Puerto Rico Banking Industry Report

Issue XXIII **January to December 2014**

EXECUTIVE SUMMARY: The local banking industry posted modest earnings in 2014, reaching a Pre-Tax ROE of 3.4% on a consolidated basis. When excluding Doral, which was ultimately closed by the OCFI and the FDIC after years of financial and legal troubles and was the only bank to report negative returns in 2014, the pre-tax ROE of the industry reached 6.8%. While productivity levels improved in 2014 vis-à-vis 2013, as did capital levels, the delinquency ratio for the industry, after four consecutive years of decline, experienced some deterioration. The 90+ days past due–non accruing ratio increased from 6.0% in 2013 to 7.3% in 2014. In anticipation of potential future losses due to nonperforming assets and a macroeconomic environment riddled with uncertainties, local banks have increased their loan loss reserves. Doral, after struggling to survive for several years, was ultimately closed by the FDIC and partially bought by Popular and FirstBank, who will further solidify their positions in the local banking market. In this issue we analyze some of the potential impacts of the 2015 tax reform, whose major component is the introduction of a value added tax (VAT), on the overall economy and specifically the banking sector. There are both downsides and upsides to the proposed transformation of the Island's tax code.

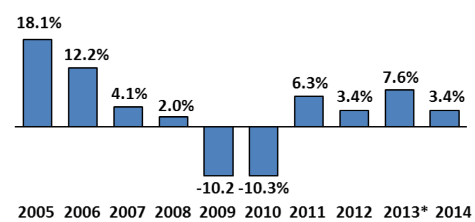
PROFITABILITY: "A tough operating environment keeps profits of banking industry subdued in 2014 (Pre-Tax ROE: 3.4%)"

The local banking industry as a whole, which has exhibited resilience in the midst of arguably the longest and deepest economic downturn of Puerto Rico post-World War II, reached a Pre-Tax ROE of 3.4% in 2014, below the adjusted Pre-Tax ROE of 7.6% experienced in 2013 (see Figure 1). All banks, with the exception of Doral, had positive Pre-Tax ROEs. If we exclude Doral from the profitability figures, whose banking operations in Puerto Rico have been absorbed by Popular and FirstBank, the 2014 industry's Pre-Tax ROE is 6.8%.

2014 has been a challenging year for local banks, operating in a tough environment characterized by moderate levels of profitability, continued shrinking of balance sheets, asset quality deterioration, and few opportunities for growth. Further consolidation after Doral's failure will further intensify competition for market share in 2015.

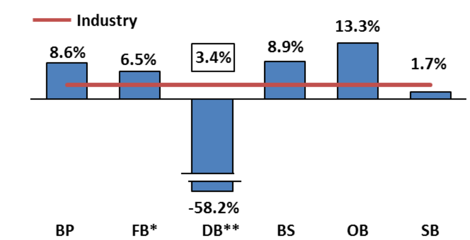
Oriental obtained the highest level of profitability of the industry in 2014, reaching a Pre-Tax ROE of 13.3% (see Figure 2). Moreover, its 2014 Pre-Tax ROE is its highest since 2007 when it reached 14.8%. The improvement in profitability in 2014 (13.3%) vis-à-vis 2013 (10.3%) was driven by higher interest and other income which was partially offset by an increase in operational expenses and a decreased financial leverage (see Figure 3). Santander and Popular reached the second and third highest levels of profitability in 2014, with Pre-Tax ROEs of 8.9% and 8.6%, respectively. Santander's higher Pre-Tax ROE in 2014 vs. 2013 was thanks to higher interest income which was partially offset by lower other income and decreased financial leverage. Popular's decrease in Pre-Tax Roe in 2014 with respect to 2013 was mainly due to higher operational expenses and lower financial leverage. FirstBank registered a Pre-Tax ROE of 6.5%, considerably better than 2013 when it was in negative territory (-0.6%). The improvement was propelled chiefly by higher other income and lower financial expenses. Scotia in the same time period saw a decrease from 3.4% to 1.7% in its Pre-Tax ROE due to materially higher credit provision expenses, expense increased to cover for potential future losses due to signs of weakening asset quality. Doral, which has been in the red since 2007, took a hard hit in 2014.

