VISION TO ACTION

Puerto Rico Banking Industry Report

Issue XXV | **January to June 2015**

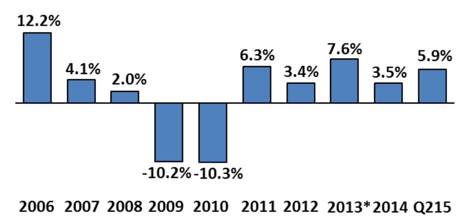
EXECUTIVE SUMMARY: The local banking industry on a consolidated basis has been able to maintain positive returns in the first half of 2015, reaching a Pre-Tax ROE of 5.9%, highlighting the resilience of this sector despite steep challenges in Puerto Rico's operating environment. The Island is undoubtedly traversing one of the most challenging economic and fiscal periods of its post-World War II history, as has been consistently chronicled in past issues. Real economic output has decreased by close to 15% since FY 2006, the liquidity drought that ails the government could ultimately lead to a partial government shutdown and population decline continues unabated reaching historic proportions in 2014 with a net migration of -64,000. Furthermore, on Aug. 1 the government made an incomplete payment to cover the Public Finance Corporation's (PFC) debt which has been seen by Wall Street and the investor community as the Commonwealth's first-ever default. Given current elevated capital ratios, the industry will be able to withstand additional economic deterioration in the short-term. However, a worsening of economic and fiscal conditions may lead to higher non-performing loans, higher credit provisions and a depletion of capital levels. This issue will briefly examine local credit unions' exposure to $1.1 billion in PR government debt, sector which might be dealt a hard blow if public sector defaults continue.

PROFITABILITY: "Industry-level Pre-Tax ROE reached 5.9%; Turbulent economic outlook will keep ROE subdued"

The local banking industry's profitability level remained in positive territory during the first half of 2015, reaching a Pre-Tax ROE of 5.9% (see Figure 1), but is kept suppressed due to a continuing economic and fiscal crisis that has severely weakened government, business and household balance sheets. Although the Aug. 2015 figures of the GDB Economic Activity Index point to some stabilization, remaining flat compared to Aug. 2014, and increasing 0.4% compared to Jul. 2015, the Commonwealth's lack of strong economic growth drivers, negative demographic trends and restrained access to capital markets will make it difficult to dramatically shore up its economy.

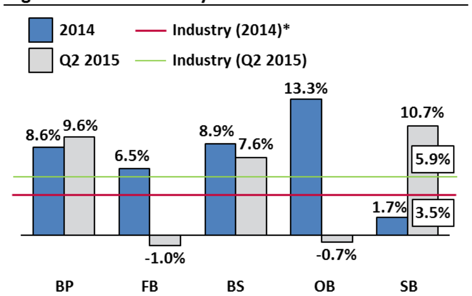
When analyzing profitability by banks, Scotia registered the highest Pre-Tax ROE with 10.7%, followed by Popular with 9.6% and Santander with 7.6% (see Figure 2). Scotia, which registered its highest profitability since 2012, fared better than the industry due to a higher interest and other income, which was partially offset by higher operating expenses and lower financial leverage (see Figure 3). Popular 's profitability was driven by higher fee income and lower credit provision expense while Santander's ROE levels were driven by higher other income and lower operating expense. FirstBank and Oriental registered negative profitability levels in the first half of 2015, reaching a Pre-Tax ROE of -1.0% and -0.7%, respectively. FirstBank's negative ROE was driven by an increase in provision expense while Oriental's was caused by a rise in provision expense and a decrease in fee income.

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



*Adjusted for the sale of NPAs by BP and FB which resulted in a combined loss of -$180M. (-2.3% unadjusted Pre-Tax ROE)
**January to June 2015 annualized.

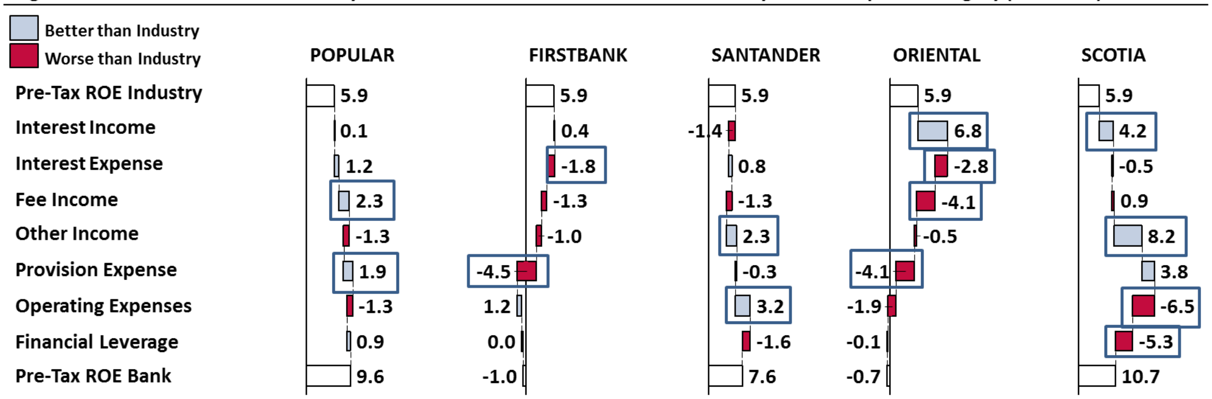
Figure 2: Pre-Tax ROE by Bank



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

Moody's downgraded on Sept. 1 Popular's, FirstBank's, and Santander's standalone baseline credit assessments by one notch pointing to concerns of potential future government defaults, material uncertainties regarding the upcoming government debt restructuring process due to the absence of a bankruptcy legal framework, and a further deepening economic and fiscal crisis. Santander was the only one to maintain a stable outlook due to the bank's connection with its U.S. affiliate. Possible materialization of downside risks will negatively impact the banking industry in coming quarters.

