Puerto Rico Banking Industry Report

Issue XXIV January to March 2015

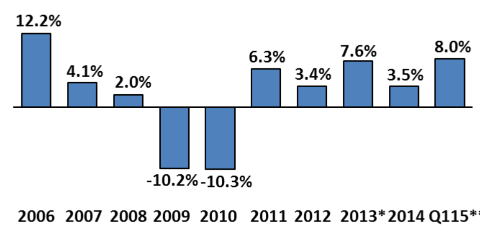
EXECUTIVE SUMMARY: The local banking industry underwent a reconfiguration during the first quarter of 2015 after federal and local regulators shutdown Doral following years of struggling with profitability and inadequate capital levels. Popular and FirstBank aptly seized the opportunity of acquiring a large part of Doral's assets and deposits, further strengthening their leading position in the local market. The reshaped banking industry registered a pre-tax ROE of 8.0% in Q1 2015, showing a strong improvement vis-à-vis 2014 despite operating in a challenging environment. The most recent macroeconomic and fiscal indicators point to continued economic contraction in fiscal years 2015 and 2016 and severe governmental liquidity problems which will continue to pose challenges for local banks. However, extremely strong capital levels will help banks cope with potential future difficulties. Delinquency ratios continued to increase in Q1 2015, trend that must be closely observed. In this issue, given the profound economic and fiscal issues Puerto Rico is facing, an analysis of the exposure of local banks to government-related assets and deposits is presented. Lastly, given the growth in assets of International Banking Entities, a brief analysis of this important sector of the Island's financial system is also put forth.

PROFITABILITY: "The consolidated Pre-Tax ROE reached 8.0% in Q1 2015, the highest level of profitability since 2006"

The local banking sector, which closed the first quarter of the 2015 with one less key player after Doral was shut down by regulators on Feb. 27, 2015, started off the year with higher levels of profitability vis-à-vis 2014 with an industry-wide pre-tax ROE of 8.0%. Doral, whose ultimate failure cost the FDIC close to $750 million, had been dragging down performance and condition indicators for the banking industry as a whole for several years due to sizable negative earnings and its inability to raise enough capital to meet the FDIC's 2012 consent order. This third wave of banking consolidation, which further strengthened Popular's and FirstBank's position in the local market, is reflective of the protracted shrinking of the economy. The PR Planning Board, which has the responsibility of publishing PR's annual national accounts, forecasts continued economic contraction in FY2015 ending in Jun. 30, 2015 as well as in FY2016 starting July 1, 2015.

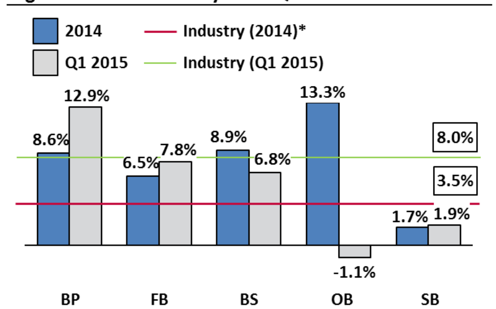
Popular, despite incurring in additional operational expenses due mainly to the acquisition of a large part of Doral's assets and deposits and subsequent integration costs, posted the highest level of profitability of the industry with a pre-tax ROE of 12.9% (see Figures 2 and 3). FirstBank, which was recently unshackled from a 2010 consent order which required it to reach certain capital levels and reduce its exposure to nonperforming and adversely classified assets, registered the second highest level of profitability with a pre-tax ROE of 7.8%. In third place came in Santander with a pre-tax ROE of 6.8% followed by Scotia with a pre-tax ROE of 1.9%. Santander obtained a lower Pre-Tax ROE when compared to the industry because of lower fee and interest income and lower financial leverage which was partially offset by higher other income and lower operating expenses. Scotia's low profitability level was mainly due to higher operating expenses. Oriental registered negative earnings in the first quarter of 2015 driven mainly by an increase in credit provision expenses. After purchasing BBVA in 2012, Oriental manages a $200 million participation in a syndicated $550 million PREPA fuel purchase line of credit which it placed in nonaccrual status and recorded a $24 million provision expense due to PREPA's potential non-payment.

Figure 1: Industry Pre-Tax ROE Trend (2005-2015)(1)



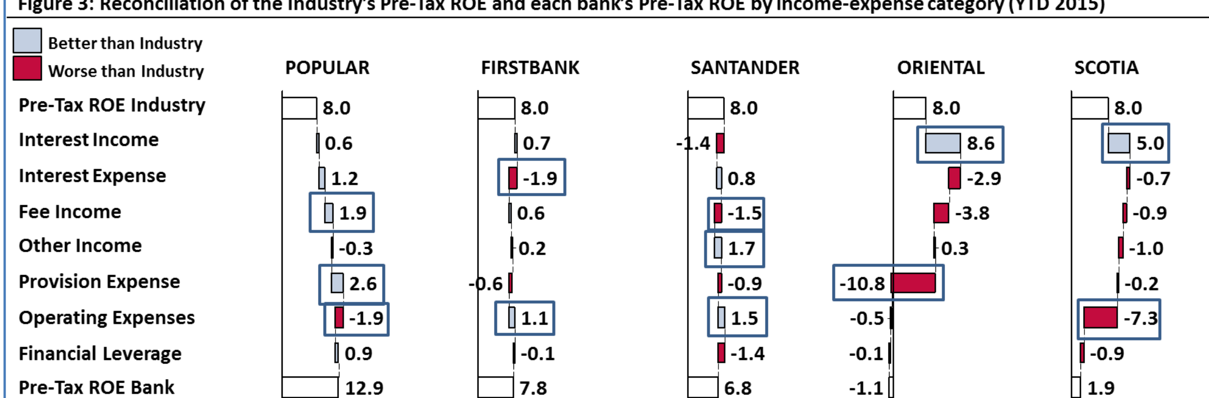
*Adjusted for the sale of NPAs (-2.3% unadjusted Pre-Tax ROE).
**Q1 2015 is annualized.

Figure 2: Pre-Tax ROE by Bank Q1 2015



*Includes Doral which had a Pre-Tax ROE of -58.2% in 2014.

