Puerto Rico Banking Industry Report

Issue XXVI — January to September 2015

EXECUTIVE SUMMARY: The local banking industry continues to weather the storm of economic and fiscal malaise that is gripping the Island. It has maintained positive, albeit modest, levels of profitability during YTD 2015, reaching a Pre-Tax ROE of 6.2% on a consolidated level. Profitability by individual bank exhibited notable variability. Popular, Scotia and Santander posted relatively strong levels of profitability, with Pre-Tax ROEs of 9.7%, 8.9%, and 7.2% respectively, while FirstBank and Oriental produced ROEs below 1% (0.9% and 0.3%, respectively). Higher provision expenses due to heightened credit risk stemming from uncertainties regarding PR government assets and current shaky economic grounds, have adversely impacted local banks' 2015 performance. Nevertheless, a strong capital base provides banks with an adequate cushion to assimilate potential future losses. Given the importance of the auto industry for the local economy and specifically for local banks and other financial institutions, this issue will provide an overview of key auto trends. New auto sales in Puerto Rico peaked in 2005 with 140,400 cars sold, dropping to 88,175 in 2014 (-52K units or -37%), continuing a downward trend in YTD 2015. This trend has important implications for local banks as well as for already strained public coffers.

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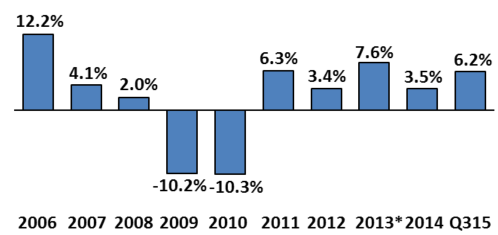
PROFITABILITY: "Popular, Scotia and Santander posted Pre-Tax ROEs between 7-10%; Oriental and FirstBank below 1%"

Puerto Rico's banking industry, on a consolidated basis, registered a Pre-Tax ROE of 6.2% during the first three quarters of 2015, an improvement with respect to 2014 (see Figure 1). The ongoing economic and fiscal troubles of Puerto Rico in conjunction with high levels of uncertainty will continue to exert downward pressure on banks' profitability. Although the GDB's Economic Activity Index on a Y-o-Y basis entered positive territory in Sep. 2015 for the first time in 32 months (+0.8), downside risks will dominate the Island's short- and medium-term economic and fiscal outlook (2). Dwindling liquidity of the government, an approaching Medicaid cliff, uncertainty regarding the public debt restructuring process, and limited options to stimulate the economy will continue to fuel economic and fiscal distress and suppress business and consumer confidence, adversely impacting the banking sector's performance and financial condition.

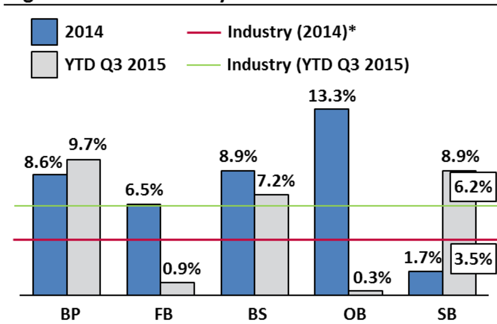
Popular, Scotia and Santander posted comparatively strong returns with Pre-Tax ROEs of 9.7%, 8.9%, and 7.2%, respectively, while FirstBank and Oriental registered razor-thin positive returns, with Pre-Tax ROEs of 0.9% and 0.3%, respectively. Popular's and Scotia's YTD 2015 Pre-Tax ROE compared favorably to 2014 due to higher other income and a lower provision expense (see Figure 3). Scotia's provision expense decreased by close to $100 million or -62% when comparing Q1 to Q3 2015 annualized vs. 2014, and its other noninterest income increased by close to $100 million, spiking in Q2 and Q3 2015, more than offsetting material losses on sales of OREO. Looking to expand its earning potential and strengthen its position as market leader, Popular launched the Investor Services Hub to provide services to those benefitting from Act 20-2012 (Export of Services) and Act 22-2012 (Transfer of Individual Investors to PR). Santander's higher provision expense during YTD 2015, which was partially offset by higher interest income, drove the dip in its performance. FirstBank's and Oriental's tepid YTD 2015 returns vis-à-vis 2014 were both driven by lower interest income and materially higher provision expenses. Furthermore, FirstBank and Oriental incurred in losses during 2015 from the sale of nonperforming and adversely classified assets .

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



*Adjusted for the sale of NPAs. (-2.3% unadjusted pre-tax ROE)
**2015: Q1 to Q3 2015 annualized.

Figure 2: Pre-Tax ROE by Bank



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

Figure 3: Reconciliation of each bank's 2014 and YTD 2015 Pre-Tax ROEs by income-expense category (%)

Better than 2014 / Worse than 2014

	POPULAR	FIRSTBANK	SANTANDER	ORIENTAL	SCOTIA
Pre-Tax ROE 2014	5.9	6.5	8.9	13.3	1.7
Interest Income	0.6	-2.4	1.8	-4.5	-2.3
Interest Expense	-0.1	1.0	0.0	0.4	1.1
Fee Income	0.2	1.7	0.8	3.2	1.0
Other Income	2.4	-0.1	0.1	-1.7	4.1
Provision Expense	1.5	-4.9	-2.7	-10.1	5.6
Operating Expenses	-0.8	-0.6	-0.5	-0.2	-0.9
Financial Leverage	-0.2	-0.2	-1.1	0.0	-1.3
Pre-Tax ROE YTD 2015	9.7	0.9	7.2	0.3	8.9

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) The GDB's Economic Activity Index registered a positive Y-o-Y change in Oct. 2015 (1.0%), the second consecutive month of positive Y-o-Y change.

PRODUCTIVITY: "The efficiency ratio of the banking industry as a whole stood at 62.2%, highest level of productivity since 2011 (60.7)%"

The cost-to-income ratio of the local banking industry as a whole reached 62.2% during YTD 2015, highest level of productivity since 2011 (see Figure 4). Given the limited organic opportunities to expand the income-generating capacity of banks, cost rationalization measures, streamlining of processes, and the optimal use of technological advancements remain critical. Banks have taken important steps to restructure their respective branch networks and promote internet and mobile banking usage among their customers.

When analyzing productivity levels by bank, the efficiency ratio of all local banks fluctuated between 55% and 65%, Santander being the only bank close to the lower end of this range (see Figure 5). Popular, the island's largest bank, managing as of Sep. 30, 2015 $27.7 billion in assets (48% of total assets of Top 5), obtained the second highest productivity level (62.4%). During Q3 2015, Popular finalized the information systems conversion and integration of the assets and liabilities it purchased from Doral, costing the bank $3.7 MM during said quarter. Oriental, which reached a cost-to-income ratio of 63.2%, will likely see its costs rise in coming quarters due to a consent order it entered with the FDIC to establish appropriate internal controls to fully comply with the regulator's Bank Secrecy Act / Anti-Money Laundering (BSA/AML) compliance program.

To effectively target the cost portion of their cost-to-income ratio, bank executives should look beyond traditional cost-cutting measures, devise innovative operating models, and implement sustainable and long-term cost-reduction measures that include straight through processing, first-time resolution, and self-service channels, by leveraging new technologies and optimizing and modernizing their IT infrastructure.

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

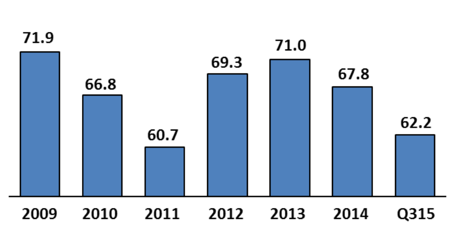
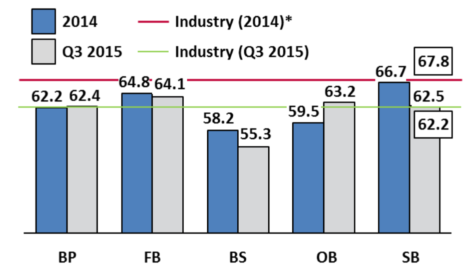


Figure 5: Cost to Income by Bank (%)



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

CAPITAL ADEQUACY: " Upward ascent of capital ratios continues unabated in 2015"

The Tier 1 Risk Based Capital Ratio of the Puerto Rico banking industry continues its upward ascent during YTD 2015, reaching 18.3%, slightly more than three times the well-capitalized level established by the FDIC's risk-based assessment system. This strong capital base provides banks with the necessary capacity to absorb the potential materialization of downside risks in the economy and in the government's financial situation.