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



	POPULAR	FIRSTBANK	SANTANDER	ORIENTAL	SCOTIA
Pre-Tax ROE Industry	5.9	5.9	5.9	5.9	5.9
Interest Income	0.1	0.4	-1.4	6.8	4.2
Interest Expense	1.2	-1.8	0.8	-2.8	-0.5
Fee Income	2.3	-1.3	-1.3	-4.1	0.9
Other Income	-1.3	-1.0	2.3	-0.5	8.2
Provision Expense	1.9	-4.5	-0.3	-4.1	3.8
Operating Expenses	-1.3	1.2	3.2	-1.9	-6.5
Financial Leverage	0.9	0.0	-1.6	-0.1	-5.3
Pre-Tax ROE Bank	9.6	-1.0	7.6	-0.7	10.7

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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: "While expense control must remain a top priority, cost-cutting is a challenge given rising compliance and regulatory costs"

Productivity of the industry as a whole, as measured by the cost to income ratio, has improved materially when compared to the previous three years, reaching 62.7% in the first half of 2015 (see Figure 4), but remains well below pre-recession levels.

Santander clearly led the way in terms of efficiency with a cost to income ratio of 54.9%. Operating expenses to total assets of said bank was 2.9% while that of the industry as a whole was 3.3% (see Annex 1). Scotia came in second place with a cost to income ratio of 60.5%, followed by Popular (62.2%) and FirstBank (64.0%). Oriental's productivity levels was hard hit in Q2 2015 due to not obtaining $4.2MM in tax free interest income from loans to the Electric Power Authority (PREPA) and the Aqueduct and Sewer Authority (PRASA), $10.2MM increase in FDIC commercial loss share amortization, and $4.5MM of additional loss in Other Real Estate Owned (OREO). Given that its efficiency ratio was affected largely by non-recurring items, it is likely to normalize in the coming quarters.

Furthermore, low financial leverage continues to put downward pressure on profitability levels. Total assets of the local banking industry reached $59.4B at the end of Q2 2015, a close to $7B or 11% decrease with respect to Q2 2014 and a $43B or 42% decrease with respect to peak asset levels registered in Q2 2008. The assets to equity ratio of the local banking industry decreased to 7.4 from 9.0 in 2014 and 15.5 in 2005. If economic contraction and population decline continue, financial leverage will likely follow suit. Given stricter regulations of financial institutions and fierce local competition, banks will increasingly find it difficult to reduce costs in a significant manner.

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

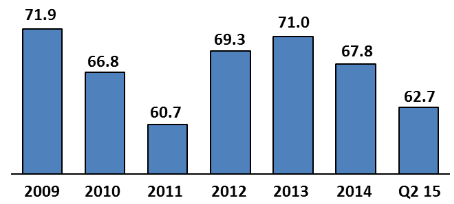
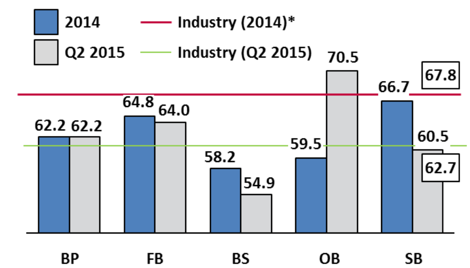


Figure 5: Cost to Income by Bank (%)



*Includes Doral which had a Cost/Income of 145.1% in 2014.

CAPITAL ADEQUACY: "Robust capital levels provide strong buffer in case of losses"

The capitalization level of the Island's banking industry has continued to be strengthened during the first half of 2015. The Tier 1 risk based capital ratio increased from 15.9% in 2014 to 17.8% in 2014 (see Figure 6), close to threefold well-capitalized levels.

Local banks which must go through the Dodd-Frank Act Stress Test or DFAST, as per the Dodd-Frank Wall Street Reform & Consumer Protection Act, have passed said tests comfortably given robust capital levels. The stress test evaluates if banks have robust, forward-looking (i.e. nine quarters of forecasted results) capital-planning in place to adequately manage adverse macroeconomic conditions, to prevent financial meltdowns like the one experienced in 2007. Even in the severely adverse economic scenarios that are included in the stress test, local banks, given their sizable capital cushion, are able to meet minimum capital ratios established by the Basel III accords and the FDIC.

