V2A CONSULTING

DOCUMENTING THE SOCIOECONOMIC CONTRIBUTIONS OF PUERTO RICO'S BANKING SECTOR

Final Report

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AGENDA

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I. EXECUTIVE SUMMARY

The banking sector plays a crucial role in modern economies. Banks connect the individuals' and companies' need to deposit their savings in a secure manner (and earn some interest) with their need to finance their purchases, investments, and business opportunities. The importance of this financial intermediation is clearly reflected in the large employment and production multipliers of the local banking sector compared to most of the other economic sectors.

In the past 25 years, the Puerto Rico banking sector has gone through a deep transformation. The total number of banking institutions in 1995 was 21, compared to only 6 as of December 2019[1]. The banking sector has had to navigate a very challenging economic environment, with reductions of the Gross National Product (GNP) in 11 of the last 15 years, and recent external shocks such as Hurricane María and the COVID-19 pandemic. After a long period of adjustments, today banks in Puerto Rico show a solid financial position and performance, and are in a good position to continue funding economic activity despite the challenging environment.

Banks are not the only financial intermediaries that provide banking services in Puerto Rico. Based on the Office of the Commissioner of Financial Institutions of Puerto Rico (OCIF by its Spanish acronym), there are another 21 financial industry sectors (e.g. Credit Unions, Mortgage Institutions, International Banking Entities, Venture Capital Companies, Leasing Companies, Money Transmitters, Check Cashers) in Puerto Rico, and a total of 856 active business licenses registered with OCIF as of December 2019.

These market participants represent very active competitors for banks, particularly in the lending business. For example, local credit unions hold ~35% of the personal unsecured loan business in Puerto Rico, and together with Federal credit unions and auto financing companies they accumulate at least 30% of the auto loan outstanding balances. Additionally, Puerto Rico's residents have access to credit cards issued by US banks as well as non-lending products like Certificates of Deposit and deposit accounts in US Banks. Similarly, medium and large local businesses can finance their activities through syndicated loans that are participated by US banks.

Among all the financial sectors, local and mainland based, the local banking sector is the one that contributes the most to the local economy. The Puerto Rico banking sector employs 44% of the Finance and Insurance sector as reported by the Puerto Rico Department of Labor and Human Resources and has the second highest salary level among all major economic sectors. Additionally, it is by far the largest tax contributor, not only because of its size but also because other large financial sectors enjoy

[1] Banco Popular, FirstBank, Oriental Bank, Citibank, Banesco and Banco Cooperativo. Banco Santander is not included because its operations in Puerto Rico were recently acquired by FirstBank

significant tax exemptions, and those that provide products and services from the US do not pay taxes to the local Treasury.

Aside from its employment and tax contributions, the local banking sector has a very active participation in the development of low-and-medium income communities in Puerto Rico. In 2019, local banks provided more than $700M in loans to finance revitalization and stabilization projects, affordable housing, economic development, and community services activities. They also invested ~$218M in community development projects and provided $3.5M in philanthropic contributions in 2019.

Finally, the Puerto Rico banking institutions are also an important ally of the public sector when it comes to provide services to the Island's residents. Their physical and digital networks are leveraged by various public agencies and corporations to perform transactions like utilities payments or license renewals.

From a public policy perspective, there is no doubt that having a strong and dynamic banking sector that competes fairly against other financial sectors and outside entities, will contribute to fuel the economic activity. In the last section of the report, there are several recommendations for the local authorities to strengthen the banking sector and improve the banking and public services to Puerto Ricans. These can be summarized as follows: 1) Leverage the banking network further, 2) Streamline and digitalize public sector transactions and databases, 3) Do not overregulate a sector that is already very regulated, 4) Strengthen the financial sector reporting, 5) Encourage the participation of local banks in the public sector deposit needs, 6) Promote the bankarization of the Puerto Rico population.

II. INTRODUCTION

1. The Banking Sector's Key Role in Society

The banking sector plays a crucial role in modern economies. Banks connect the individuals' and companies' need to deposit their savings in a secure manner (and earn some interest) with their need to finance their purchases, investments, and business opportunities. This essential intermediary role explains the large spillover effect associated with the banking activities. As we will see in Section IV, the banking sector has some of the largest employment and production multipliers among Puerto Rico economic sectors, reflecting the magnitude of the aforementioned spillover effect.

Banks perform many other important financial services aside from the regular deposit and credit facilitation activities. For example, they process payments and funds transfers for individuals and businesses, provide investment advice, cash and process checks, exchange foreign currency, provide access to cash through tellers and ATMs, detect money laundering activities, and clear financial transactions, among other activities.