Figure 3: Reconciliation of the Industry's Pre-Tax ROE and each bank's Pre-Tax ROE by income-expense category (YTD 2015)



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: "The industry-wide cost to income ratio of Q1 2015 was 61.2%, the highest level of productivity since 2011"

The local banking industry registered a cost to income ratio of 61.2% in Q1 2015 which is a material improvement when compared to the productivity level obtained in 2014 (see Figure 4). When excluding failed Doral from 2014 figures, which had an efficiency ratio of 145.1% in said year, we still see an improvement in productivity (61.2% vs. 62.3%).

Although the operational expenses to assets ratio decreased to 3.1% in Q1 2015 from 3.5% in 2014 (3.3% excluding Doral), it still remains well above pre-economic downturn levels which were below 2%. Total assets continue to drop, reaching $59.3B as of Mar. 31, 2015, representing an $8.3B or 12.3% decrease when compared to 12 months ago.

The levels of profitability of the local banking industry have been primarily adversely impacted by other factors other than productivity: high credit provision levels and low financial leverage. The downward trend of the local banking industry's financial leverage levels has continued in the first quarter of 2015. The assets to equity ratio stood at 7.5 in Q1 2015 (see Annexes 2 and 4) compared to 9.0 in 2014 and an average of 14.5 in the 2002-2006 period. The credit provision expenses to assets ratio, after decreasing from 1.6% in 2013 to 0.86% in 2014, ticked up to 0.95% in Q1 2015.

When analyzing productivity by bank, Santander and FirstBank posted the highest levels of productivity, with cost to income ratios of 57.6% and 58.8%, respectively (see Figure 5). Oriental and Popular obtained the third and fourth highest levels of productivity, with cost to income ratios of 60.3% and 60.7%, respectively. Scotia, mainly due to lower interest income, posted the lowest level of productivity with a cost to income ratio of 75.3%.

Figure 4: Cost to Income Trend 2005-2015 (%)

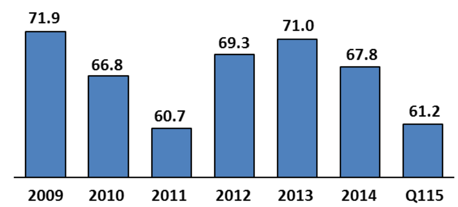
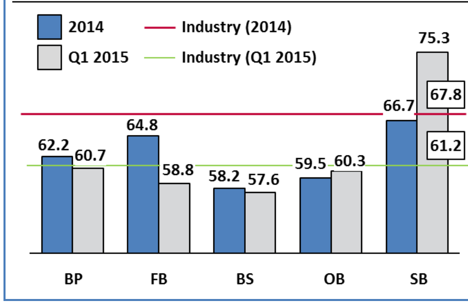


Figure 5: Cost to Income by Bank Q1 2015 (%)



CAPITAL ADEQUACY: "Tier 1 Risk Based Capital Ratio is 3 times well-capitalized level"

The local banking industry's Tier 1 risk based capital ratio on a consolidated basis continues to be strengthened reaching 18.0% in Q1 2015, three times the well-capitalized level established by the FDIC (see Figure 6 and Annex 2).

When analyzing capital adequacy by bank, Scotia and Santander continue to have the highest Tier 1 Risk Based Capital Ratios, reaching 27.1% and 23.7%, respectively in Q1 2015 (see Figure 7). FirstBank, despite purchasing certain assets and deposits from the FDIC, as receiver for Doral, was able to maintain its Tier 1 Risk Based Capital Ratio unchanged at 17.6%, the third highest of the industry. FirstBank in the aforementioned transaction acquired 10 branches, close to $523 million in deposits and a performing residential mortgage loan portfolio of close to $325 million. Popular, which also partook in purchasing certain assets and deposits from failed Doral and has been implementing the Basel III capital adequacy framework, exhibited robust capital levels with a Tier 1 Risk Based Capital Ratio of 16.6%. It purchased close to $2.3 billion in assets (BPPR: $827 million of PR loans; PCB: $891 million of US mainland loans and $607 million in other assets) and $2.2 billion in deposits (BPPR: $1B in PR deposits and 8 branches; $1.2B in New York deposits and 3 branches). Oriental, which has the lowest Tier 1 Risk Based Capital Ratio among its peers, saw a slight decrease in its ratio, reaching 14.9% in Q1 2015. In short, high capitalization levels of local banks has strengthened the sector's financial stability.

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

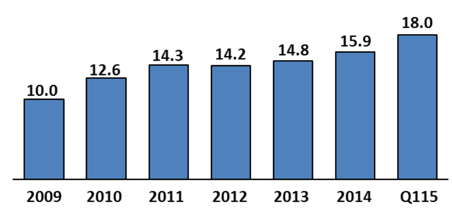
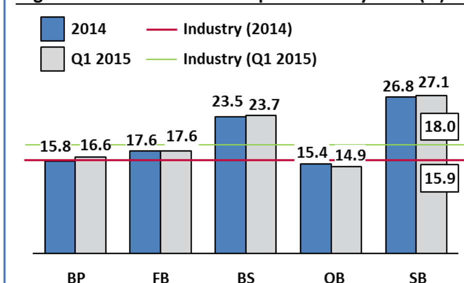


Figure 7: Tier 1 Risk Based Capital Ratio by Bank (%)

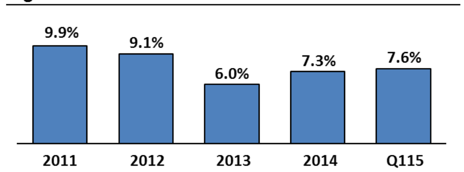


ASSET QUALITY: "The rise in the delinquency ratio for the industry continues in 2015"

The unwelcomed trend of deteriorating asset quality continued in the first quarter of 2015, with the industry's 90+ days past due–non accruing ratio increasing from 7.3% in 2014 to 7.6% in Q1 2015 (see Figure 8). With few prospects for economic growth in the short- and medium-term and a debilitated labor market, delinquency may very well continue to increase in the coming quarters. Given this scenario, banks will likely be forced to continue to derisk their balance sheets through the sale of nonperforming assets.