When analyzing capital adequacy by bank, Scotia and Santander exhibited the highest levels of capitalization, with Tier 1 Risk Based Capital Ratio of 28.9% and 23.3%, respectively (see Figure 7). These are followed by FirstBank (17.9%), Popular (16.1%), and Oriental (14.9%). Popular, currently unfettered by capital deployment restrictions after completing the payment of $935 million of trust capital securities issued to the U.S. Treasury under the TARP Capital Purchase Program, reinstated quarterly cash dividends to return excess capital to its shareholders, the bank's first cash dividend since April 2009.

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

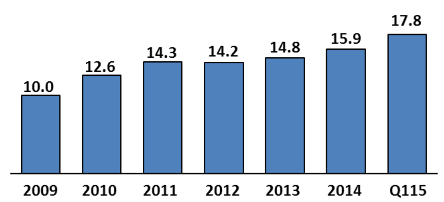
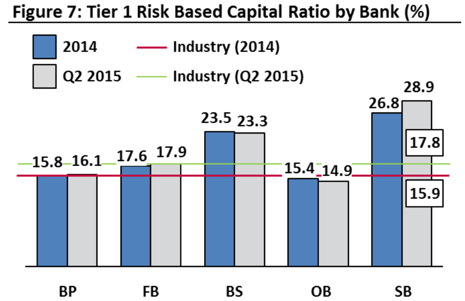


Figure 7: Tier 1 Risk Based Capital Ratio by Bank (%)



*Includes Doral which had a capital ratio of 2.7% in 2014.

ASSET QUALITY: "90+ days past due–non accruing ratio improved from 7.3% to 6.9%"

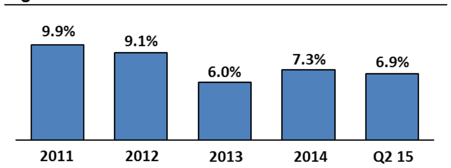
Asset quality of the local banking industry as a whole, as measured by the 90+ days past due–non accruing ratio, improved in the first half of 2015 to 6.9% from 7.3% in 2014, (see Figure 8). However, there is still a long-way to go before reaching pre-recessionary levels. It should be noted that these figures exclude FDIC covered portfolios, held for sale portfolios and guaranteed portion of portfolios by the U.S. government.

When analyzing asset quality by bank Santander has the lowest 90+ days past due–non accruing ratio with 4.8%, followed by Popular (5.5%), FirstBank (6.7%) and Oriental (8.7%). The asset quality of Scotia continues to deteriorate, reaching 19.5% in the first half of 2015. Construction and development loans continue to pose the greatest burden.

Given an economic and fiscal outlook plagued by numerous downside risks, it is possible that in coming quarters banks will register higher nonperforming ratios, a major concern pointed out by credit agencies. Although there has been a decrease in recent month of the unemployment rate, reaching 11.6% in Aug. 2015, growth of net private sector jobs remains lackluster. Total employment as measured by the household survey remains below 1 million and the labor force participation is 40% compared to 63% in the U.S.

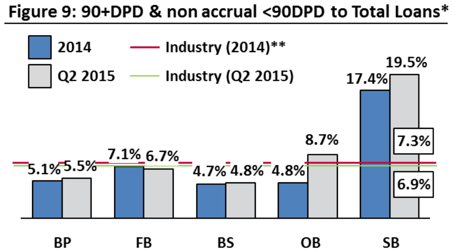
Banks will surely continue to look for opportunities to clean their balance sheets through the sale of nonperforming assets, albeit at a loss. Oriental recently announced it would be selling nonperforming loans and real estate acquired in the Eurobank and BBVA deals.

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.
** Includes Doral which had a ratio of 16.0% in 2014.

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 INDUSTRY REPORT" please contact:

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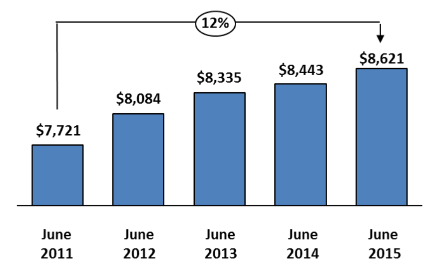
GOVERNENT EXPOSURE OF CREDIT UNIONS: "$1.1B in gov. debt, including $360 million in unrealized losses"

In previous issues of this report, an analysis of the exposure local banks have to PR government assets and deposits has been presented, depicting the varying degrees of vulnerability commercial banks have to these assets and deposits. Credit unions are also facing steep challenges due to government exposure. Given the significant weight of this sector in the Island's financial system (when combining commercial banks and the credit union sector, the latter represent 13.4% of assets), and potential losses due to public sector exposure, a brief overview of the current state of affairs is presented.

According to the data published by COSSEC, as of June 30, 2015, local credit unions totaled 116, managing $8.6 billion in assets, an increase of $900 million or 12% with respect to 2011 (see Figure 10). While asset-reduction and deleveraging has characterized the local banking industry since the beginning of the economic downturn, credit unions have maintained a steady growth trend.