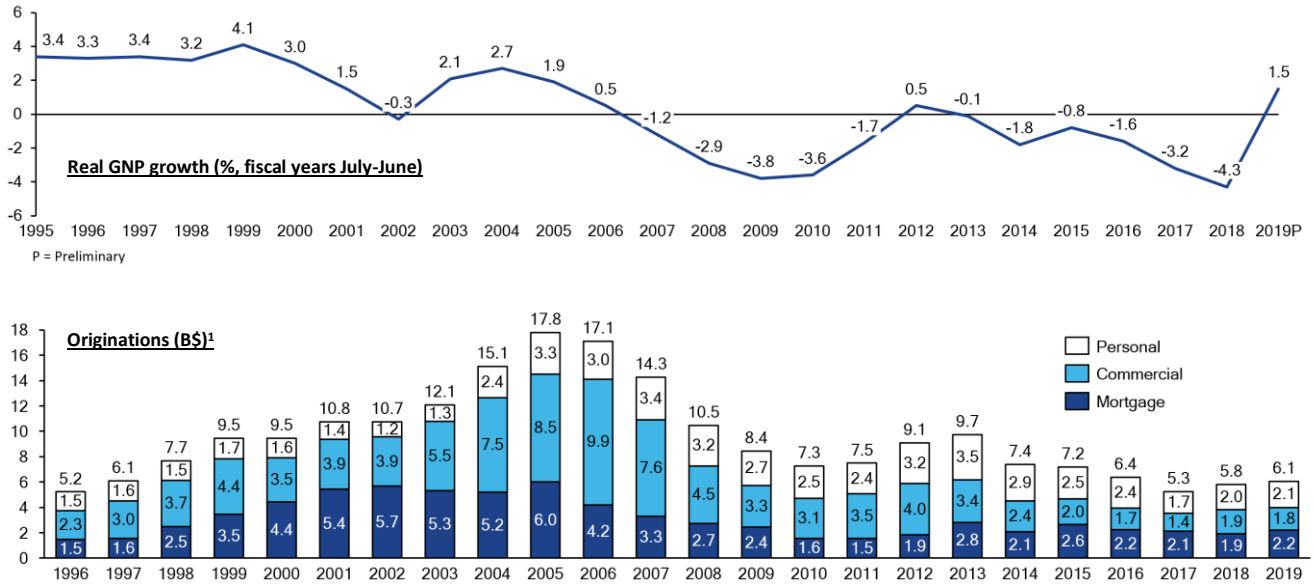
Additionally, banks perform multiple community development activities and philanthropic contributions that benefit low-and-middle income citizens as well as cultural and non-for-profit organizations in Puerto Rico. In Section IV, we will be sizing some of these activities and community contributions to understand their impact on the Puerto Rico economy and society in general.

2. The History of Puerto Rico's Banking Sector

The first banking institutions in Puerto Rico date back to the last years of the XIX Century with the establishment of banks like "Banco de Economías y Préstamos" (1881), "Banco Español de Puerto Rico" (1888), "Banco Popular de Puerto Rico" (1893), and "Banco de Crédito y Ahorro Ponceño" (1895). These and other institutions founded later, where key in providing financing to the Puerto Rico businesses during the industrialization of the local economy in the XIX and XX Centuries.

In the past 25 years, the Puerto Rico banking sector has gone through a deep transformation. The total number of banking institutions in 1995 was 21, compared to only 6 as of December 2019. The banking sector has had to navigate a very challenging economic environment, which is clearly reflected in the fact that the Gross National Product (GNP) of Puerto Rico has decreased in 11 of the last 15 years in real terms. In Figure 1 we can observe how the banking activity has mirrored that of the general economy, confirming the role of the banking sector as facilitator in channeling individual and institutional deposits towards business opportunities.