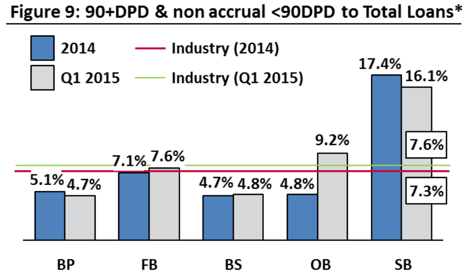
When analyzing delinquency ratios by bank, Popular and Santander had lowest 90+ days past due–non accruing ratios with 4.7% and 4.8%, respectively (see Figure 9). It should be noted that Popular's commercial loss share agreement (LSA) expires in Q2 2015, while single family LSA expires in Q2 2020. FirstBank, which saw its 90+ days past due–non accruing ratio increase to 7.6% in Q1 2015, will sell close to $200 million in nonperforming and classified commercial loans, and other real estate owned for $87.6 million or 43.8% of the unpaid principal balance in cash to clean up its balance sheet. Although FirstBank's earnings will take a hit in the short-term when this transaction is carried out, it will improve the bank's future prospects. Oriental suffered a substantial increase in its 90+ days past due–non accruing ratio to 9.2% mainly due to the placement in nonaccrual status of a $200 million line of credit with PREPA. Scotia's delinquency ratio experienced a small drop in Q1 2015, but it still remains materially higher than the industry level.

Figure 8: 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 9: 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.

GOVERNMENT EXPOSURE(2): "Local banks have continued to decrease their exposure to government-related assets"

Given the precarious financial condition of PR's central government, public corporations and other government instrumentalities coupled with a somber economic outlook, it is critical to ascertain the risks local banks face with regards to their exposure to PR government's assets. A brief update of the economic and fiscal state of the Island is subsequently presented as well as the local banks' level of exposure to government loans, deposits and securities. A government default will most certainly adversely impact the local banking industry, particularly those banks with greatest exposure.

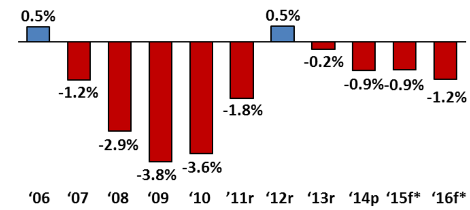
Economic Outlook Update: The Planning Board's latest national account figures point to a continued decline in the real gross national product (GNP). The base projection for fiscal year 2015 is -0.9% and for fiscal year 2016 it is –1.2% (see Figure 10). If these projections materialize, Puerto Rico's economic production in real terms in a span of 10 years would contract by 15% when comparing FY 2016 with FY 2006. The GDB's monthly economic activity index (GDB-EAI), another key gauge of the Island's economic performance, also points to the Island's ongoing and profound economic difficulties. Although the GDB-EAI, whose seasonal adjustment methodology was recently revised to more accurately measure month-over-month fluctuations, registered a 0.1% YoY increase and a 0.2% MoM increase in April 2015, it did so after 27 consecutive months of YoY decline. Similarly, although in April 2015 nonfarm employment numbers point to an increase of 3,700 jobs in the private sector when comparing it to April 2014, the 7,400 jobs lost in the government sector far out-weighed the jobs created, for a YoY net loss of 3,700. Moreover, the unemployment rate stood at 12.2% as of April 2015. In essence, labor market indicators remain materially weak when compared to pre-recessionary levels.

Fiscal Outlook Update: The big three credit rating agencies, Standard and Poor's (S&P), Moody's and Fitch, have aggressively downgraded Puerto Rico's general obligation debt and other government instrumentalities deep into junk territory, actions driven by concerns of default due to tight liquidity problems, restrained access to traditional sources of financing, an almost decade-long economic downturn and few options in the short-term to dramatically propel the Island's economy. Although a bill was submitted in March 2015 to amend the PR Constitution to reduce the protections awarded to holders of PR debt, it is unlikely to be enacted given the opposition from the leadership in both the executive and legislative branches. The GDB, which serves as a bank, fiscal agent and financial advisor to the Central Government and the Island's government instrumentalities and has historically provided financing needs to cash-strapped public corporations and other government entities, as of May. 31, 2015 had a total net liquidity of close to $778 million, a decrease of more than $2.3B when compared to Jun. 30, 2014. In an attempt to shore up its finances, the PR Government has signed into law House Bill 2482 which increases the sales and use tax (SUT) of 7% to 11.5% during a nine month period, serving as a transitory phase to a new tax system which has yet to be precisely defined. House Bill 2329 submitted by the executive branch, known as the Commonwealth of Puerto Rico Tax System Transformation Act, was ultimately struck down, facing strong opposition from many sectors, even after it suffered important amendments including reducing the value added tax rate originally proposed. With regards to the General Fund Budget, FY2015 is estimated to close with a close to $650 million deficit and it seems unlikely the government will be able to achieve a balanced budget in FY2016 and subsequent fiscal years, particularly when considering a host of risk factors including increasing debt-service payments, continued economic contraction and loss of population which will further erode the tax base. The Government of Puerto Rico has hired a number of seasoned consultants and economists, including former IMF economists, to assist in addressing the Island's economic and financial stability and growth prospects.

Banks' exposure to government-related assets and deposits: Local banks, in an effort to diminish the risks from exposure to government-related assets, have begun to clean their balance sheets of these assets. When comparing exposure to government loans as a percent of total loans in Dec. 31, 2013 and Mar. 31, 2015, there is a clear decrease in said period. The industry-wide ratio of government loans to total loans decreased from 7.2% to 5.8% (see Figure 11). Oriental (12.1%) and Santander (10.6%) have the largest exposure to government loans of the local banks. Exposure to government deposits as a percent of total deposits on the other hand remained essentially unchanged at the industry level, increasing for Popular and Santander and decreasing for FirstBank, Oriental and Scotia (see Figure 12). Exposure to government securities as a percent of total securities held experienced a significant decrease in the aforementioned period, from 5.0% to 2.6% (see Figure 13). Scotia and Oriental experienced the most dramatic decrease in their exposure to government securities in said period. In summary, if the government's liquidity issues continue and the fiscal crisis deepens even further, more cases like the one experienced by Oriental from its exposure to a PREPA line of credit may surface in the coming quarters.

Figure 10: Real GNP Annual Growth

(Fiscal years: July-June)

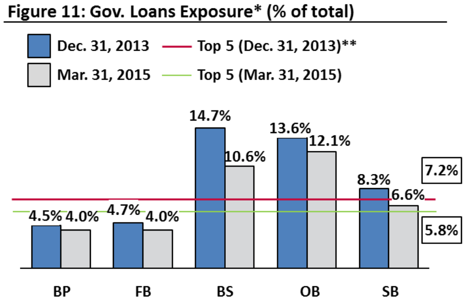


Source: Puerto Rico Planning Board

r = revised, p = preliminary, f = forecast

*The optimistic forecast for FY'15 is -0.5% and for FY'16 is +0.8% while the pessimistic forecast for FY'15 is -1.3% and for FY'16 is -4.2%.