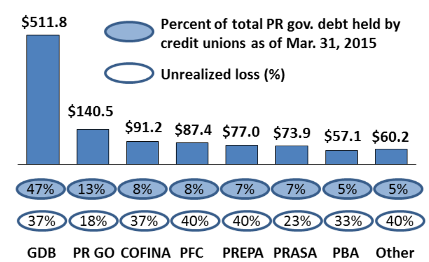
Credit unions, after regulators allowed them to invest in lower-rated PR bonds in 2009, have invested heavily in PR gov. debt. These financial institutions, lured in by the high returns, tax-free-status and strong legal protections, reached $1.1 billion in PR gov. debt as of Mar. 31, 2015. The combined unrealized losses of credit unions due to their gov. exposure totaled $360 million. This represents 4.2% of consolidated assets and 13.5% of total capital. When accounting for these unrealized losses, the equity-to-assets ratio dips from 30.9% to 26.7%. Further weakening of the Island's fiscal situation may continue to fuel the downward trend in the market values of PR gov. debt, adversely impacting credit unions.

Figure 10: Total Assets of Credit Unions (in millions)



Source: Corporation for the Supervision and Insurance of Cooperatives (COSSEC by its Spanish acronym)

Figure 11: Investments in PR Gov. Debt (in millions)



Debt issuers: GDB: Government Development Bank; PR GO: PR General Obligation Bonds; COFINA: PR Sales Tax Revenue Bonds; PFC: Public Finance Corporation; PREPA: PR Electric Power Authority; PRASA: PR Aqueduct and Sewer Authority; PBA: Public Buildings Authority;

Source: Corporation for the Supervision and Insurance of Cooperatives (COSSEC by its Spanish acronym)

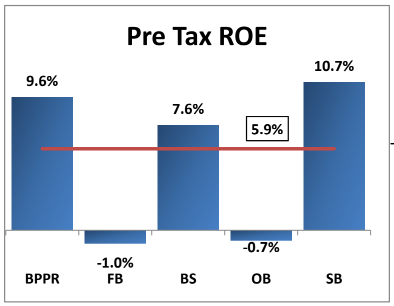
Of these $1.1 billion in PR gov. debt, 47% or $511.8 million were invested in Government Development Bank notes while 13% or $140.5 million were put in PR General Obligation Bonds (see Figure 11). Close to 50% or $185 million of the unrealized losses is attributable to the GDB notes, which have been downgraded by credit agencies due to the significant depletion of GDB's cash resources and severely restrained access to capital markets. Although a final decision hasn't been made, there have been talks by government officials to possibly carry out an exchange of GDB notes ($4 billion) to bring in liquidity to the government to support its operations beyond November. There are concerns that the government's liquidity will reach critical levels towards the end of the year. According to a liquidity update published on Aug. 25, 2015(2), the Commonwealth's cash balance at the end of the current fiscal year 2016 could fluctuate between negative $612 million and negative $1.8 billion. Credit unions also invested $91.2 million in COFINA bonds and $87.4 million in Public Finance Corporation (PFC) bonds (see Figure 11). On Aug. 3 the Public Finance Corporation made only a partial payment of $628,000 of the $58 million in principal and interest due.

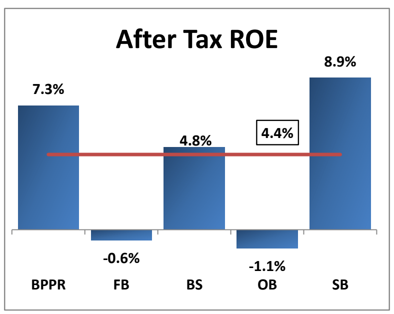
The importance of credit unions in the Island's financial system should be underscored. Credit unions serve a critical role, managing a significant share of deposits in certain areas and associations that are not traditionally served by commercial banks. If these unrealized losses were to materialize and the weaker credit unions were to ultimately close their operations, these areas and associations would be severely negatively impacted either due to loss of deposits, loss in share value, or less credit availability(3).

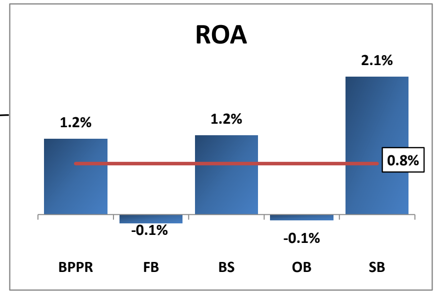
In summary, the local banking industry, as well as local credit unions, should brace themselves for continued challenging economic and fiscal times fraught with uncertainty and downside risks. Although local banks have sufficiently strong capital levels to withstand continued economic hardships, a further weakening of the economy and fiscal health of the gov. would undoubtedly have direct negative impacts in the performance and condition of financial institutions, which may result in higher nonperforming assets, higher credit provisions and erosion of capital levels.

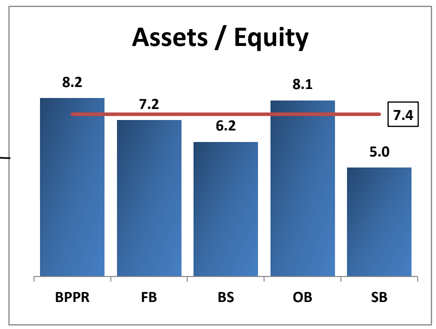
(2) Commonwealth of Puerto Rico Liquidity Update prepared by Conway MacKenzie available at the GDB's website.
(3) It should be noted that on June 18, 2009 COSSEC increased the maximum amount insured per depositor from $100K to $250K.

