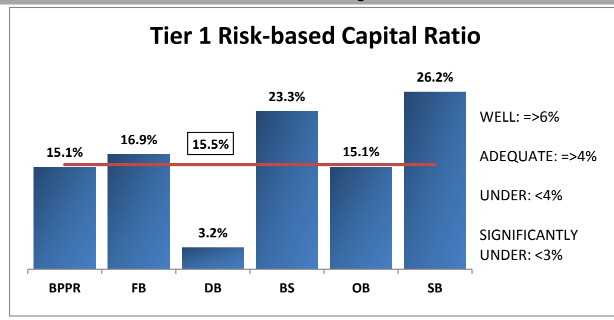


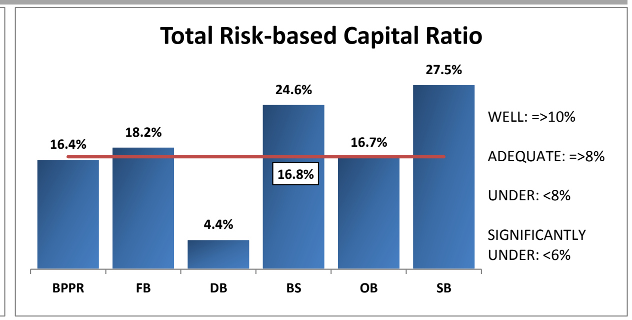




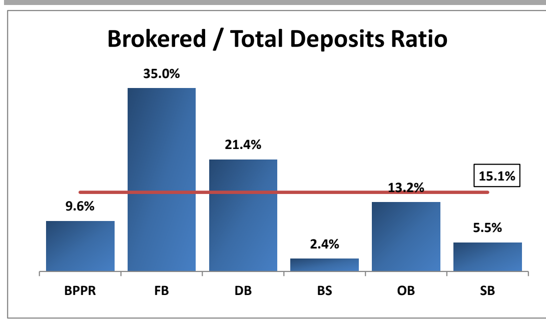
CAPITAL ADEQUACY

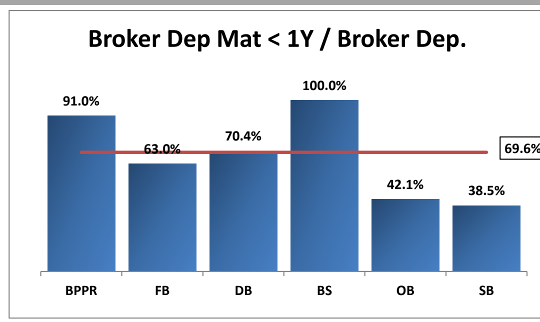




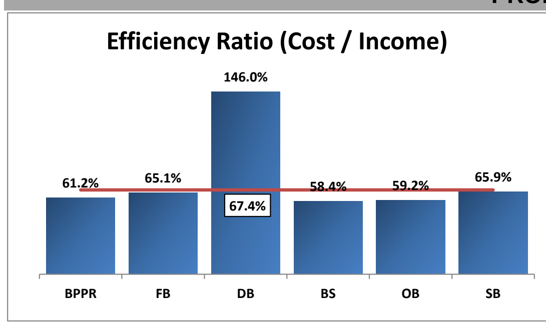


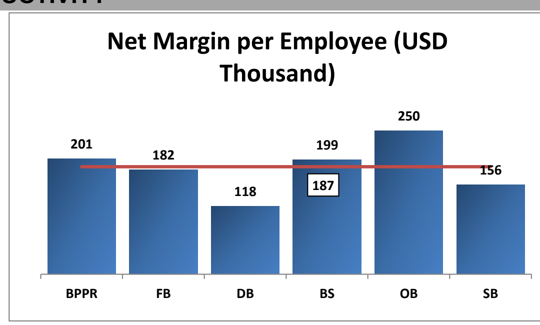
LIQUIDITY





PRODUCTIVITY





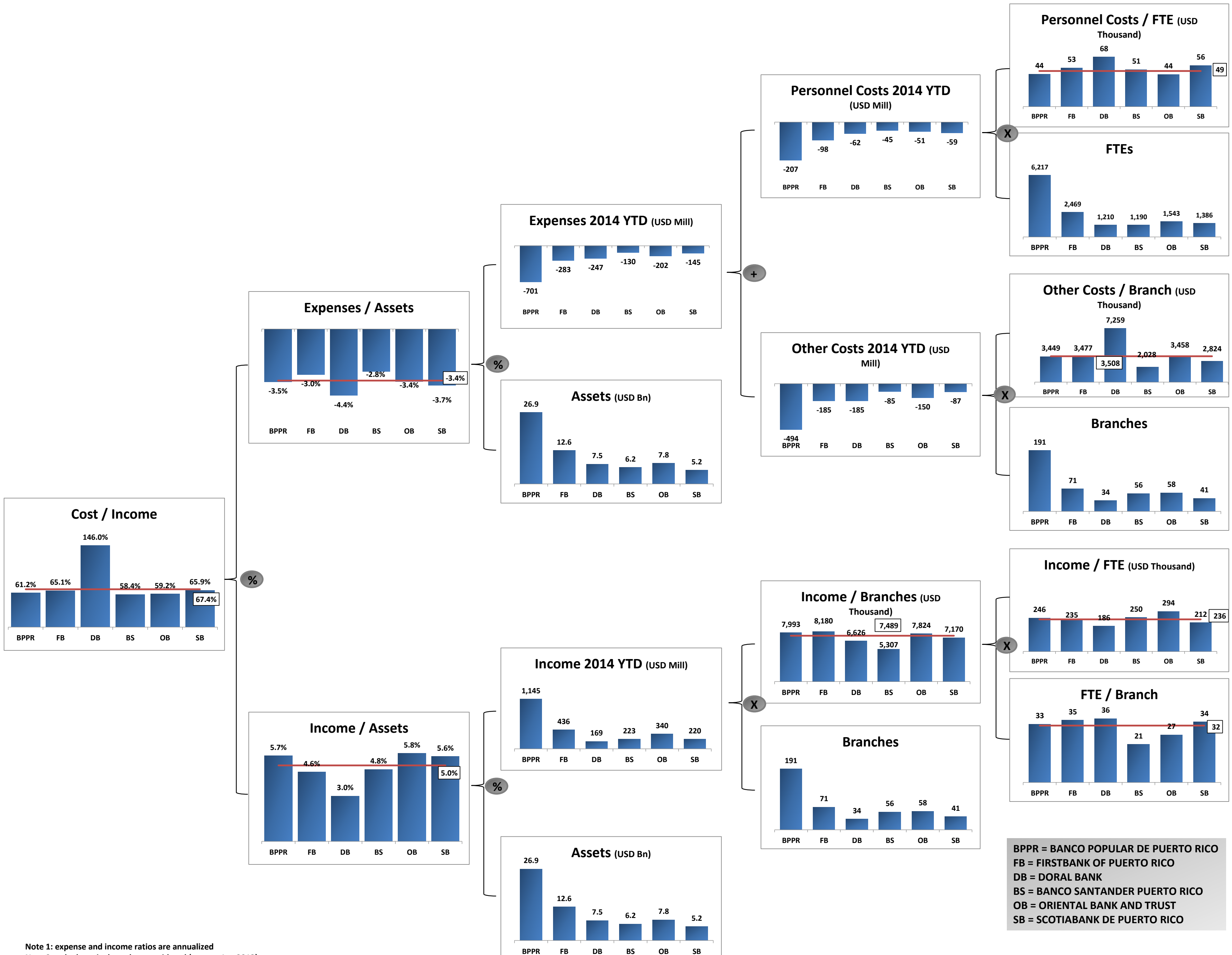
BPPR = BANCO POPULAR DE PUERTO RICO
FB = FIRSTBANK OF PUERTO RICO
DB = DORAL BANK
BS = BANCO SANTANDER PUERTO RICO
OB = ORIENTAL BANK AND TRUST
SB = SCOTIABANK DE PUERTO RICO