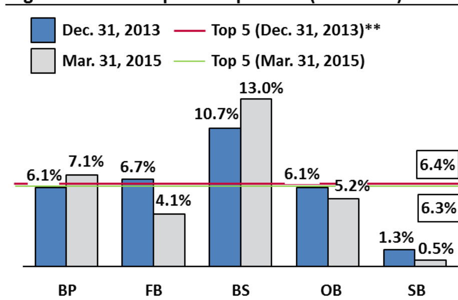
Figure 11: Gov. Loans Exposure* (% of total)



*Obligations (other than securities and leases) of states and political subdivisions in the US as a % of total loans and leases, net of unearned income.

**Top 5 (Dec. 31, 2013) does not include Doral Bank.

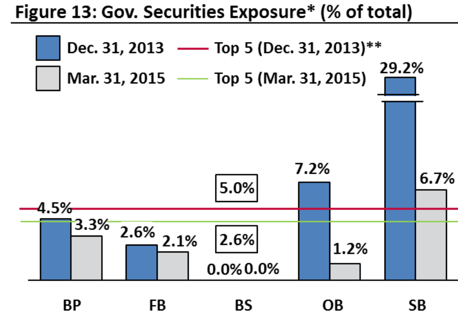
Figure 12: Gov. Deposits Exposure* (% of total)



*Transaction and non-transaction accounts of states and political subdivisions in the US as a % of total deposits.

**Top 5 (Dec. 31, 2013) does not include Doral Bank.

Figure 13: Gov. Securities Exposure* (% of total)



*Securities issued by states and political subdivisions in the U.S. as a % of total securities held-to-maturity and available-for-sale at fair value.

**Top 5 (Dec. 31, 2013) does not include Doral Bank.

(2) Government loans: Obligations (other than securities and leases) of states and political subdivisions in the U.S. (including PR); Gov. deposits: Deposits of states and political subdivisions in the U.S. (including PR); Gov. securities: Securities issued by states and political subdivisions in the U.S. (including PR).

Puerto Rico Banking Industry Report

INTERNATIONAL BANKING ENTITIES: "2nd largest player in PR's financial sector managing $50.3 billion in assets"

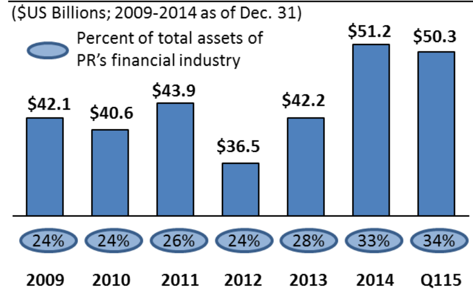
International banking entities (IBEs) is the second largest sector in in PR's financial system in terms of assets. According to the PR Office of the Commissioner of Financial Institutions (OCFI), as of March 31, 2015, commercial banks managed $55.9 billion in assets (37.5% of the total assets of the financial sector) while IBEs administered $50.3 billion (33.8%). International Financial Entities (IFEs) managed $422 million (0.3%). IBEs and IFEs, licensed and authorized by the OCFI to engage in offshore financial activities in PR, provide financial services mostly to non-residents.

Puerto Rico, since the 1980s, has enacted several pieces of legislation to promote the Island as a leading regional financial center and carve out a niche market to compete with jurisdictions the likes of Panama, the Bahamas, the Cayman Islands (e.g. Act 16-1980; Act 52-1989; Act 121-1996; Act 273-2012). PR policymakers have provided attractive benefits to IBEs including preferential tax treatment and the relaxation of many regulations governing traditional commercial banking activities. The main benefits provided through Act 273-2012 include a tax decree effective during a period of 15 years which may be extended by two additional periods of 15 years (i.e. total 45 years), 4% fixed income tax rate on the net income generated from eligible financial activities and total exemption from property and municipal license taxes, among others. It should be noted that Act 273 allows IBEs operating under Act 52 to continue operating under Act 52 or convert to an IFE to be able to take advantage of the additional eligible activities and the tax advantages provided by Act 273.

As of March 31, 2015, there were 32 IBEs and 16 IFEs operating in PR. Although many IBEs are under the direction of local commercial banks, there are others from other U.S. and foreign jurisdictions. IBEs operating in PR on a consolidated basis and in terms of assets grew dramatically during 2014, increasing by $9 billion or more than 20% (see Figure 14). Profitability of IBEs has been improving significantly in recent years, reaching an After-Tax ROE of 5.2% in 2014 and 3.6% in Q1 2015 from -6.4% in 2009 (see Figure 15). The efficiency ratio has also been improving dramatically since 2009, reaching 37% in Q1 2015 (see Figure 16). The effective promotion of the benefits awarded to IBEs and IFEs is critical for the continued evolution of PR as a regional financial center.

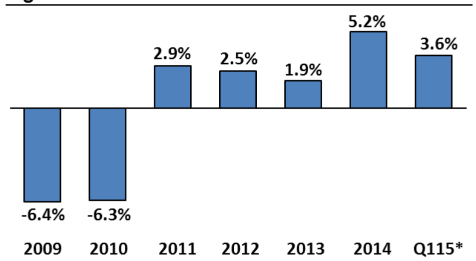
Figure 14: Total Assets of IBEs

($US Billions; 2009-2014 as of Dec. 31)



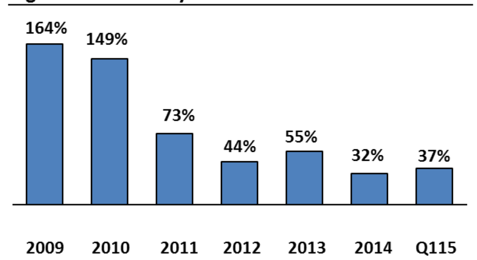
Source: Office of the Commissioner of Financial Institutions (OCFI)

Figure 15: After-Tax ROE of IBEs



Source: Office of the Commissioner of Financial Institutions (OCFI)
*Q1 2015 annualized.