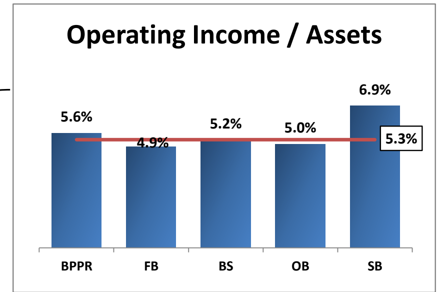
ANNEX 1: BANKING INDUSTRY PROFITABILITY 2015

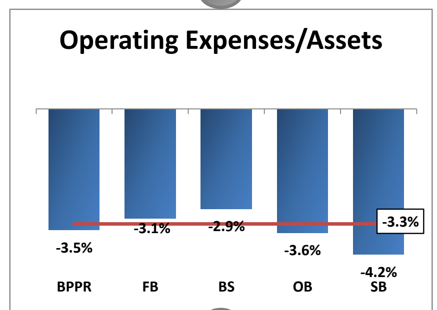


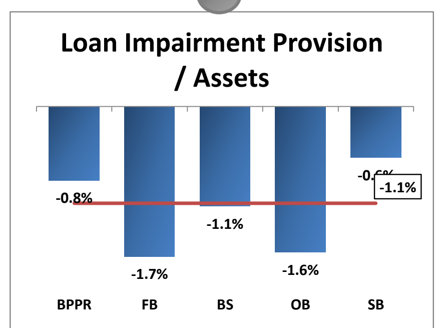


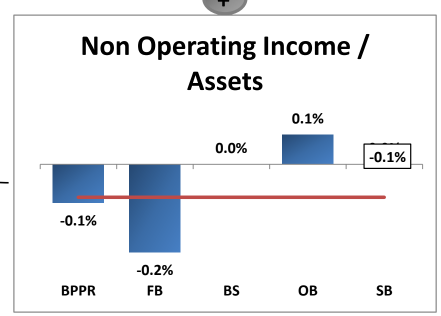


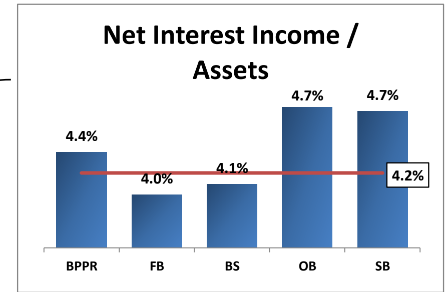


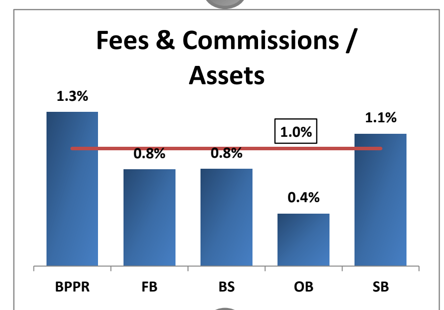


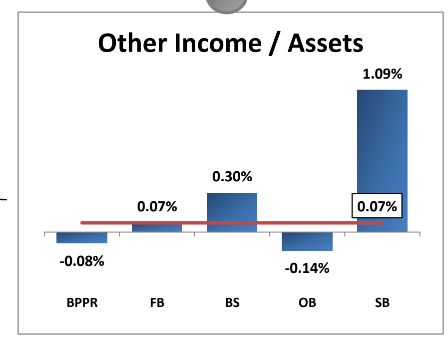












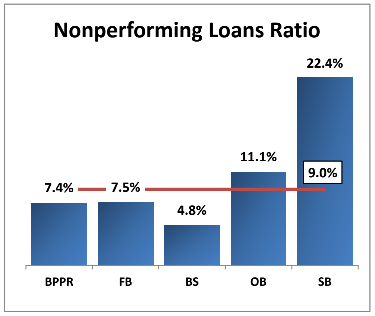
BPPR = BANCO POPULAR DE PUERTO RICO
FB = FIRSTBANK OF PUERTO RICO
BS = BANCO SANTANDER PUERTO RICO
OB = ORIENTAL BANK AND TRUST
SB = SCOTIABANK DE PUERTO RICO

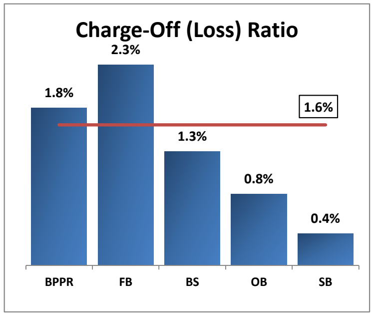
Note: Income and expense ratios are annualized
Source: Federal Deposit Insurance Corporation (FDIC)