Scotia and Santander continue to boast the highest Tier 1 Risk Based Capital Ratio, reaching 27.3% and 25.0%, respectively. FirstBank came in third with a Tier 1 Risk Based Capital Ratio of 18.2%, followed by Popular (16.6%) and Oriental (15.0%). Looking to deploy its excess capital but still maintaining robust capital levels, Popular reinstated the cash dividend ($0.15 per share) on its common stock during Q3 2015, resulting in a close to $15.5 million payout to its shareholders. It had not paid dividends to its shareholders since April 2009, a restriction imposed due to the receipt of Troubled Asset Relief Program (TARP) funds which were ultimately fully repaid in July 2014. During Q3 2015, Oriental repurchased 500,000 shares for a total of $4.7 million, as part of its stock repurchase program of $70 million of the bank's common stock. Moreover, despite maintaining healthy capital levels, it decided to reduce the quarterly amount it pays out to its shareholders by 40% (from $0.10 to $0.06 per common share). Banks have been deploying excess capital cautiously given the uncertain economic panorama.

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

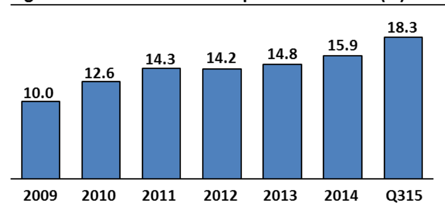
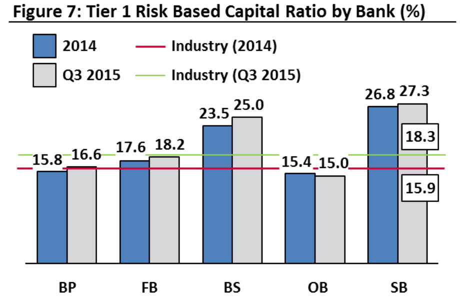


Figure 7: Tier 1 Risk Based Capital Ratio by Bank (%)



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

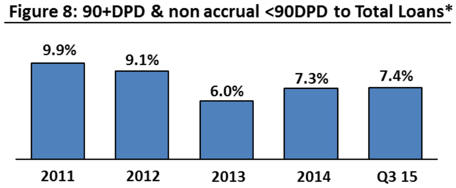
ASSET QUALITY: "90+ days past due–non accruing ratio increases for most banks"

The 90+ days past due–non accruing ratio, a measure of asset quality, of the Top 5 banks in the aggregate stood at 7.4% during YTD 2015, just slightly higher than in 2014 when it reached 7.3% (see Figure 8). This figure excludes loans and other real estate owned (OREO) that remain covered under the terms of the FDIC sponsored single-family loss share agreement. However, the commercial loss share agreement that several banks entered in 2010 with the federal regulator expired on June 30, 2015 after a 5 year term.

The 90+ days past due–non accruing ratio of all banks, except FirstBank, rose during YTD 2015 when comparing it to 2014 (see Figure 9). Scotia's delinquency ratio, the highest among its peers, continues to rise, reaching a precarious level of 22.5%. Further compounding this issue is the fact that Scotia has the lowest reserve-to-NPL ratio of the industry (see Annex 2). Subsequent issues of this report will closely monitor these asset quality ratios which pose steep challenges for Scotia going forward. Oriental, which registered a 90+ days past due–non accruing ratio of 10.0%, incurred in a net loss of $20.9 MM from the sale of assets from the 2010 Eurobank and 2012 BBVA acquisitions.

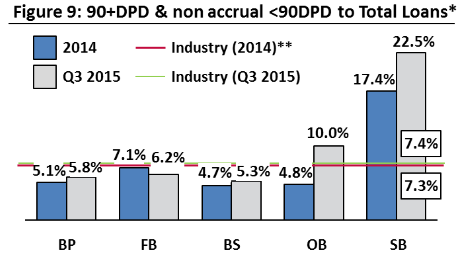
A significant improvement in job indicators could help strengthen the asset quality of banks but there has been little movement in this respect. As of Oct. 2015, total employment is barely above 1 MM (close to 1.3 MM in peak levels), the unemployment rate stood at 12.4% (U.S. 5%), and the labor participation rate reached 40.9% (U.S. 62.4%)

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.

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AUTO INDUSTRY TRENDS: "Drop in auto sales is adversely impacting the financial and government sectors"

Many economic sectors and industries have been hard hit by the economic downturn that has afflicted Puerto Rico for close to 10 years, one of which is the auto industry. For three consecutive years new auto sales have been decreasing, reaching 88,175 units in 2014 and 65,009 units from Jan. to Oct. 2015, 8.8% or 6,251 units less vis-à-vis the same period of 2014. The United Automobile Importers Group (GUIA by its Spanish acronym) revised its 2015 forecast downward to 80,000 (see Figure 10). A growing tourism sector, which has in turn spurred demand for vehicle fleets, has helped mitigate the falling trend in auto sales.

This marked decrease in auto sale activity has direct consequences for the performance of local banks and other financial institutions, as well as for public funds. It should be noted that the auto industry collected $298.5 million in excise taxes in fiscal year 2015, representing 3.4% of the general fund's net revenues (Peak level reached in FY 2005: $606.7 MM or 7.3% of general fund net revs.).

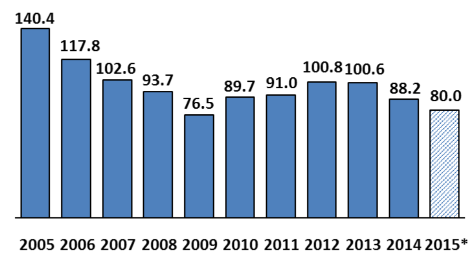
The auto loans and leases portfolio has remained essentially stable since 2013, reaching $6.41 billion as of the end of Q2 2015. Reliable (28%), FirstBank (15%), Oriental Auto (15%), Popular Auto (12%), and Toyota Credit (10%) are the market leaders, managing 80% of the portfolio (see Figure 11). Among the top players, Popular, Toyota and Credit Unions (COSSEC) have been expanding their share of the total portfolio during the last four years, while Reliable, FirstBank and Oriental have seen a decrease in their share.

Efforts to reduce delinquent auto loans and repossessed auto inventory have yielded results. According to the latest OCIF data, delinquent auto loans as of the end of Q2 2015 decreased to $262.9 million (11.4%) from $289.3 million in 2014 (11.9%). Furthermore, there were a total of 3,853 repossessed auto units on the books as of June 30, 2015, 2,056 units less (-35%) when compared to 2014. Derisking measures should continue.

In terms of auto loan and leases origination, there has been a steady decrease since 2013 (see Figure 12). During the first two quarters of 2015, commercial banks and non-depository institutions have originated $1.07 billion in auto loans and leases, 17% or $220 million less when compared to the same period of 2014.

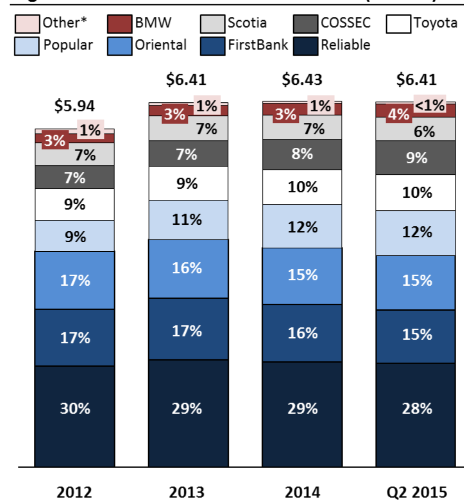
Despite a lower excise tax rate levied on motor vehicles enacted on Nov. 2014 (15% cut) to help boost sales and low interest rates, a number of more compelling factors will likely keep auto loan and leases originations and sales subdued, including a potential continued loss of population, low consumer and business confidence, large inventory of used cars and weak labor market indicators.

Figure 10: New Auto Sales (thousands)



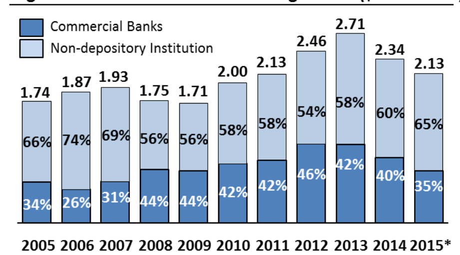
Source: United Automobile Importers Group (GUIA by its Spanish acronym). * GUIA's revised 2015 forecast.

Figure 11: Auto Loan and Leases Portfolio (billions)



*Other includes United Insurance, Banco Cooperativo, Doral, Atlantic Capital, General Motors, Ford and W.C. Finance, Inc.