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



*Adjusted for the sale of NPAs. (-2.3% unadjusted pre-tax ROE)

Figure 2: Pre-Tax ROE by Bank 2014



* FirstBank's P&L does not include the adjustment tied to a reversal in its deferred-tax asset ($302.9 million).
**Doral's Pre-Tax ROE was not adjusted for the sale of delinquent portfolios due to insufficient data provided by public documents.

Figure 3: Reconciliation of each bank's 2013 and 2014 Pre-Tax ROEs by income-expense category (%)

Better than 2013
Worse than 2013

	POPULAR*	FIRSTBANK*	DORAL	SANTANDER	ORIENTAL	SCOTIA
Pre-Tax ROE 2013	10.7	-0.6	-11.3	7.6	10.3	3.4
Interest Income	0.1	0.1	-0.7	3.7	5.0	-0.6
Interest Expense	1.0	0.9	1.8	0.6	0.0	1.1
Fee Income	-0.9	-0.2	0.6	0.4	-0.9	0.0
Other Income	0.4	6.8	-7.0	-1.0	8.6	-0.7
Provision Expense	0.3	-0.4	-27.0	-0.2	-0.1	-4.0
Operating Expenses	-1.6	0.0	-8.7	-0.4	-7.3	2.8
Financial Leverage	-1.4	-0.1	-5.8	-1.9	-2.4	-0.3
Pre-Tax ROE 2014	8.6	6.5	-58.2	8.9	13.3	1.7

*Adjusted for the sale of NPL portfolios in 2013
FirstBank's P&L does not include the adjustment tied to a reversal in its deferred-tax asset ($302.9 million) .

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.

PRODUCTIVITY: "Cost to income ratio of the local banking industry improved in 2014 (67.8%) with respect to 2013 (71.0%)"

The asset reduction trend that has characterized the local banking industry since the onset of the still lingering economic slump which began in 2006, continued in 2014. Total assets of the Top 6 banks reached $63.2B as of Dec. 31, 2014, a decrease of $4.3B or 6.3% compared to 12 months prior ($67.4B). When compared to the peak level reached in Dec. 31, 2005 ($104.1B), there has been a decrease of $40.9B or 39.3%. The decrease in operating expenses has not kept up with the dramatic fall in assets. Operating expenses to total assets in reached 3.4% in 2014 vs. 3.3% in 2013 and 1.8% in 2005 (see Annex 4). Despite the aforementioned trends, productivity levels in 2014 did improve slightly with respect to 2013, reaching a cost/income ratio of 67.8% (see Figure 4). When excluding failed Doral, which according to estimates will cost the FDIC's Deposit Insurance Fund (DIF) $748.9 million, the cost/income ratio reached 62.3%.

When looking at productivity levels by bank, Santander, which has recently announced that it will integrate its PR operations within its U.S. subsidiary, Santander Holdings USA, leads the way with a cost/income ratio of 58.2%, followed by Oriental with 59.5%. Popular, the Island's largest bank which will further strengthen its foothold in PR and may reap greater economies of scale from the acquisition of great part of Doral, had the third highest productivity level with a cost/income ratio of 62.2%, followed by FirstBank with 64.8% and Scotia with 66.7%. FirstBank, solidifying its position as the Island's second largest bank, also partook in the purchase of Doral's assets, acquiring 10 branches, $600 million in deposits and a mortgage loan portfolio of $300 million. Popular and FirstBank should be vigilant of keeping operating expenses in check during the merger integration process.

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

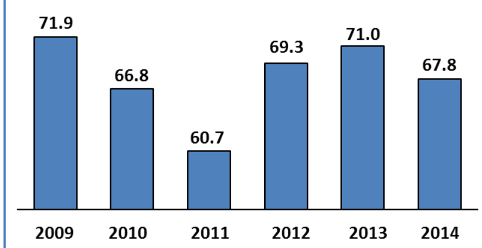
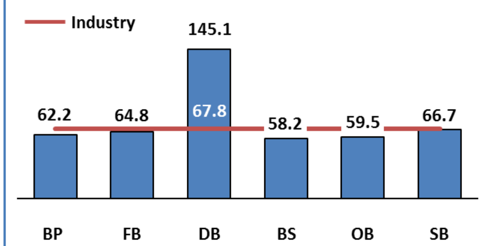


Figure 5: Cost to Income by Bank (%) 2014



CAPITAL ADEQUACY: "Robust capital levels; DB unable to meet capital requirements"

The capitalization level of the Island's banking industry has continued to be strengthened during 2014. The Tier 1 risk based capital ratio increased from 14.8% in 2013 to 15.9% in 2014 (see Figure 6), more than double the well-capitalized levels established by regulators. Other capital ratios including the Tier 1 leverage ratio and Total risk based capital ratio have also continued an upward trend, reaching 10.6% and 17.2%, respectively.