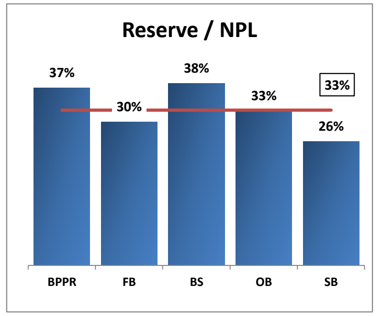
Industry

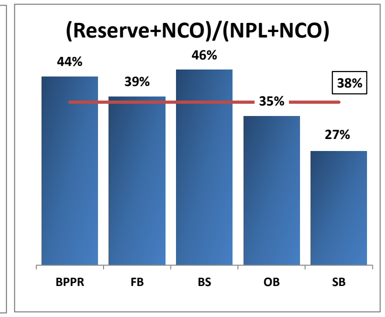
ANNEX 2: BANKING INDUSTRY PERFORMANCE RATIOS 2015

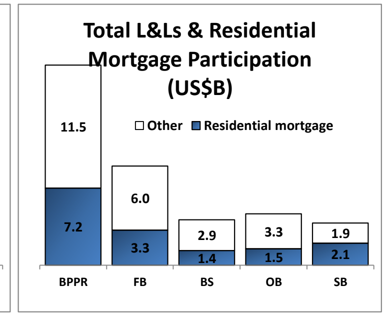
ASSET QUALITY



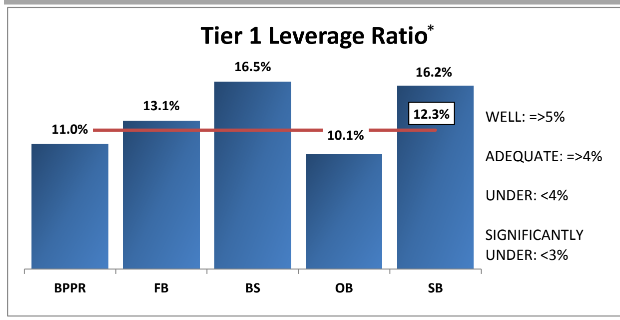


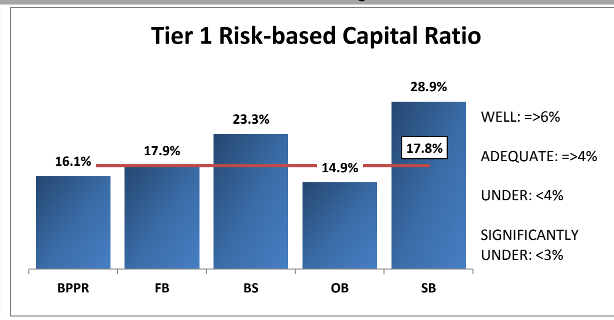


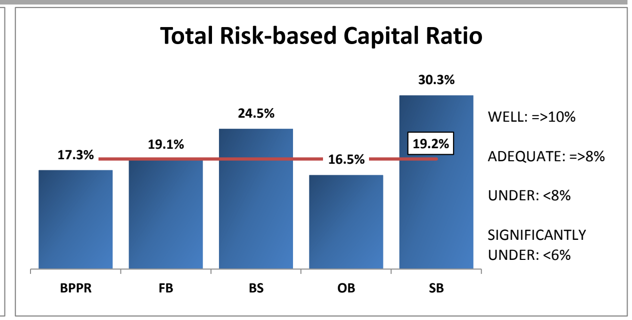




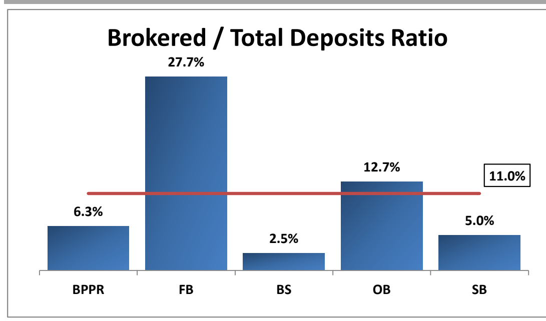
CAPITAL ADEQUACY

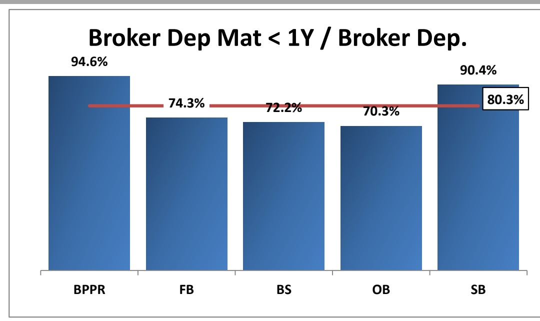




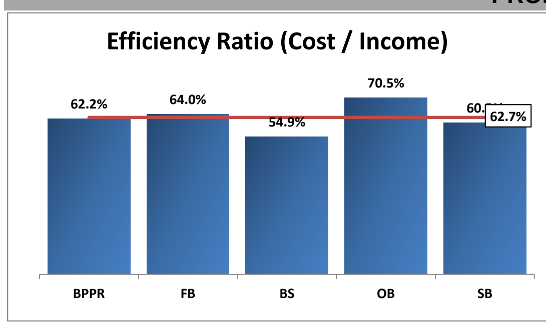


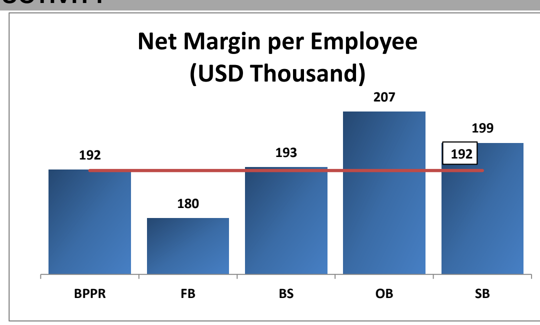