Figure 12: Auto Loan and Lease Origination ($US billions)

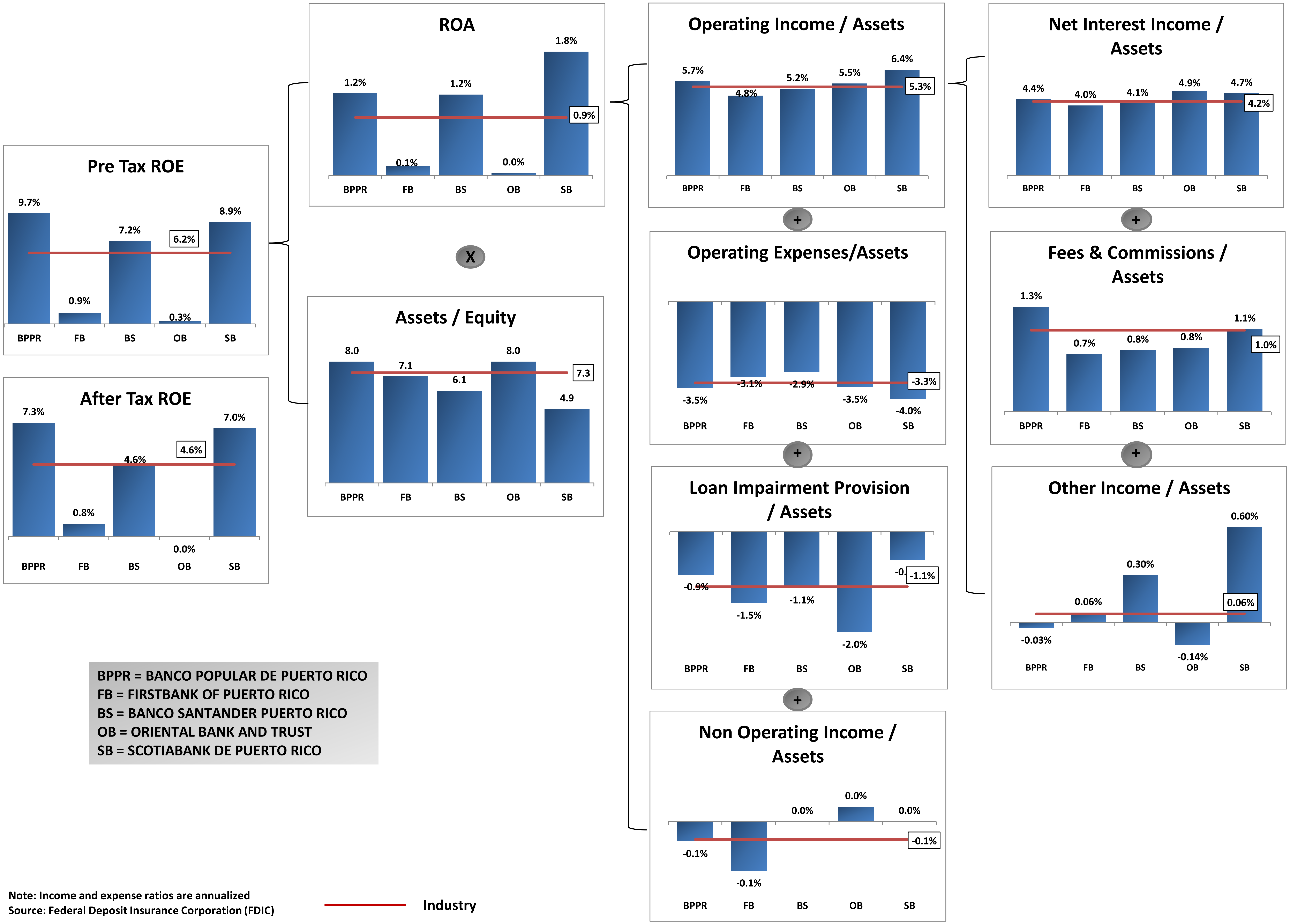


Source: Office of the Commissioner of Financial Institutions
* Q1 and Q2 2015 annualized.

In summary, the local banking industry has become largely acclimated to a challenging operating environment characterized by negative or sluggish growth, maintaining on a consolidated basis, positive Pre-Tax ROE figures. It should be noted that the government of Puerto Rico, which is entering a crucial phase in the negotiation of its debt, was able to meet the scheduled payment on Dec. 1, 2015 ($354 MM) and has an upcoming payment on Jan. 1, 2016 ($357 MM). Nonpayment would constitute its first default on debt guaranteed by the Commonwealth's Constitution. The need for banks to keep high provision expenses in anticipation of a potential deterioration in the overall economy and in government, will likely continue to cut into their returns. The rising delinquency ratios of most banks will surely prompt them to continue selling nonperforming and adversely classified assets.

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

ANNEX 1: BANKING INDUSTRY PROFITABILITY 2015



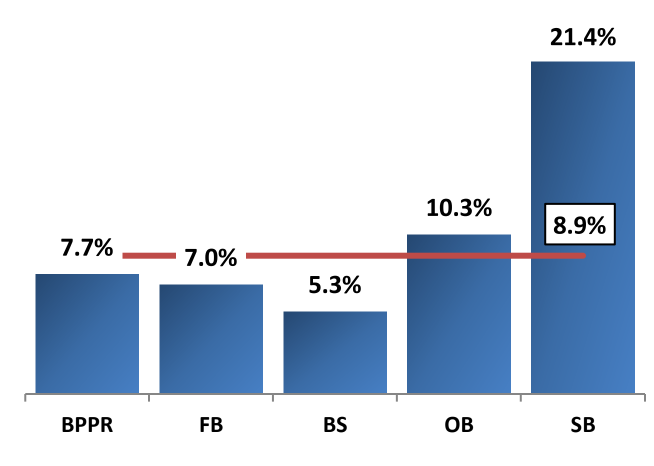
BPPR = BANCO POPULAR DE PUERTO RICO
FB = FIRSTBANK OF PUERTO RICO
BS = BANCO SANTANDER PUERTO RICO
OB = ORIENTAL BANK AND TRUST
SB = SCOTIABANK DE PUERTO RICO

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

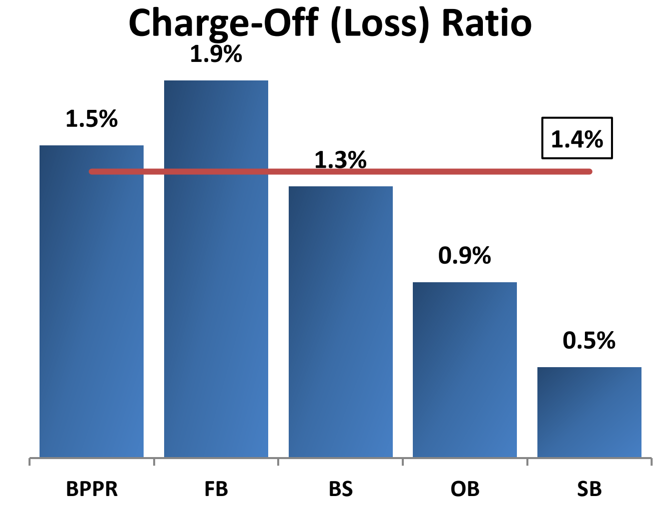
ANNEX 2: BANKING INDUSTRY PERFORMANCE RATIOS 2015