Figure 16: Efficiency Ratio* of IBEs



Source: Office of the Commissioner of Financial Institutions (OCFI)
*Efficiency Ratio = (Operating expenses/ Total net interest income and non-interest income)

In summary, the year 2015 started off reasonably well for local banks considering the economic and fiscal environment they are operating in. It should be noted that the improvement in condition and performance indicators in Q1 2015 was largely due to the fact that failed Doral is no longer part of the analysis. Doral had been significantly dragging down industry-wide indicators for several years due to its exceedingly poor performance and inadequate capital levels. Economic growth forecasts for PR point to continued contraction in FY2015 and FY2016, which will continue to create challenges for local banks. Nevertheless, banks' strong liquidity and capital level s will serve as a buffer for potential future losses. Furthermore, local banks have effectively implemented measures to rationalize their costs which is reflected in their improving productivity levels. However, loan demand must pick up in order for banks to see a sizable improvement in their profitability levels. Going forward, local banks must be watchful of increasing nonperforming assets, including government-related assets. Exposure to government-related assets, as was experienced by Oriental due to its PREPA line of credit, could produce hefty losses for banks with the greatest exposure.

V2A 10 GREAT YEARS

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)

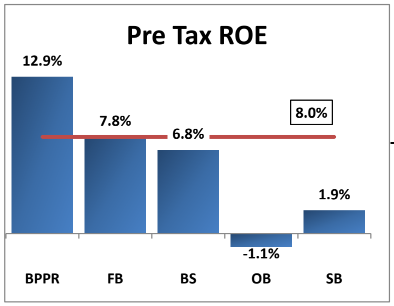
V2A, Inc.

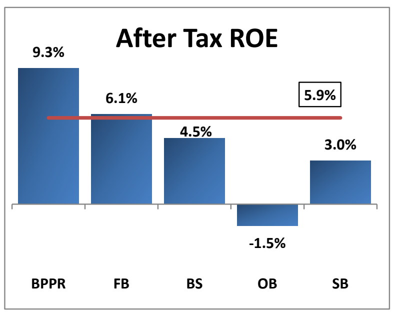
San Juan
District View Plaza (Suite 401)
644 Ave Fernández Juncos
San Juan, PR 00907-3122

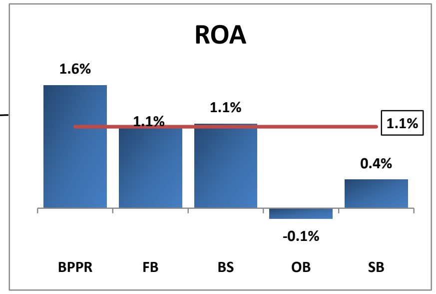
Miami
20801 Biscayne Blvd (Suite 403)
Aventura, FL 33180

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

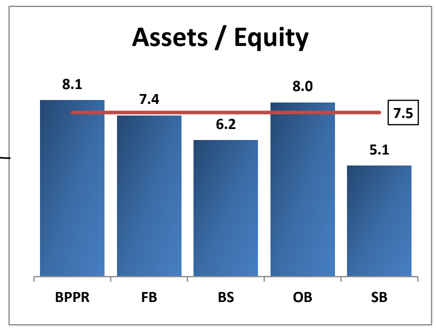
ANNEX 1: BANKING INDUSTRY PROFITABILITY 2015