LIQUIDITY





PRODUCTIVITY





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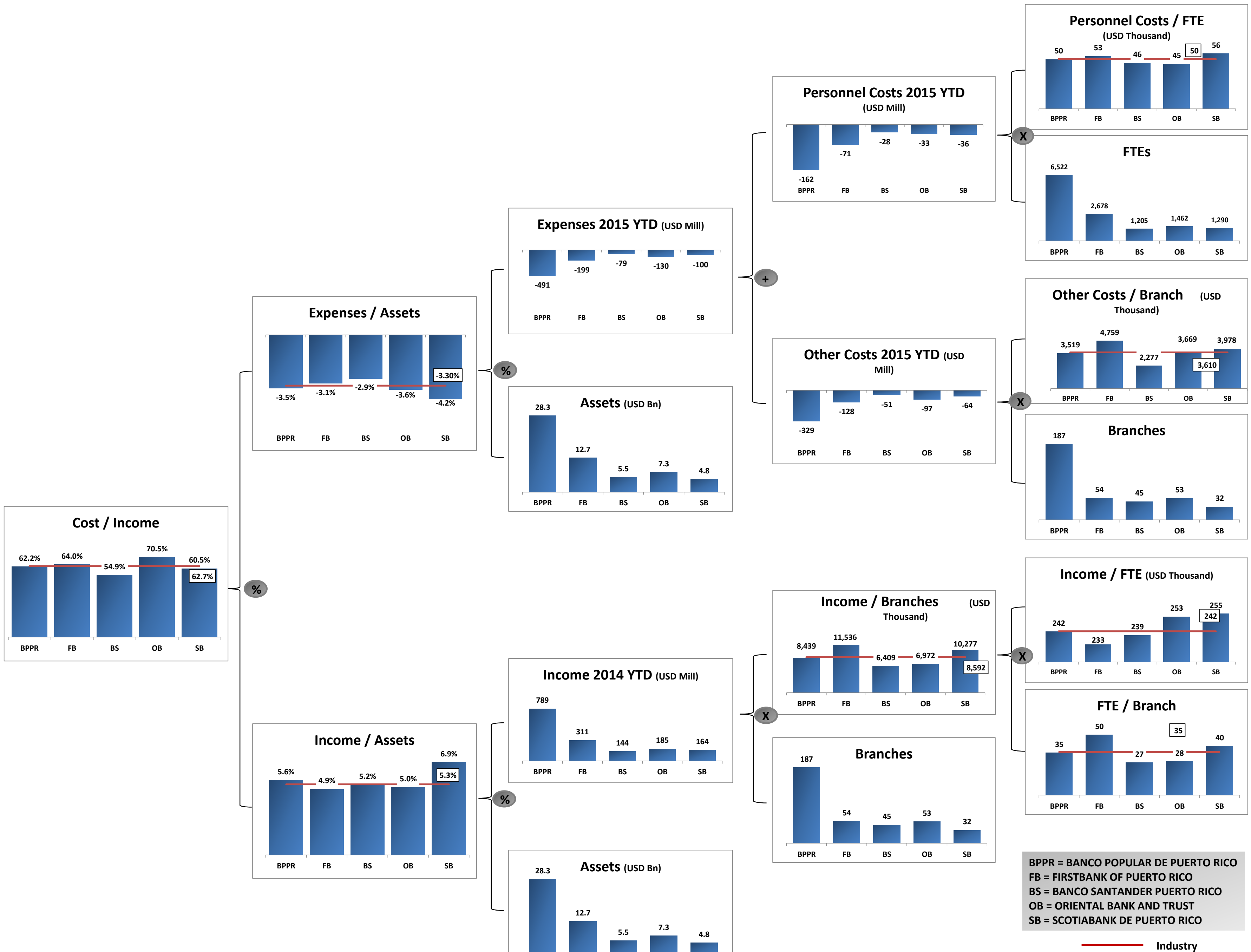
Industry

* 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 2015

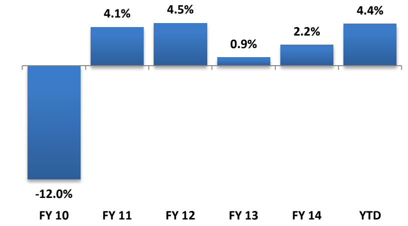


Note 1: Expense and income ratios are annualized.
Note 2: Only deposits branches considered (Source: June 30, 2015 Summary of Deposits Report FDIC; Service Type Codes included: 11, 12 and 23)

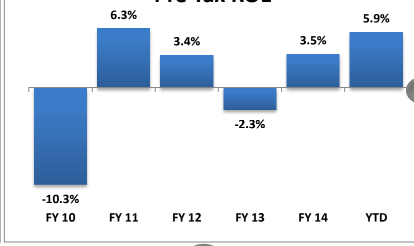
ANNEX 4: INDUSTRY TRENDS - SELECTED METRICS