ASSET QUALITY

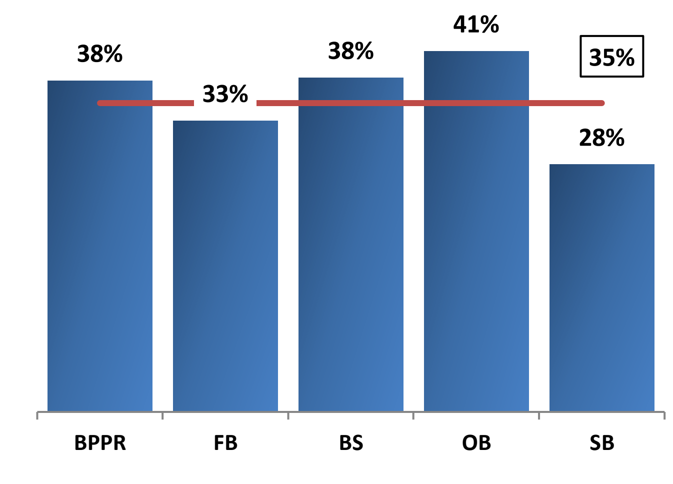
Nonperforming Loans Ratio



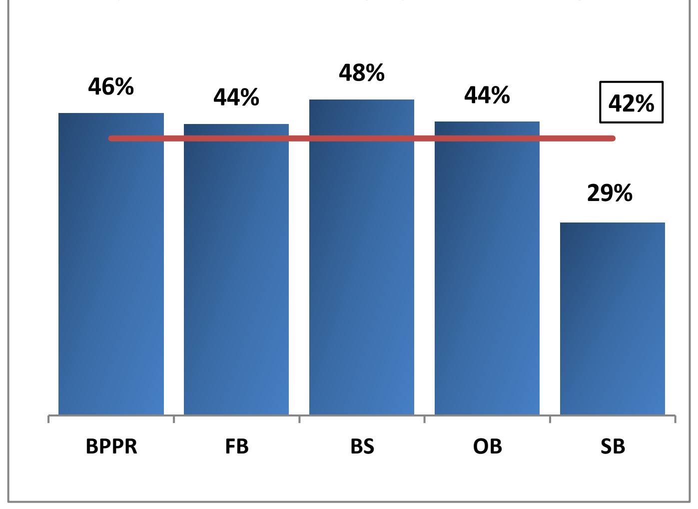
Charge-Off (Loss) Ratio



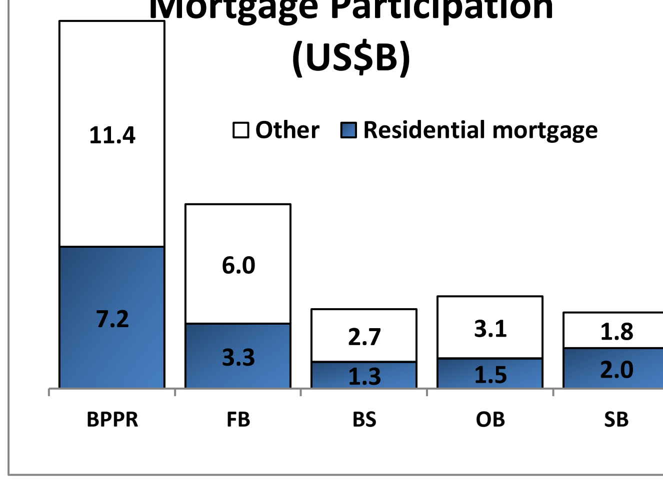
Reserve / NPL



(Reserve+NCO)/(NPL+NCO)

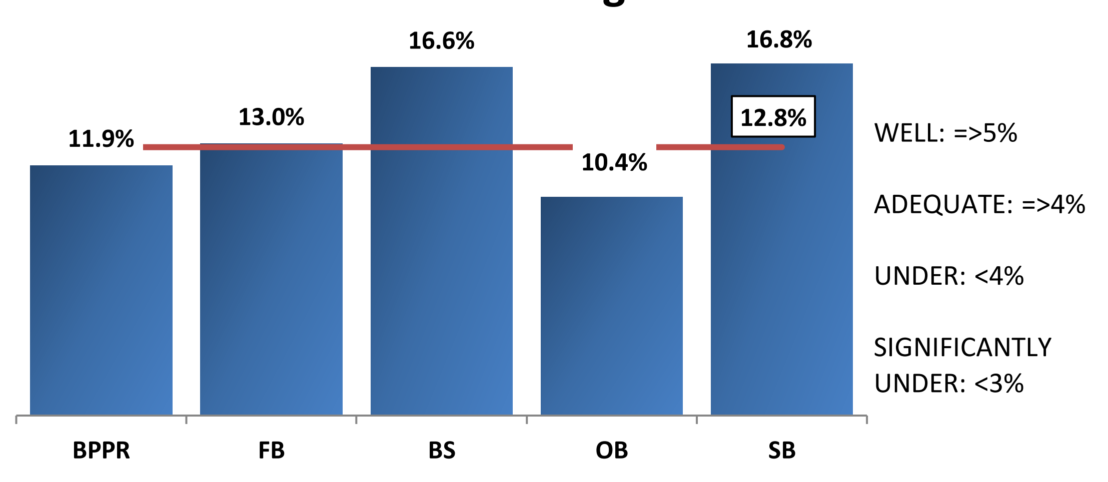


Total L&Ls & Residential Mortgage Participation (US$B)