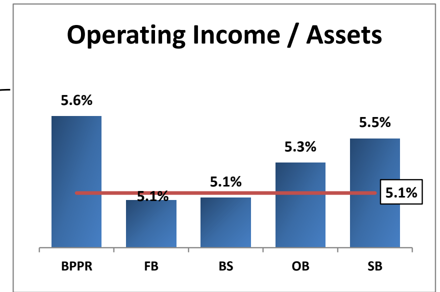




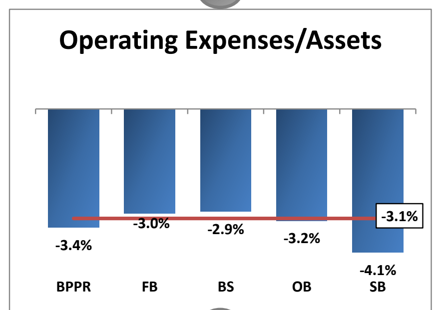


X

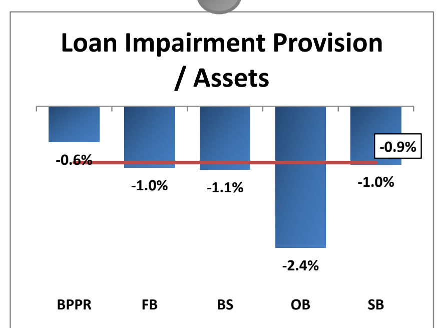




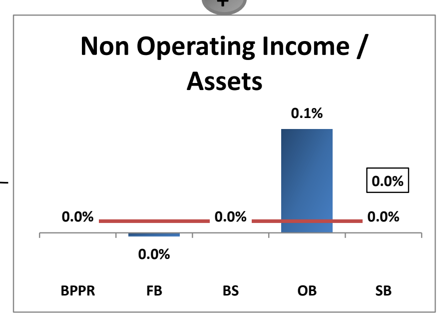
+

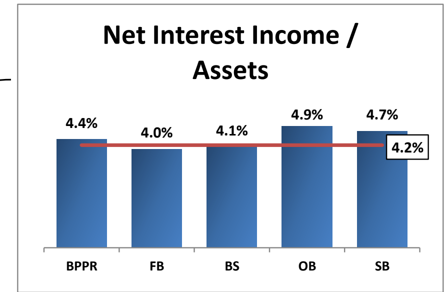


+

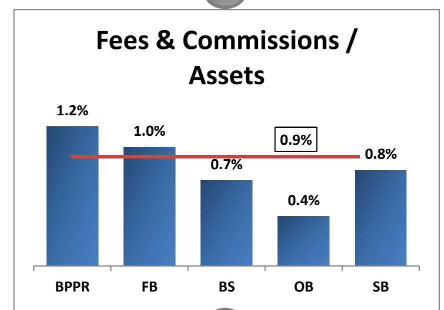


+

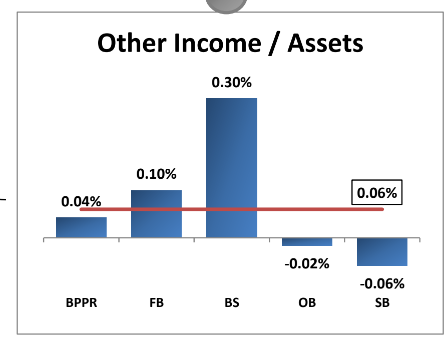




+



+



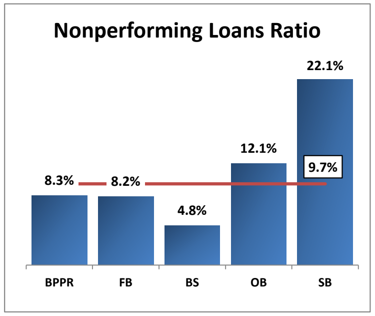
BPPR = BANCO POPULAR DE PUERTO RICO
FB = FIRSTBANK OF PUERTO RICO
BS = BANCO SANTANDER PUERTO RICO
OB = ORIENTAL BANK AND TRUST
SB = SCOTIABANK DE PUERTO RICO

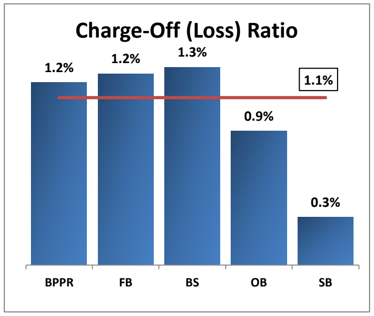
Note: Income and expense ratios are annualized
Source: Federal Deposit Insurance Corporation (FDIC)