When analyzing capital adequacy levels by bank, Scotia leads the industry with a Tier 1 risk based capital ratio of 26.8% followed by Santander with 23.5% (see Figure 7). In third place came in FirstBank with a ratio of 17.6%, followed by Popular (15.8%) and Oriental (15.4%). The capitalization levels of these banks are all very robust, well above the required levels of the FDIC. Doral on the other hand, after being classified as "critically undercapitalized" by the federal regulator, registered a Tier 1 risk based capital ratio of 2.7% in 2014. Doral, until recently PR's third largest bank in terms of assets, with $5.9B in assets as of Dec. 31, 2014 and $4.1B in deposits, was never able to meet the minimum capital requirements. It has been aggressively selling assets but was ultimately never able raise enough capital to satisfy the consent order it entered with the FDIC and the Office of the Commissioner of Financial Institutions on August 8, 2012. Furthermore, the Appellate Court ruled against Doral for the reimbursement from the PR Treasury of $229MM.

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

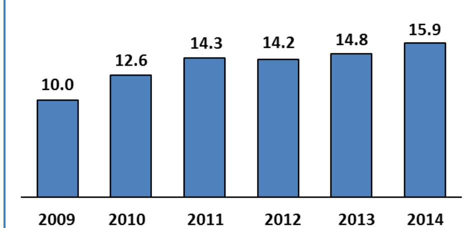
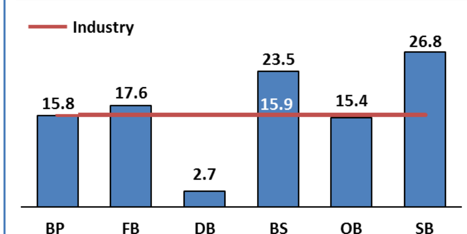


Figure 7: Tier 1 Risk Based Capital Ratio by Bank (%)



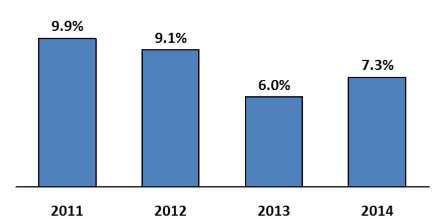
ASSET QUALITY: "Rise in delinquency ratio after four years of consecutive declines"

After four consecutive years of decline in the delinquency ratio of the local banking industry as a whole, 90+ days past due–non accruing ratio increased in 2014 to 7.3% from 6.0% in 2013 (see Figure 8). Although banks have continually looked for ways of cleaning their balance sheets, continued economic contraction in 2014 and a further weakening of the labor market creates an environment prone to loan repayment default by clients. Total employment (household survey) decreased by 1.8%, the unemployment rate averaged close to 14% during 2014 and the labor force participation rate hovers around 40%, extremely low when compared to most states. Although there has been some improvement in recent quarters in private sector jobs, it has been very limited.

In order to create a buffer for potential future losses, most banks have built up their loan loss reserves in relation to nonperforming loans. The reserves to delinquent loans of the industry as a whole have risen steadily since 2010, reaching 29.7% in 2014 (see Annex 4).

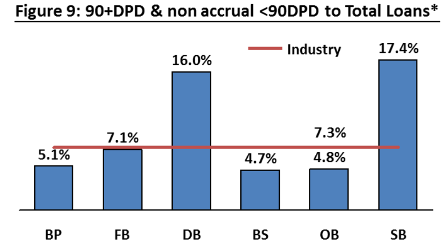
When analyzing delinquent ratios by bank, all banks experienced an increase in their 90+ days past due–non accruing ratio during 2014 vs. 2013. Santander boasts the lowest delinquency ratio in 2014 (4.7%), followed by Oriental (4.8%), Popular (5.1%) and FirstBank (7.1%). Scotia, which according to Bloomberg News is considering to sell its Puerto Rico Unit, obtained the highest 90+ days past due–non accruing ratio (17.4%) (see Figure 9). If the proposed 2015 tax reform causes job losses, borrower delinquency could rise further.