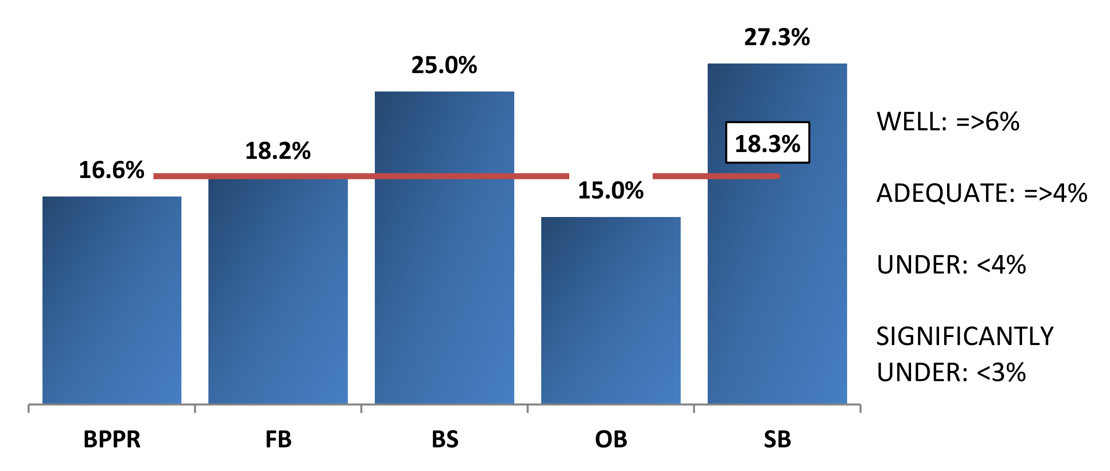


CAPITAL ADEQUACY

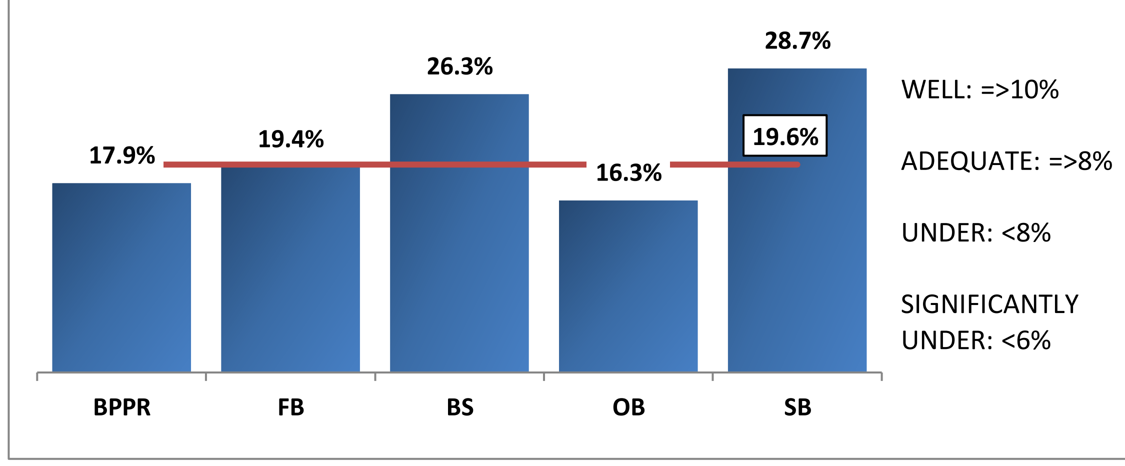
Tier 1 Leverage Ratio*



Tier 1 Risk-based Capital Ratio

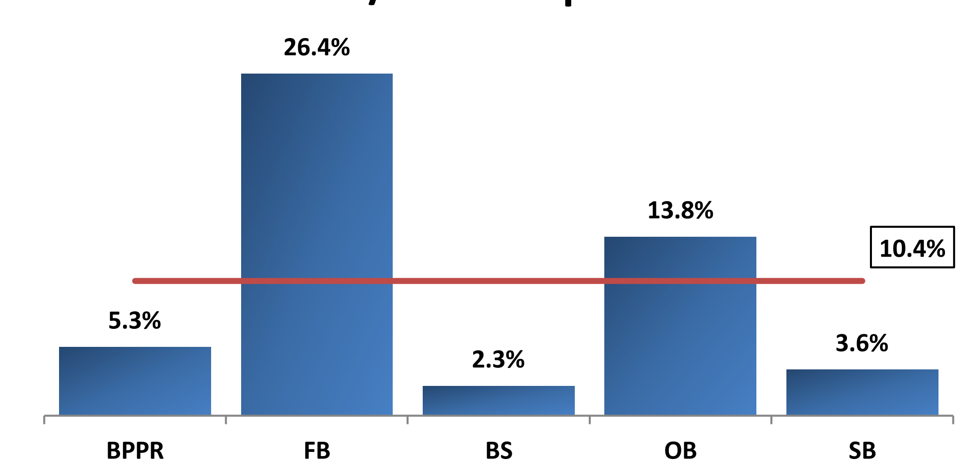


Total Risk-based Capital Ratio

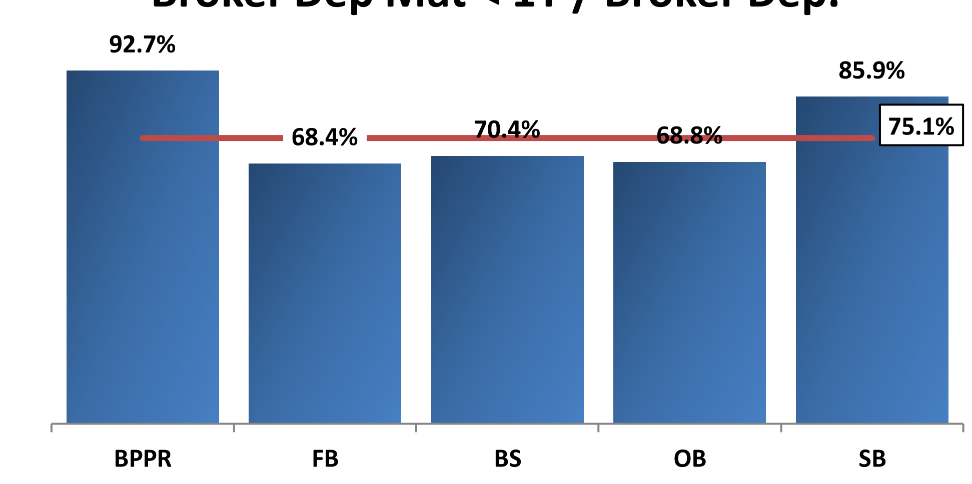


LIQUIDITY

Brokered / Total Deposits Ratio

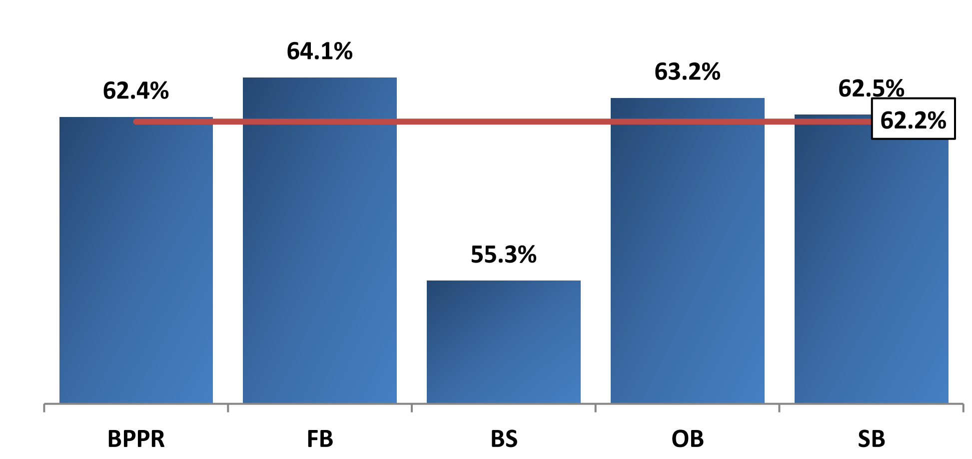


Broker Dep Mat < 1Y / Broker Dep.

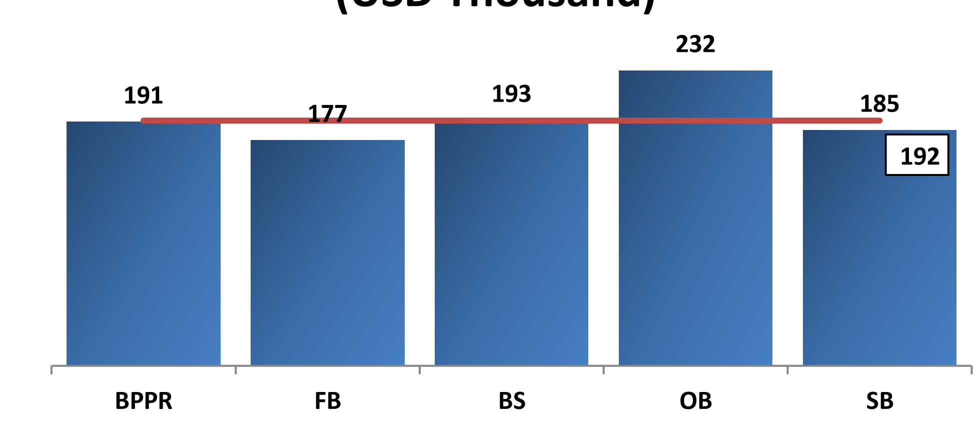


PRODUCTIVITY

Efficiency Ratio (Cost / Income)



Net Margin per Employee (USD Thousand)



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Industry

* Also referred to as Core Capital (leverage) Ratio by the FDIC

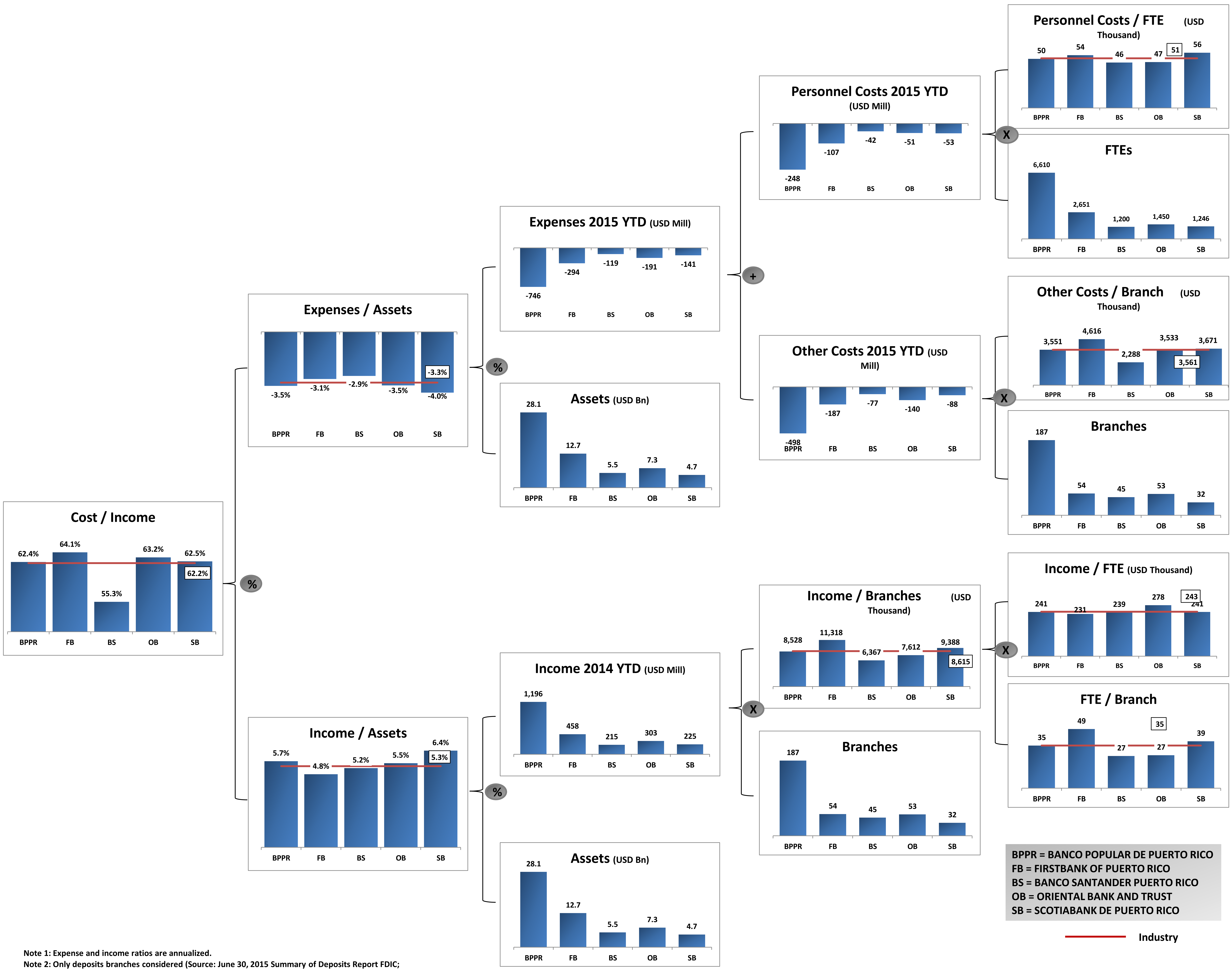
Notes:

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)