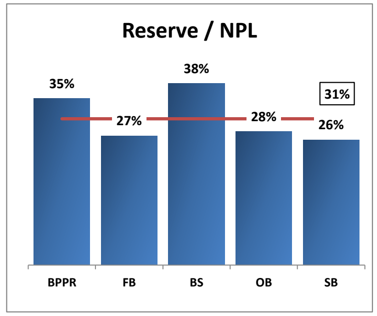
Industry

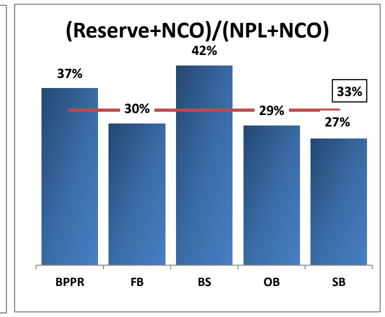
ANNEX 2: BANKING INDUSTRY PERFORMANCE RATIOS 2015

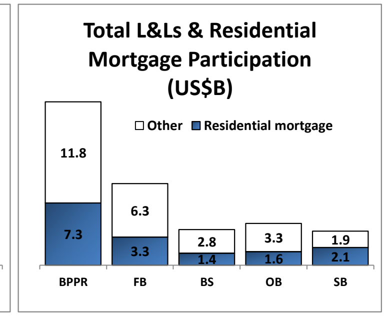
ASSET QUALITY



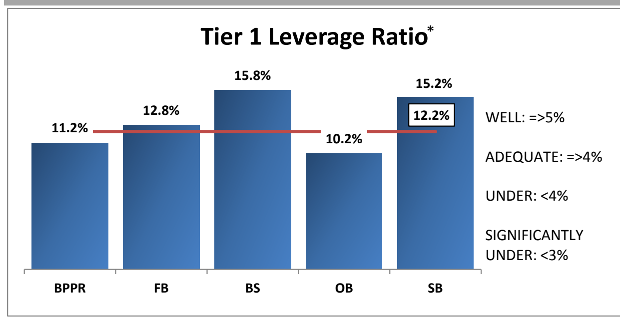


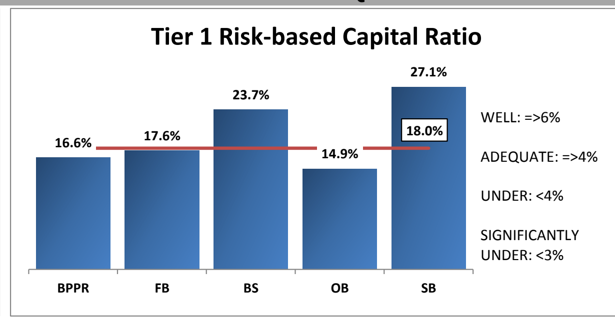


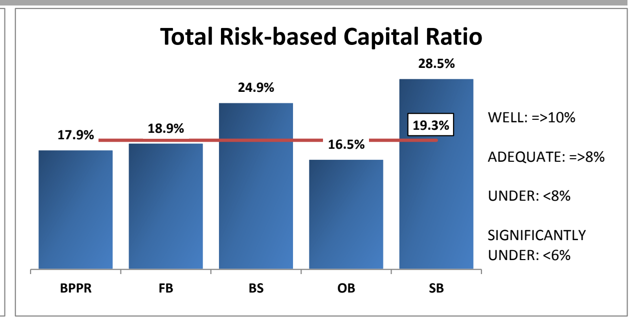




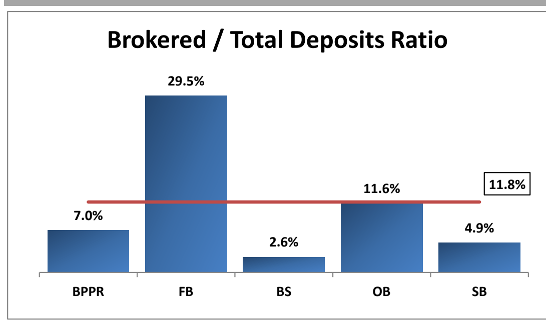
CAPITAL ADEQUACY

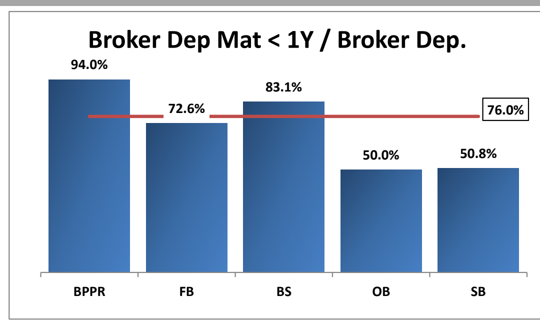




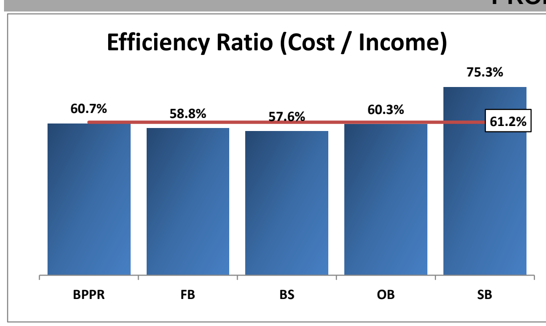


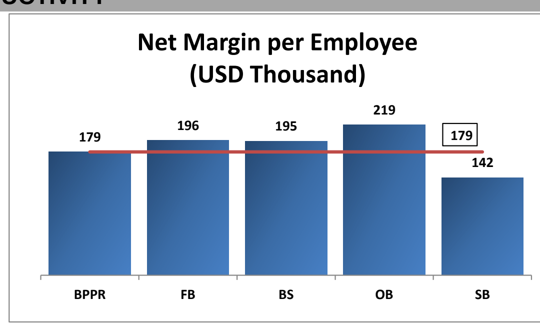
LIQUIDITY





PRODUCTIVITY





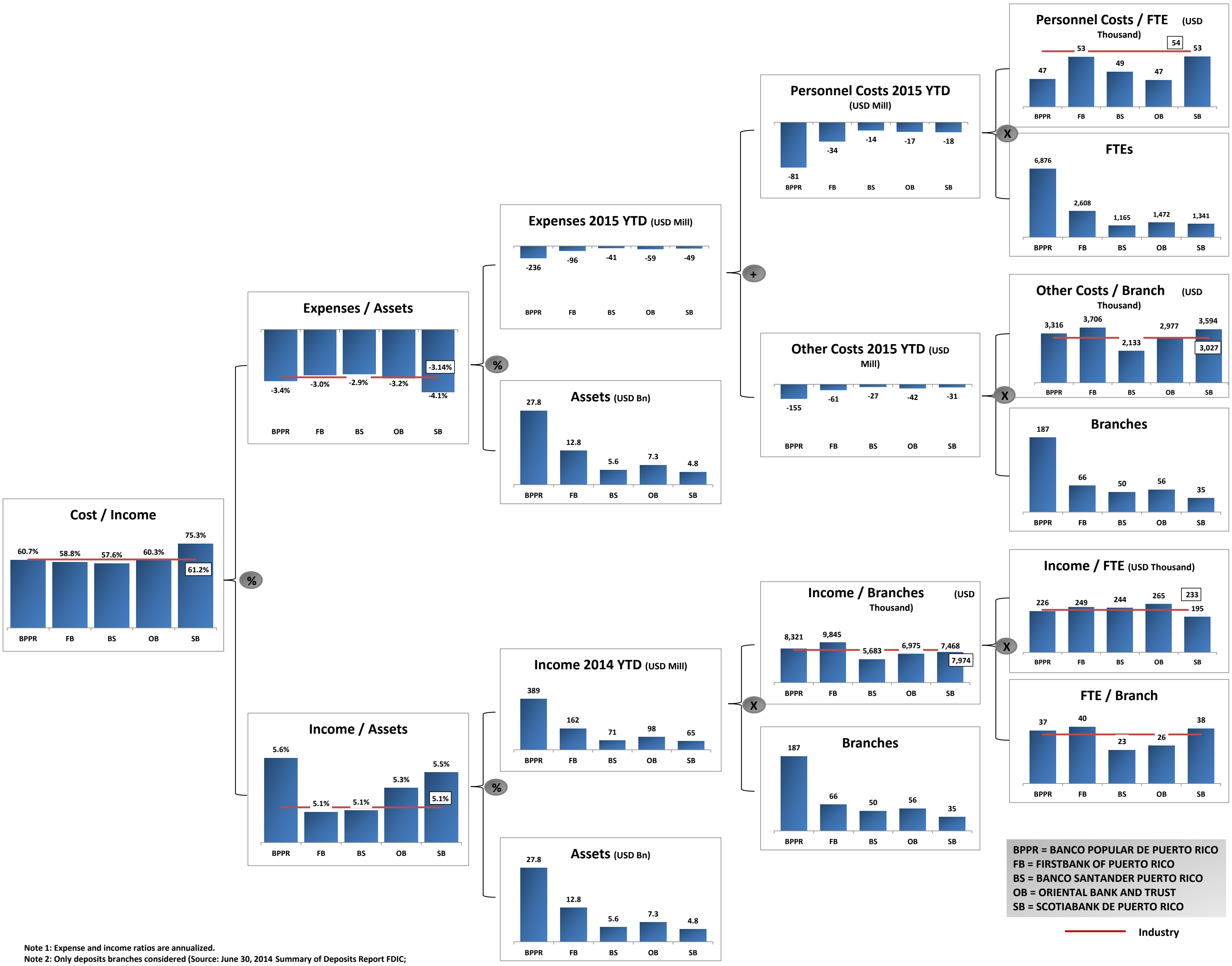
BPPR = BANCO POPULAR DE PUERTO RICO
FB = FIRSTBANK OF PUERTO RICO
BS = BANCO SANTANDER PUERTO RICO
OB = ORIENTAL BANK AND TRUST
SB = SCOTIABANK DE PUERTO RICO

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)

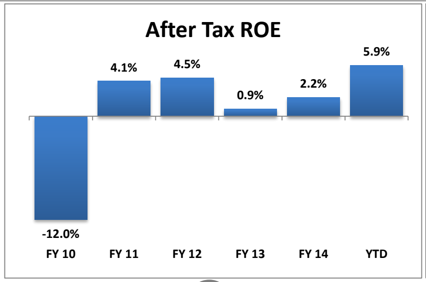
ANNEX 3: BANKING INDUSTRY PRODUCTIVITY 2015

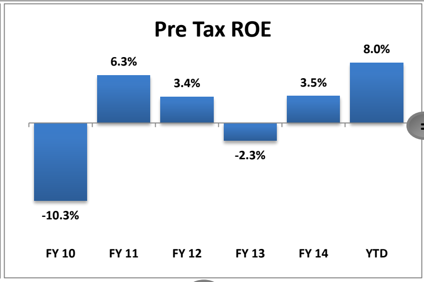


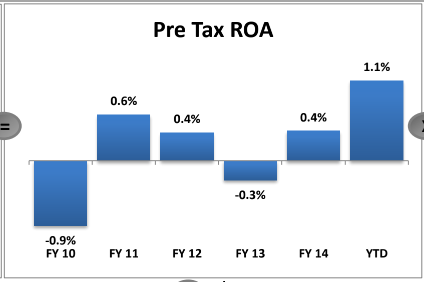
Note 1: Expense and income ratios are annualized.
Note 2: Only deposits branches considered (Source: June 30, 2014 Summary of Deposits Report FDIC; Service Type Codes included: 11, 12 and 23)