Figure 8: 90+DPD & non accrual <90DPD to Total Loans*



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

Figure 9: 90+DPD & non accrual <90DPD to Total Loans*



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

2015 TAX REFORM (INTRO): "Many concerned value-added tax will further constrain aggregate demand in an already weak economy"

In this portion of the report we present an overview of the 2015 tax reform and its potential ramifications in the banking sector and the overall economy. A brief summary of the economic and fiscal condition of PR is also put forth to frame the tax policy change in the appropriate context.

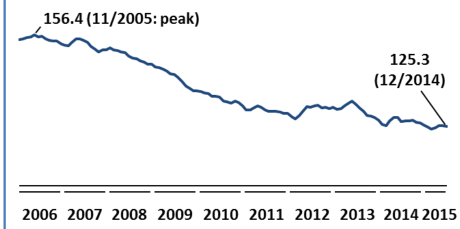
The highly contested House Bill 2329, the Tax System Transformation Act, was filed in the Puerto Rico legislature on Feb. 11, 2015 to spearhead the efforts of the current administration to reform Puerto Rico's tax system to supply adequate revenues for the government. According to KPMG's website[2], the 2015 PR Tax Code would change the tax system from one based on income to one based on consumption through four fundamental changes: (1) Elimination of a significant number of exemptions, exclusions, and the preferential tax treatment of many items, (2) increase of capital gain and dividend tax rates, (3) reductions in the income tax rates for individuals and corporations, and (4) the substitution of the current sales and use tax system (SUT) with a value added tax (VAT) regime. The new tax regime should increase revenues by an additional $700 million (previously estimated to be $1,200+million). More government revenues will be allocated for debt service payments in the coming fiscal year. The consolidated budget debt service increased from $4.1B in FY2014 to $4.5B in FY2015 and will continue its upward trend.

Economic Context: Many economists, business interest groups, government officials, and think tanks, among others, are concerned with the implementation of the value added tax (VAT) component of the tax reform given the ongoing weakened state of the economy and the substantial downside risks and uncertainties from such change. Economic activity has contracted by close to 20% when compared to its peak level (see Figure 10) and has decreased on a year-over-year basis for 24 consecutive months, according to the GDB's Economic Activity Index. Labor market indicators have shown troubling trends since the economic downturn began in 2006. When comparing peak levels reached with the latest available data published by the BLS, total employment, which includes self-employed workers, has decreased by close to 280K jobs or 22.1%, while total nonfarm employment has decreased by approximately 150K jobs or 14.4% (see Figure 11).

Fiscal Context: The Island's fragile fiscal state is patently evident when analyzing the latest GDB publications and recent actions taken by the major credit rating agencies. In Feb. 2015, S&P, followed by Moody's, further downgraded PR's GO debt rating deeper into non-investment grade territory pointing to the Island's dwindling capacity to fully meet its debt obligation (see Figure 12), limited access to capital markets, shrinking liquidity of the central government and public corporations (e.g PREPA and HTA), chronic deficit financing (see Figure 13), and a grey economic outlook with few possibilities of a robust recovery in the short-term. Recent downgrades have substantially increased the cost of borrowing. Furthermore, credit agencies also reacted to the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (No. 71-2014), overturned as unconstitutional, and meant to provide public corporations with local bankruptcy protection. H.R. 870, known as the "PR Chapter 9 Uniformity Act of 2015" is before the U.S. Congress and would amend Title 11 of the U.S. Bankruptcy Code to allow PR government-owned corporations to restructure their debts under Chapter 9 of the federal Bankruptcy Code, establishing a clear legal framework in the event of insolvency.

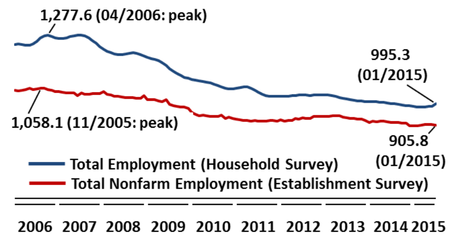
Although it is crucial for the PR government to have adequate revenues to fully meet its obligations, the proposed tax change could have a straining effect on an already weak economy and adversely impact key sectors of the economy, including the banking sector.