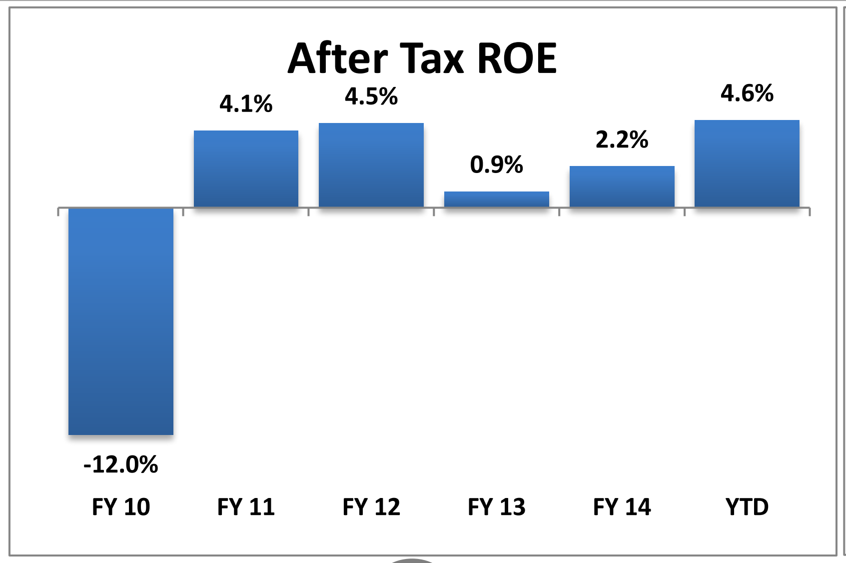
ANNEX 3: BANKING INDUSTRY PRODUCTIVITY 2015

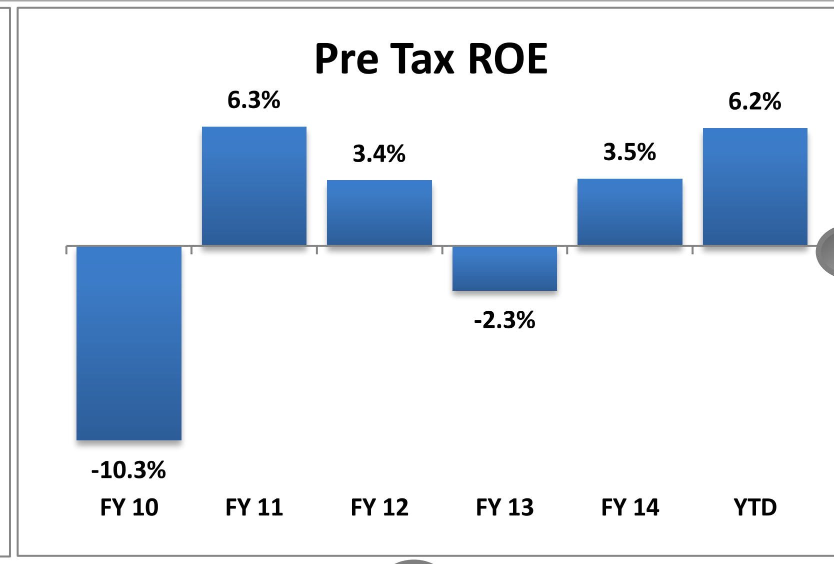


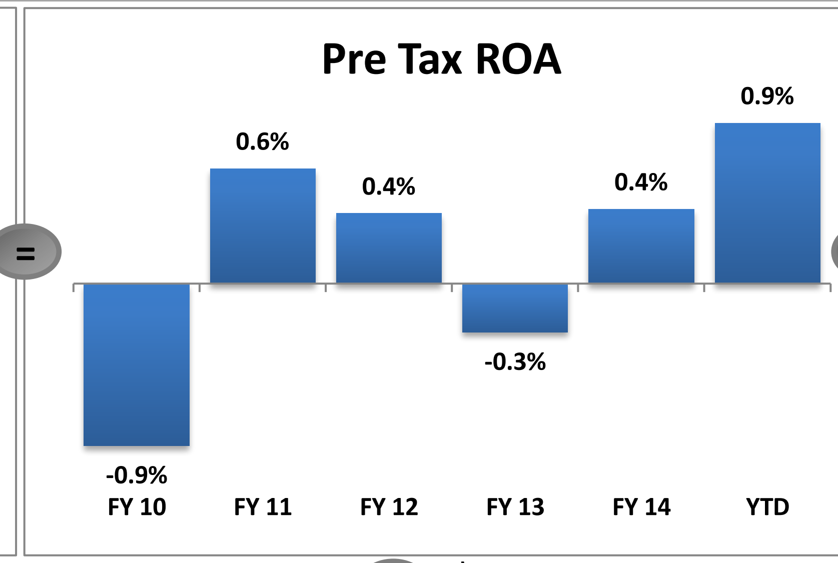
Note 1: Expense and income ratios are annualized.
Note 2: Only deposits branches considered (Source: June 30, 2015 Summary of Deposits Report FDIC; Service Type Codes included: 11, 12 and 23)

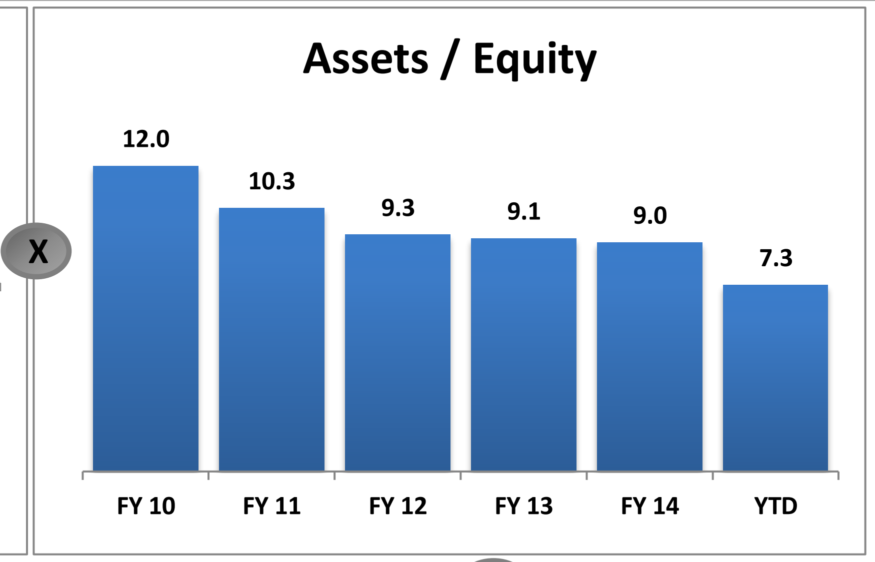
ANNEX 4: INDUSTRY TRENDS - SELECTED METRICS