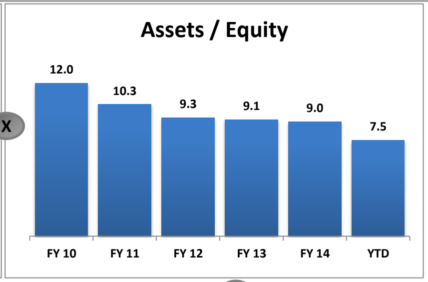
ANNEX 4: INDUSTRY TRENDS - SELECTED METRICS

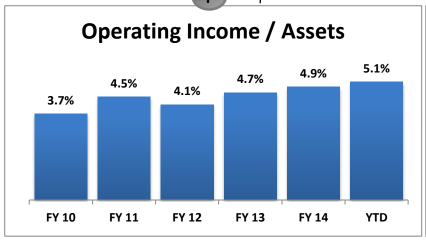
PROFITABILITY

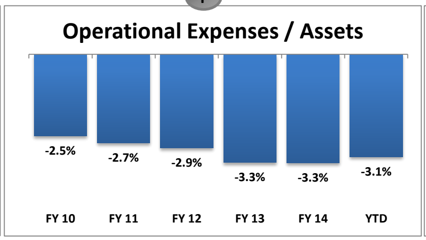


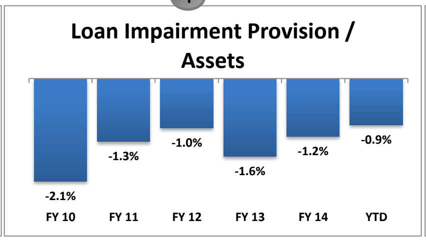


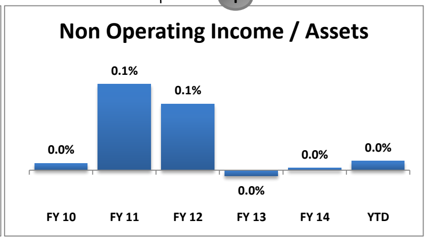




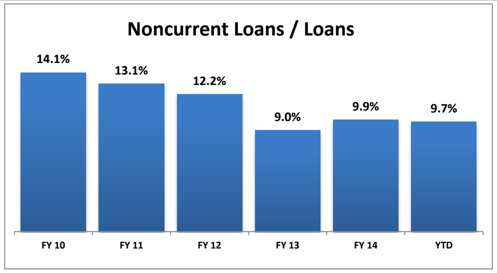


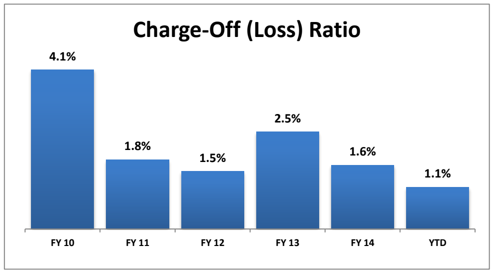


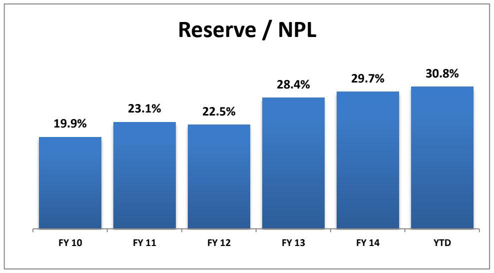


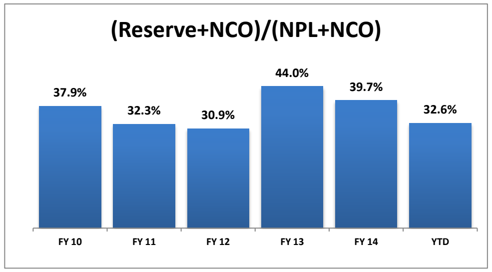


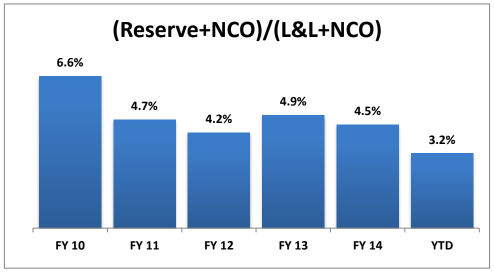
ASSET QUALITY











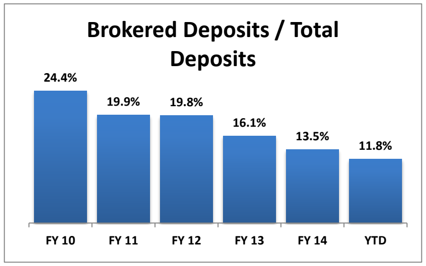
Notes:

Asset quality ratios are not adjusted for FDIC covered and available for sale portfolio.

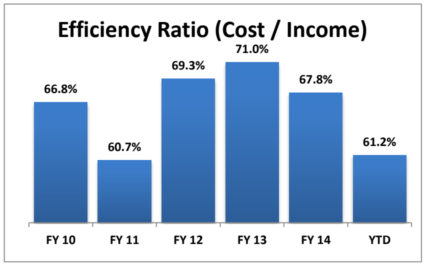
YTD numbers are annualized.

Source: Federal Deposit Insurance Corporation (FDIC)

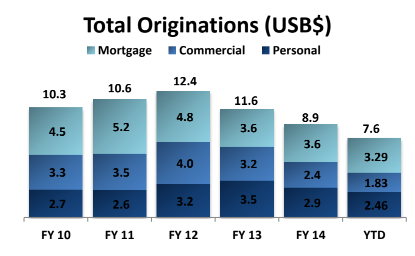
LIQUIDITY



PRODUCTIVITY



MARKET ORIGINATIONS



TOTAL ASSETS