Figure 1: Real GNP growth and originations for period 1995-2020

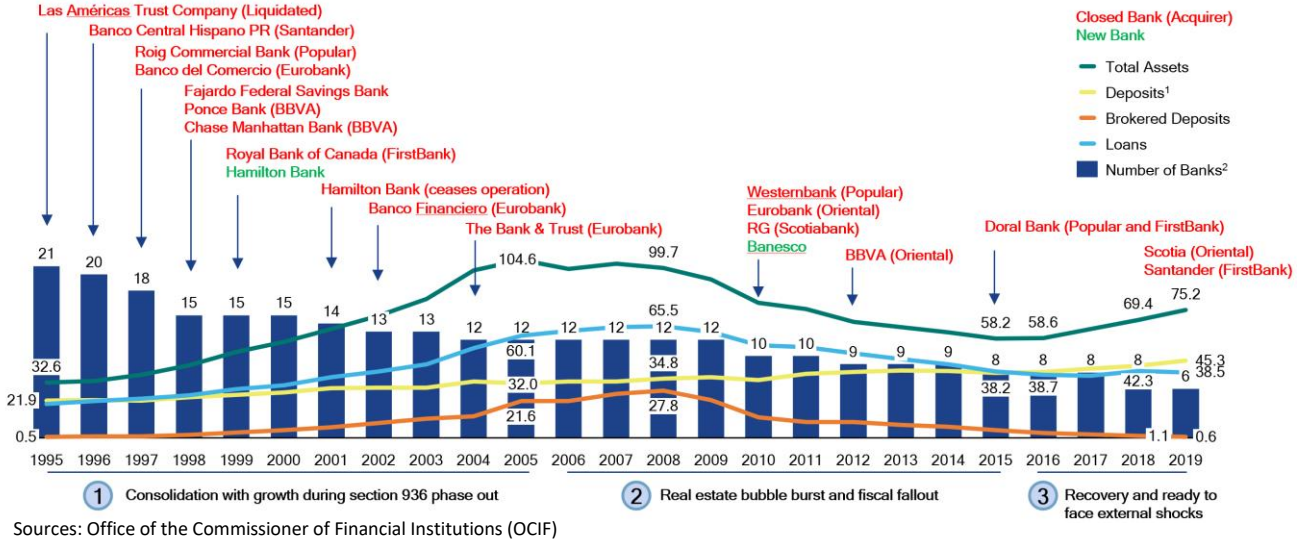


Sources: Office of the Commissioner of Financial Institutions (OCIF), PR Planning Board Notes: [1]Commercial and Mortgage originations for 1997 to 2000 have been estimated

To better understand the history of the banking sector in Puerto Rico we can divide the last 25 years in three shorter periods (see Figure 2):

- **Period 1 (1995-2005):** A period characterized by economic and banking assets growth despite the phase out and elimination of the 936 provision in Puerto Rico
- **Period 2 (2006-2015):** Collapse of the real estate market and fiscal crisis of the public sector impacting the profitability of banks, and causing the closing of several banks' operations
- **Period 3 (2016 until Today):** A restructured banking sector emerges with a much stronger position in terms of asset quality and capitalization, and ready to face various external shocks

Figure 2: Number of commercial banks, assets ($B), and deposits ($B) in Puerto Rico (1995-2019)



Sources: Office of the Commissioner of Financial Institutions (OCIF)

Notes: [1]Do not include brokered deposits nor PR Government deposits that are secured or collateralized as required under State law

[2]Assumed that B. Santander was already acquired by FirstBank in 2019, and treated Scotiabank and Bank of Nova Scotia as one institution

Period 1 (1995-2005)

Between 1995 and 2005 the total assets of the banking sector tripled, from $32.6B in 1995 to $104.6B in 2005 (see Figure 2). The increase was fueled by an economic bonanza, particularly between 1995 and 2000 when the GNP increased on average 3.4% annually. This period witnessed the acquisition of emblematic banks like Roig Commercial Bank and Ponce Bank by Banco Popular and BBVA, respectively. The total number of banks decreased from 22 in 1995 to 13 in 2006, in a consolidation wave that was driven by the need to capture additional market share under a growth environment.

The rapid increase of the banking assets was also the result of an intense real estate activity in the Island that was decoupled from supply and demand fundamentals. This activity generated a real estate bubble that would subsequently burst in 2006-2007. Mortgage originations from commercial banks peaked in 2005 with a total of $6.0B compared to $1.5B in 1996, and by 2007 they had already dropped to $3.3B (see Figure 1). Part of the mortgage loan originations translated into an increase in the banks' loan portfolios, although many loans were securitized and sold to investors in the secondary market.

Another important factor behind the banking activity increase during the 1995-2005 period was the expansion of investment portfolios. The economic growth of the 1990s and early 2000s carried an increase in disposable income. Some of that additional liquidity was invested by banks themselves or on behalf of their customers in equity and fixed income securities. The tax exemptions of the Puerto Rico government and municipal bonds played an important role in the steady increase of assets under management (AUM) of banking customers. Between 1995 and 2005, total AUM of commercial banks -managed through securities subsidiaries- increased from 0 to $10.5B and the banks' own investment portfolio increased from ~$9.7B to ~$34.3B (compounded annual growth rate of 13.5%).

In 1996 President Clinton signed legislation that phased out section 936 over a ten-year period, leaving it to be fully repealed at the beginning of 2006. Section 936, which gave mainland United States companies an exemption from Federal taxes on income earned in Puerto Rico, provided large amounts of deposits that mainland companies kept in local banks or reinvested in Puerto Rico. With the phase out of the 936 provision local banks increasingly relied on brokered deposits to finance their activities. As can be observed in Figure 2, total brokered deposits increased from $0.5B in 1995 to $21.6B in 2005 and $27.8B in 2008.