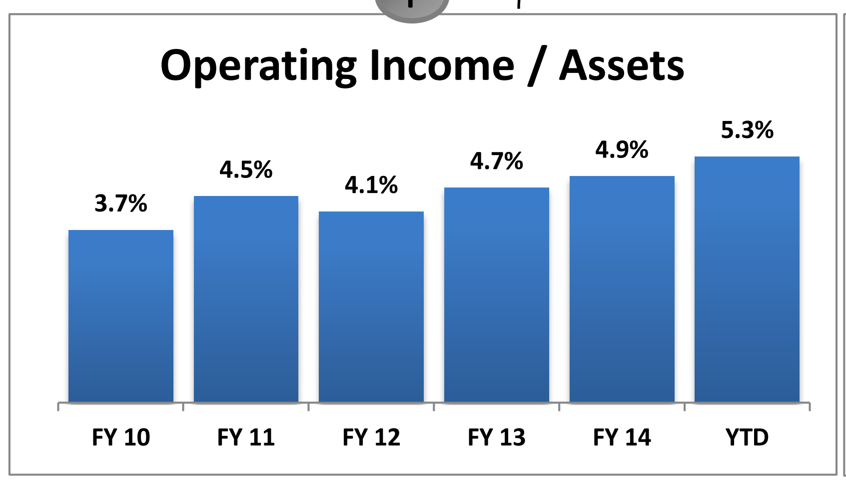
PROFITABILITY

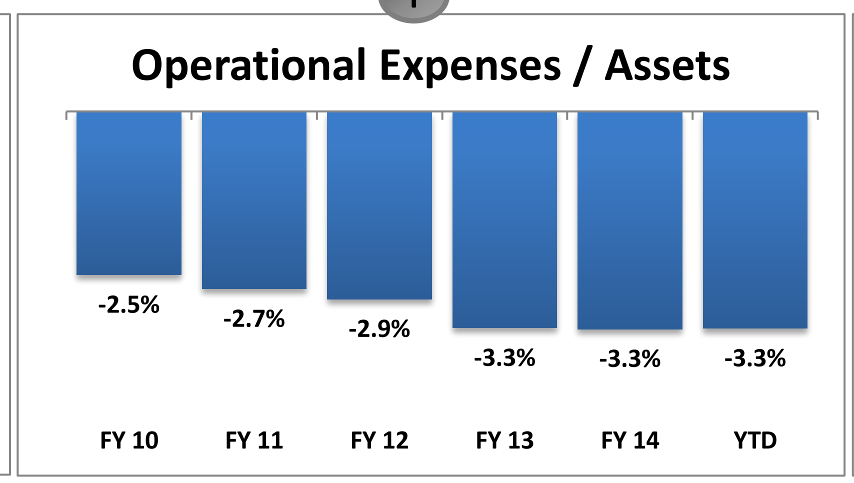


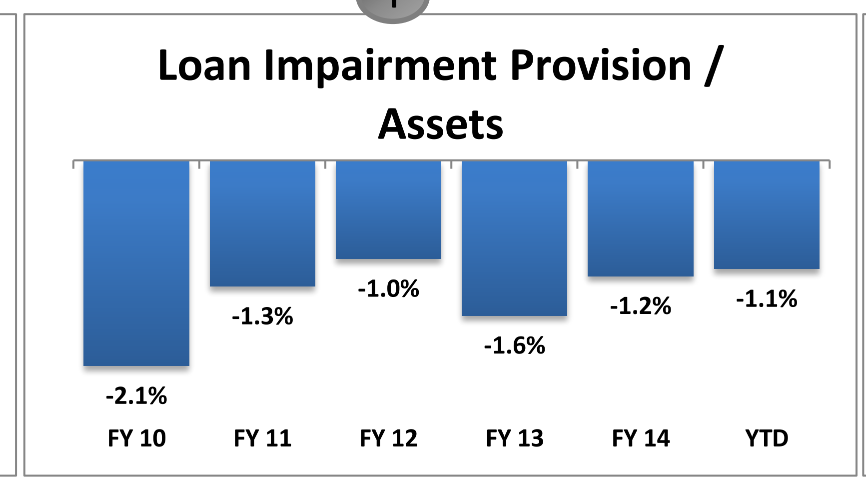


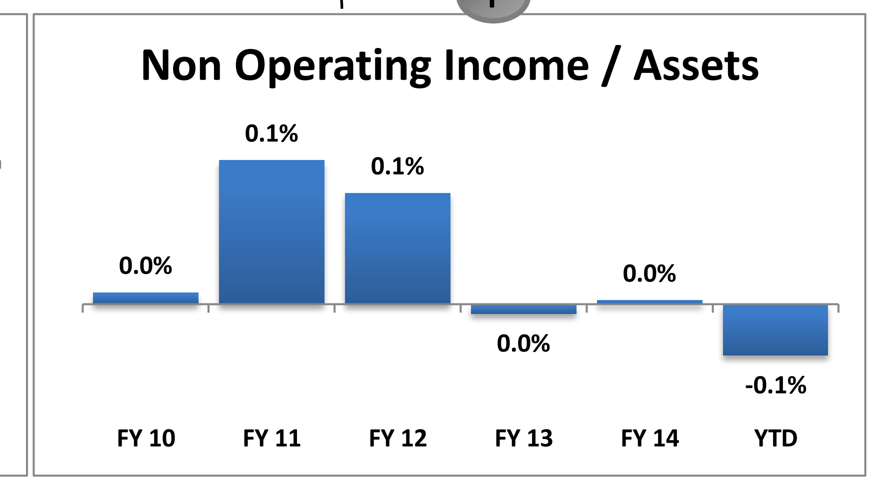




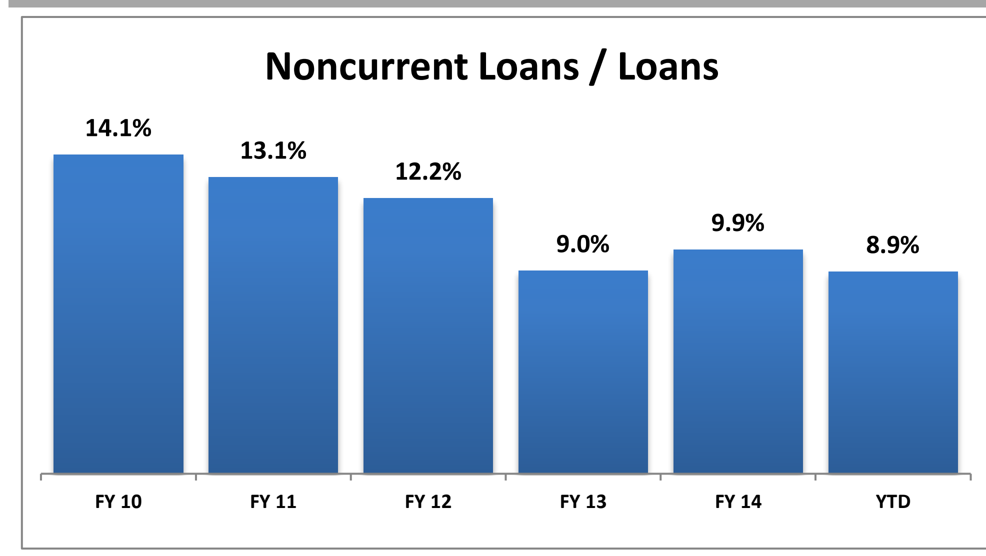


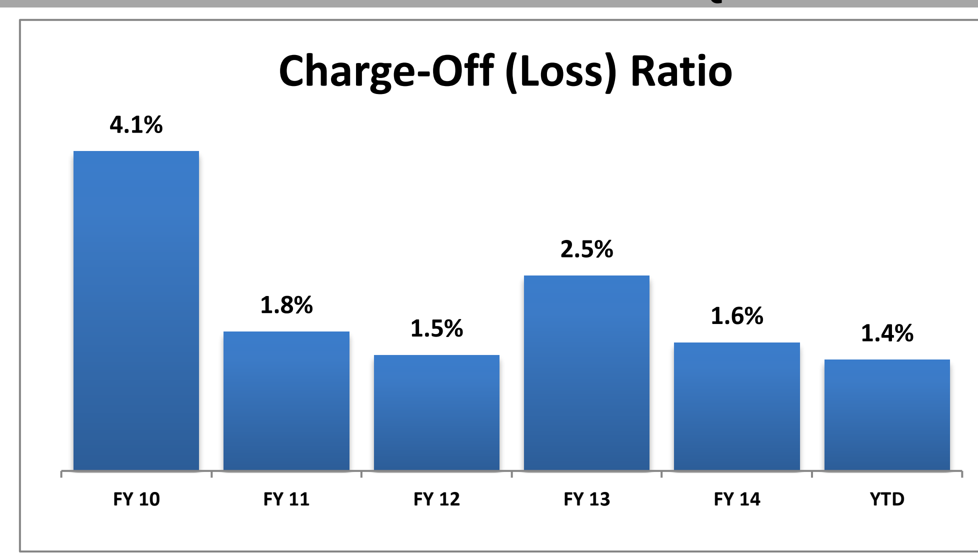


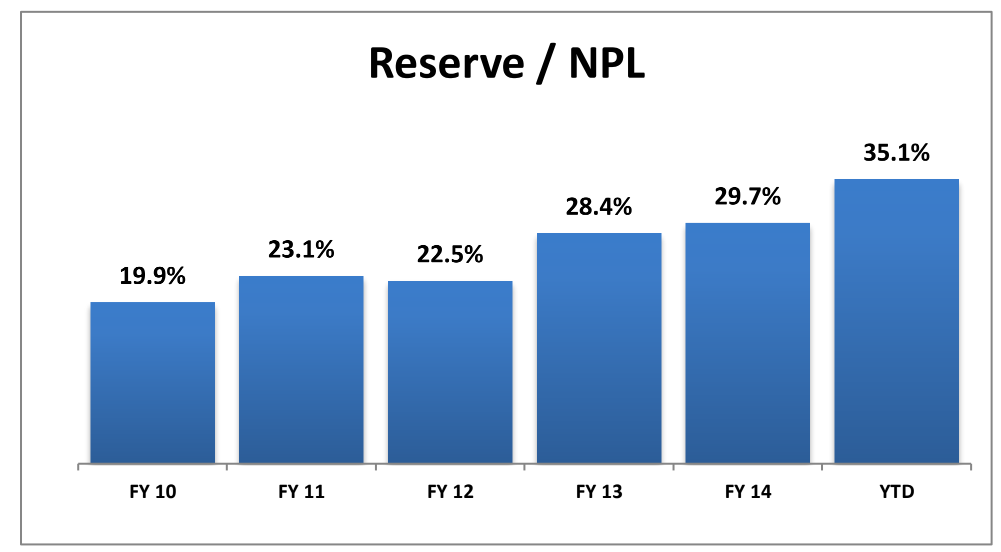


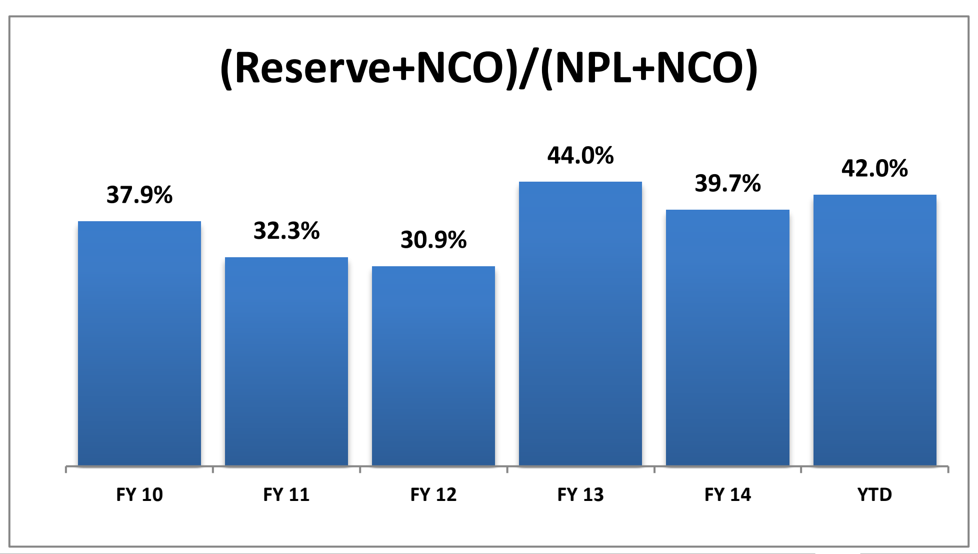


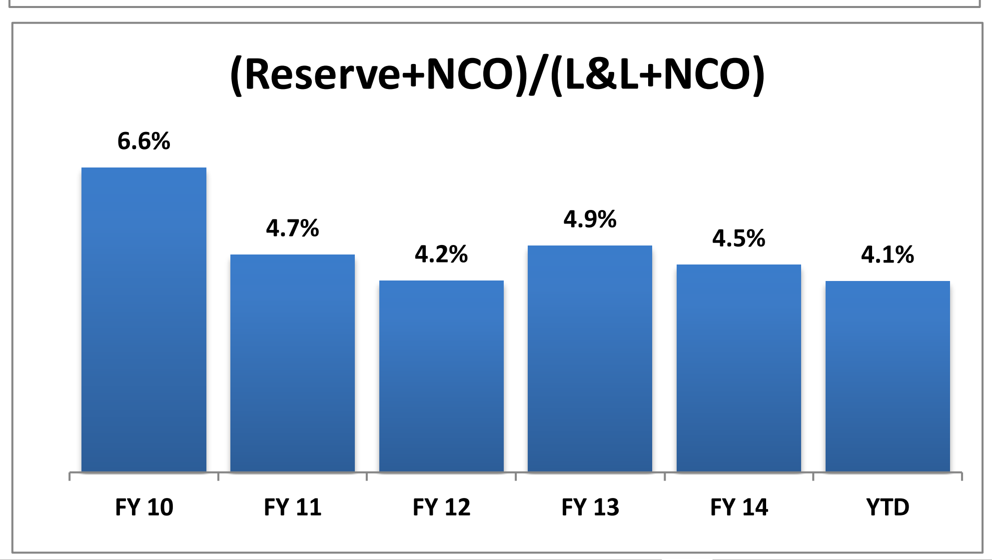