PROFITABILITY

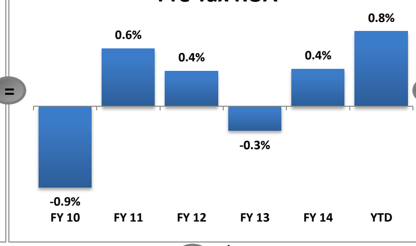
After Tax ROE



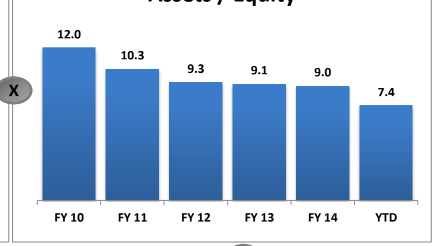
Pre Tax ROE



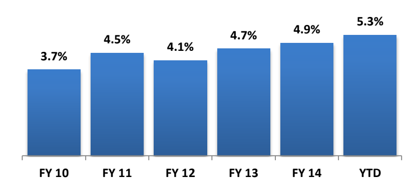
Pre Tax ROA



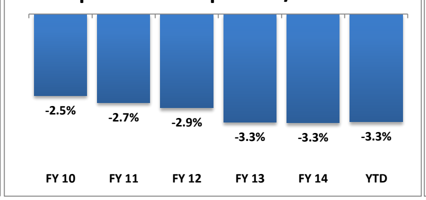
Assets / Equity



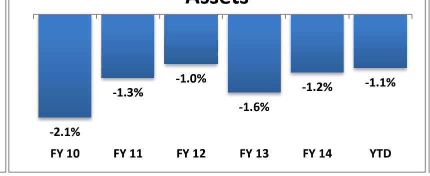
Operating Income / Assets



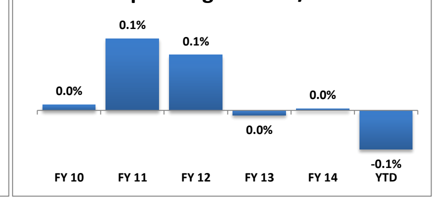
Operational Expenses / Assets



Loan Impairment Provision / Assets

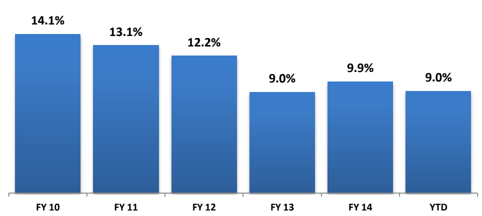


Non Operating Income / Assets

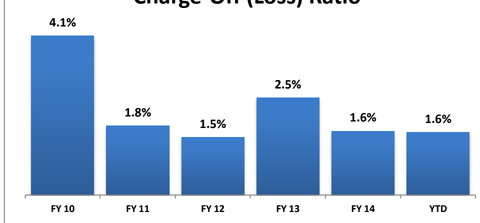


ASSET QUALITY

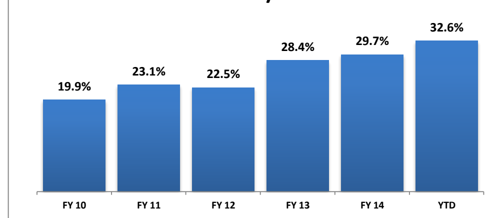
Noncurrent Loans / Loans



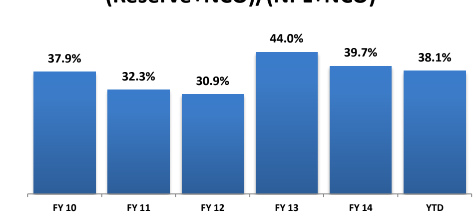
Charge-Off (Loss) Ratio



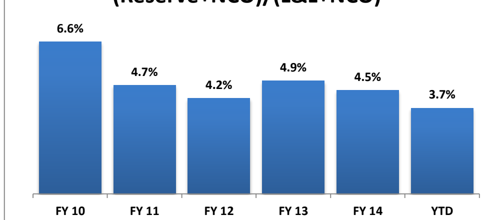
Reserve / NPL



(Reserve+NCO)/(NPL+NCO)



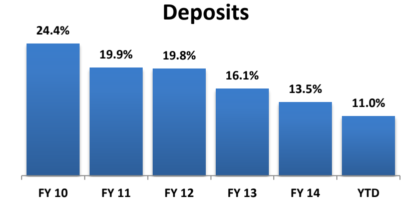
(Reserve+NCO)/(L&L+NCO)



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

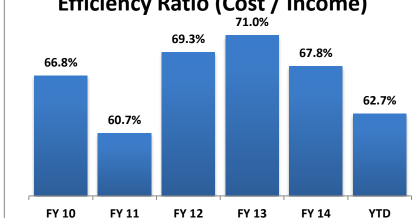
LIQUIDITY

Brokered Deposits / Total Deposits



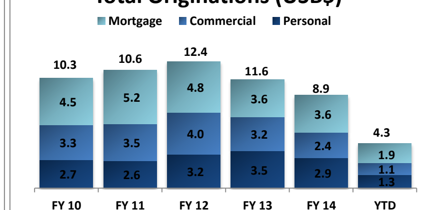
PRODUCTIVITY

Efficiency Ratio (Cost / Income)



MARKET ORIGINATIONS

Total Originations (USB$)



TOTAL ASSETS

Total Assets (USB$)