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 2014



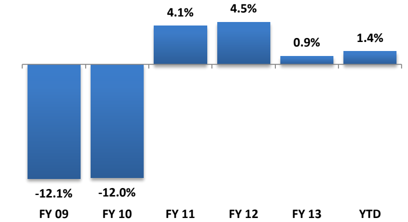
BPPR = BANCO POPULAR DE PUERTO RICO
FB = FIRSTBANK OF PUERTO RICO
DB = DORAL BANK
BS = BANCO SANTANDER PUERTO RICO
OB = ORIENTAL BANK AND TRUST
SB = SCOTIABANK DE PUERTO RICO

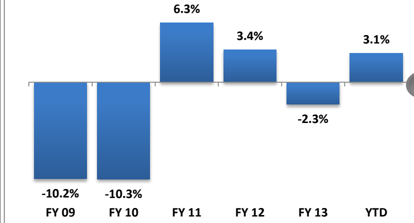
Note 1: expense and income ratios are annualized
Note 2: only deposits branches considered (source: Jun 2013)
Source: Federal Deposit Insurance Corporation (FDIC)

Industry

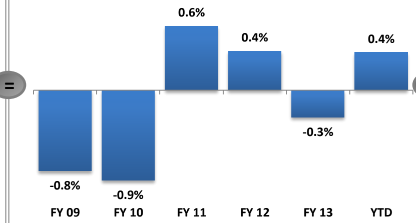
ANNEX 4: INDUSTRY TRENDS - SELECTED METRICS