ASSET QUALITY





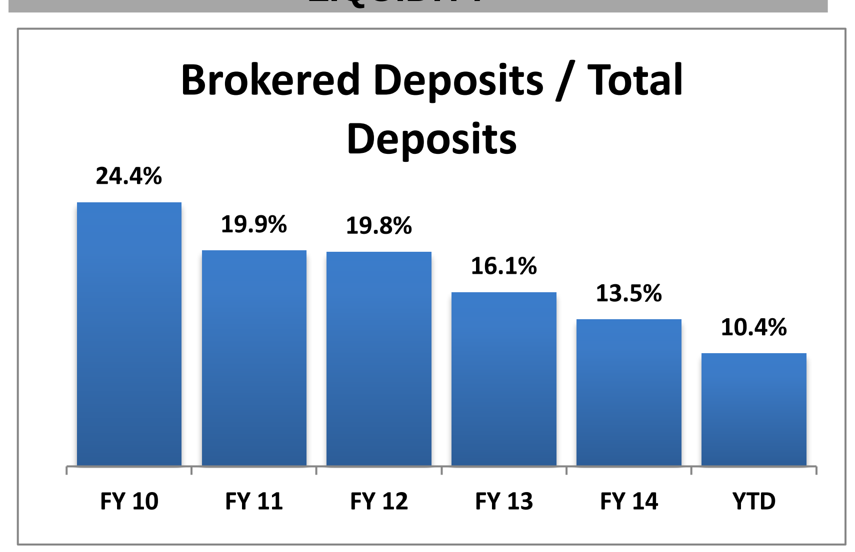




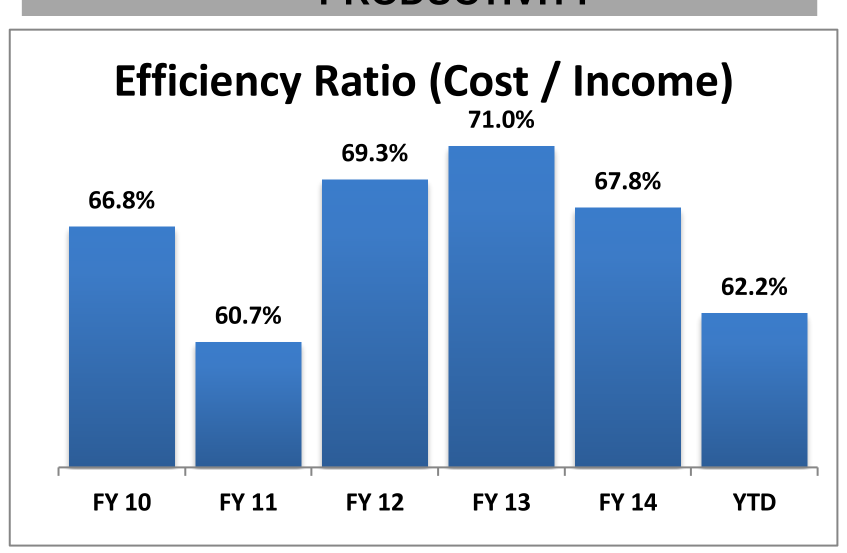


Notes:
Asset quality ratios are not adjusted for FDIC covered and available for sale portfolio.
YTD numbers are annualized.
Source: Federal Deposit Insurance Corporation (FDIC)

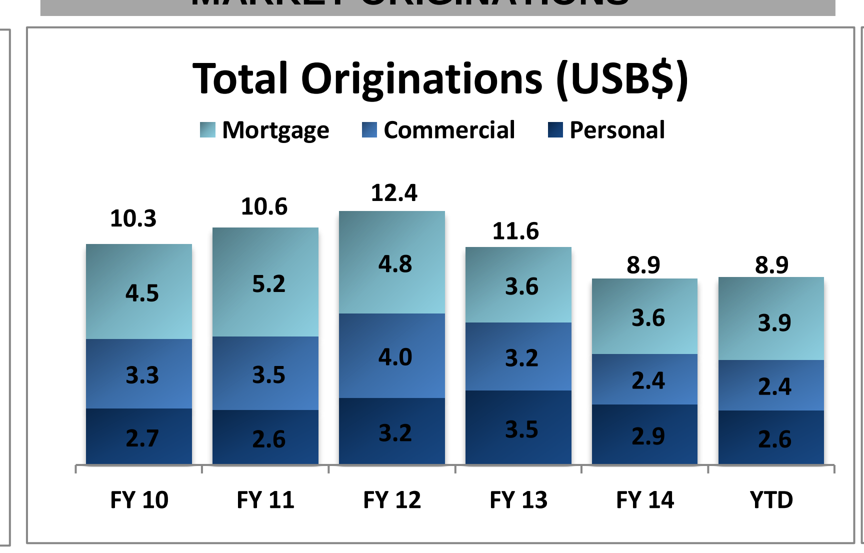
LIQUIDITY



PRODUCTIVITY



MARKET ORIGINATIONS



TOTAL ASSETS