Figure 10: Economic Activity Index Trend* 2006-2015
(Fiscal Years July-June; FY 2015 July-December)



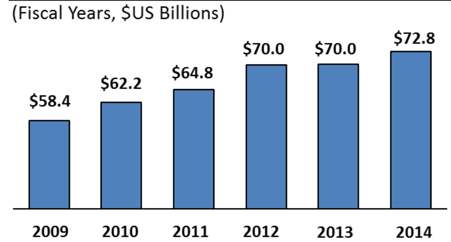
*Coincident index comprised of non-farm payroll employment, electric power consumption, cement sales and gasoline consumption

Figure 11: Employment Numbers (thousands)
(Fiscal Years July-June; FY 2015 July-January)



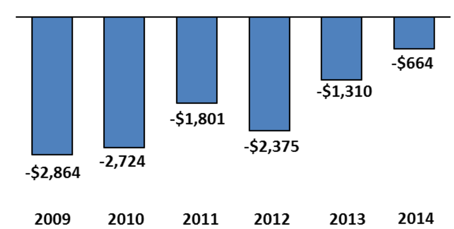
Source: U.S. Bureau of Labor Statistics

Figure 12: Puerto Rico Public Debt*
(Fiscal Years, $US Billions)



Source: GDB, Center for a New Economy
*Puerto Rico's public debt is comprised of debt issued by the central government, public corporations and municipalities.

Figure 13: General Fund Budget Deficit
(Fiscal Years, $US Millions)



Source: GDB's Financial Information and Operating Data Report – October 30, 2014

2015 TAX REFORM (BANKING SECTOR): "VAT could have adverse impact on banks' OPEX and key portfolio segments; some upsides"

Although there are a number of changes stipulated in the bill that may have an unfavorable impact in bank performance, which are delineated subsequently, there are also potential upsides to some modifications of the current tax regime included in the 2015 tax reform. Since the tax reform reduces income tax rates and the Treasury (Hacienda) will no longer retain a percentage of the income of many salaried workers, this could translate into higher savings, which in turn may positively impact deposit accounts. The debt-to-income ratio and risk profile of banks' clients might also improve due to higher disposable income.

Increase in OPEX: The operational expenses of banks might increase due to the payment of the VAT on non-exempt goods and services they acquire. The productivity levels of banks, which directly impact profitability, would suffer if an additional tax burden is levied upon them. Moreover, since financial services would be treated as exempt from VAT, financial institutions could not seek a reimbursement for the VAT they paid to sustain their operations. The PR Bankers Association, which partially supports the proposed tax change pointing to the importance of substituting the current income-based tax system for a consumption-based tax system and taxing the booming informal economy (estimated to amount $17B) which has historically undermined tax collection, proposed to classify financial services as "0% taxable transactions" rather than exempt to allow them to request a credit for VAT paid on goods and services.

Puerto Rico Banking Industry Report

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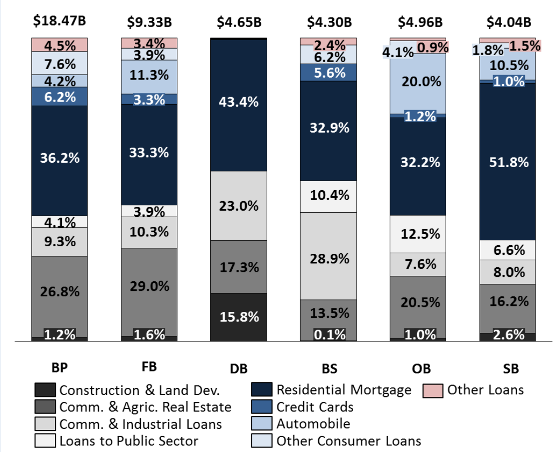
Impact on Housing Market: The Island’s construction and real-estate market has been hard hit since the beginning of the economic downturn. Cement sales, which serves as a measure of construction activity, in 2014 reached 14.4 million 94 lbs. bag and bulk, a close to 66% decrease when compared to 2006 levels (42.7 million). Under the proposed tax reform, tax deductions for interests paid on mortgages will be eliminated and will be substituted by a credit that decreases as income increases. This will possibly have the effect of disincentivizing housing demand. As can be seen in Figure 14, the local banking industry is highly dependent on real estate loans, particularly of residential mortgages. Residential mortgages represented 32.2% to 51.8% of total gross loans for the Top 6 banks as of Dec. 31, 2014. A further reduction in mortgage originations will limit much needed income generating assets.