PROFITABILITY

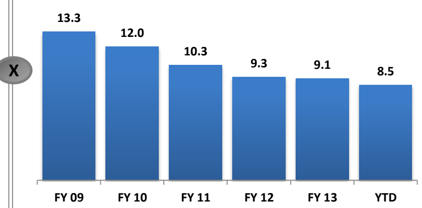
After Tax ROE


Pre Tax ROE


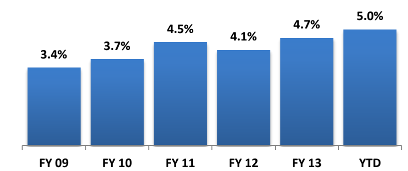
=

Pre Tax ROA


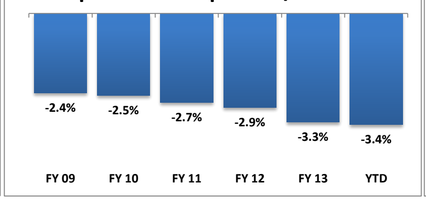
X

Assets / Equity


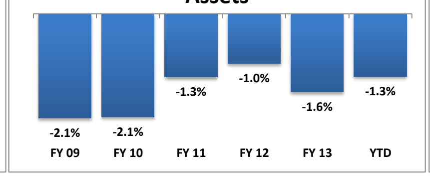
+

Operating Income / Assets


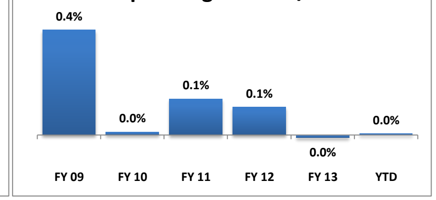
+

Operational Expenses / Assets


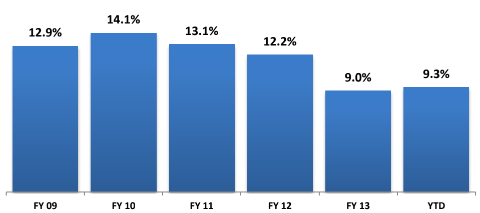
+

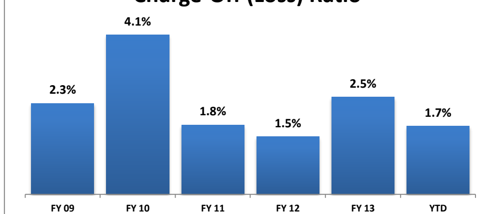
Loan Impairment Provision / Assets


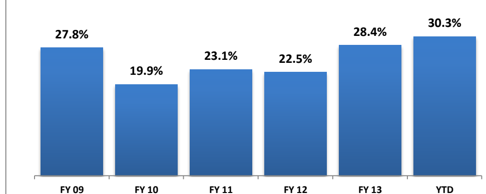
+

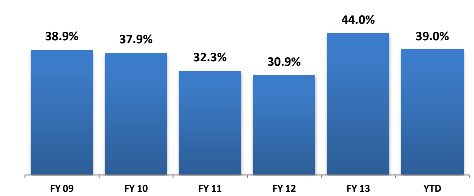
Non Operating Income / Assets


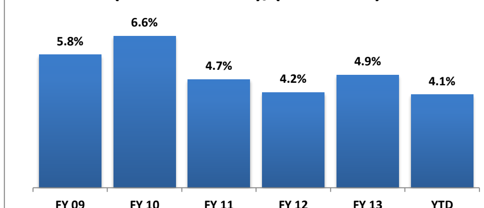
ASSET QUALITY

Noncurrent Loans / Loans


Charge-Off (Loss) Ratio


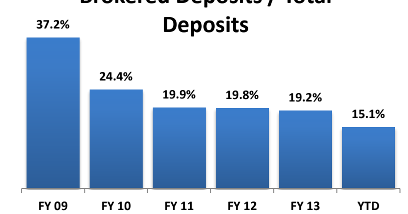
Reserve / NPL


(Reserve+NCO)/(NPL+NCO)


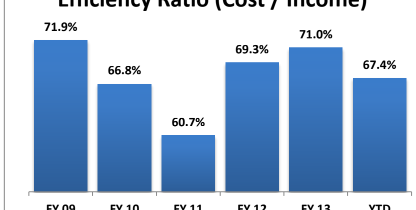
(Reserve+NCO)/(L&L+NCO)


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)

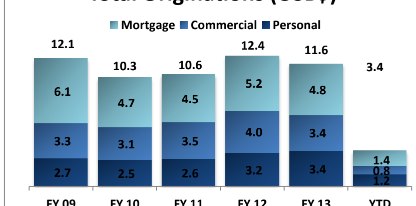
LIQUIDITY

Brokered Deposits / Total Deposits


PRODUCTIVITY

Efficiency Ratio (Cost / Income)


MARKET ORIGINATIONS

Total Originations (USB$)


TOTAL ASSETS

Total Assets (USB$)