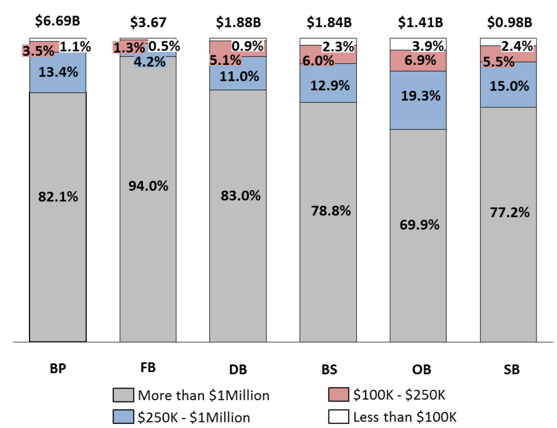
Impact on Consumer Spending: Personal consumption expenditures will most likely be curtailed if the VAT is implemented. By definition a consumption-based tax system looks to disincentivize consumption to a certain extent while incentivizing savings. Many have called for this structural change in the PR economy which has historically been a consumption-driven economy rather than a production-driven economy. The banks with greatest exposure to consumer loans like Oriental (25.4% of total) and Popular (17.9%) could be at risk if consumer spending contracts and delinquency increases (see Figure 14). The United Retailers Association stated in a tax reform hearing that the new tax system will have a direct, negative and substantial effect on retail sales in the short– and medium-term. They also stated that the B2B component will produce inflationary pressure when implemented in Jan. 2016.

Figure 14: Loan Portfolio Mix by Bank ($US Billions)



Notes: DB's loans other than real estate and commercial and industrial loans totaled 0.4%.

Figure 15: Commercial Loans* by Loan size (US$ MM)



Notes: Commercial Loans includes (1) Loans secured by nonfarm nonresidential properties, (2) Commercial and industrial loans, (3) Loans secured by farmland (including farm residential and other improvements), and (4) Loans to finance agricultural production and other loans to farmers.

Impact on Small Businesses: There is much concern over the potential impact the VAT component of the tax reform will have on small businesses. The capacity to absorb higher operational expenses and lower demand is much more limited for small businesses since they are not able to benefit from the advantages of economies of scale which larger businesses can enjoy. An impact on small businesses due to higher operational costs and lower revenues brought about by a higher tax burden will undoubtedly have repercussions on commercial loans held by banks. Figure 15 presents the commercial loans by bank and by size of the loans. Oriental has the highest exposure to loans of less than $1 million (30.1%), followed by Scotia (22.8%), Santander (21.2%), Popular (17.9%), Doral (17.0%) and FirstBank (6.0%). The banks with greater exposure to small business loans might be at a higher risk.

In summary, during 2014 banks were able to keep their bottom line in the black despite operating in an economy that has been contracting virtually incessantly for approximately 9 years. While productivity and capital levels improved with respect to 2013, asset quality deteriorated materially, a trend that must be closely monitored.

Looking forward to 2015, several important events will mark the year. A third wave of bank consolidation after Doral’s failure will change the competitive landscape of the local banking industry. Popular and FirstBank will further solidify their position as the two largest banks. The expiration of part of the loss sharing agreements with the FDIC on April 30, 2015 will prompt banks to get rid of toxic assets to be able to recover 80% of the losses or else take a hit to their bottom line. In terms of the economic and fiscal environment, the downside risks will remain higher than upside risks, continuing to subdue return levels. If the 2015 tax reform[4] is ultimately approved despite strong opposition, banks should anticipate an increase in their OPEX as well as a potential negative impact in key segments, including real-estate, consumer and small business loans, and adjust accordingly.

(4) Although a 16% VAT rate is currently proposed under House Bill 2329, some sectors, including the leadership of the legislative bodies, consider that the adverse impact on the economy will be too great and recommend reducing it to 12%. The final rate to be levied is currently still uncertain.