The mortgage and investment activities, and the overall economy, lost steam and entered a long recession in the subsequent period, driving yet another round of banking consolidation.

Period 2 (2006-2015)

The partial Government lockdown in May 2005 marks the beginning of a long economic downturn in Puerto Rico. The chronic public deficit and increasingly unsustainable debt levels had an impact on customer confidence and uncertainty spread to the business community. The real estate bubble burst

and the mortgage activity dropped abruptly. Individual consumption reduced significantly as a result of the lower customer confidence.

The lending activity suffered an important reduction with total originations decreasing from $17.8B in 2005 to $10.5B in 2008 and $7.5B in 2011. Similarly, mortgage originations reduced steadily year after year from $6B in 2005 to $1.5B in 2011 (74% reduction). The economic environment also impacted banks delinquency levels, with the non-performing loans ratio increasing from 1.74% in 2005 to 9.1% in 2008 and 13.1% in 2011. The global financial crisis that started at the end of 2007 took Puerto Rico in an already fragile state. This perfect storm, with rapidly falling house prices, lower lending activity, and increasing delinquency levels translated into substantial losses for several banks, particularly those with more exposure to the real estate market and weaker underwriting policies and processes.

In April of 2010, the Federal Deposit Insurance Corporation (FDIC) announced the acquisition of three banks, Westernbank, Eurobank and RG Premier, which had been operating under cease-and-desist orders, by Banco Popular, Oriental Bank and Scotiabank, respectively, through FDIC-assisted transactions. During this complex restructuring process, the role of the banking sector together with the local and Federal authorities was key in ensuring that customers did not lose their deposits, and that their services were not impacted by the closing of the troubled banks.

The banks that survived the prolonged economic and financial downturn did an outstanding job at cleaning their balance sheets from toxic assets and at increasing their capitalization levels. The non-performing loans ratio of the industry decreased from 13.1% in 2011 to 8.7% in 2015, and the Total Risk Based Capital Ratio reached ~20% in 2015, substantially above the well capitalized threshold.

The lower economic activity and the focus on loss mitigation translated into a steady decrease in banking assets in Puerto Rico, from a high of $104.6B in 2005 to a bottom of $58.2B in 2015. As we will see in the next section, 2016 became an inflection year in terms of banking assets and deposits growth.

Period 3 (2016-Today)

The lending and deposit activity started recovering in 2016 (see Figure 2). Total assets and deposits (excluding brokered and government) increased from $58.2B and $38.2B in 2015 to $75.2B and $45.3B in 2019, respectively. The increase in total assets was driven by a combination of inorganic growth (e.g. the acquisition of Reliable Auto by Banco Popular) and higher originations. Total originations increased from $5.3B in 2017 to $6.1B in 2019 (see Figure 1) driven by both consumer and commercial lending as local households and businesses reduced their debt and increased their consumption and investment levels.

Banks have continued to strengthen their capital position and asset quality in the past years, and they have also become more efficient and increased their digitalization levels. It is no surprise that banks were able to face unprecedented external shocks like Hurricane María in 2017, the multiple tremors

in the beginning of 2020, and the recent COVID-19 pandemic. During Hurricane María banks were able to reopen their operations within days after the natural events, and were instrumental in facilitating cash to individuals during the weeks that followed the hurricane.

After Hurricane María and during the COVID-19 pandemic local banks have put into place loan moratoriums to ease the difficulties experienced by their customers. They have also channeled the Paycheck Protection Program (PPP) to provide liquidity to local businesses during the COVID-19 pandemic. More than 30% of mortgage and consumer loan holders applied for a moratorium in Puerto Rico after the COVID-19 pandemic. Additionally, nearly 2,000 loans between $150,000 and $1 billion and nearly 36,000 loans of less than $150,000 were guaranteed through the PPP to protect ~197k jobs combined. After Hurricane María, a total of ~980k moratoriums were approved which represented approximately $22.6 billion.

III. HIGHLIGHTS OF THE PUERTO RICO'S FINANCIAL SECTOR

1. Industry Overview

Banks provide a large spectrum of services to local residents, from securing and managing their deposits to extending credit through credit cards, auto loans or mortgage loans. However, they are not the only institutions in Puerto Rico that perform these types of services. For example, local credit unions have savings and checking accounts, and CDs available for their members, as well as personal loans and credit card products. Likewise, Auto Financing Institutions like Toyota Credit de Puerto Rico Corporation and BMW Financial Services offer credit facilities to their customers to finance their car purchases. All these institutions and others compete with local commercial banks in one way or another and are part of a broader financial industry.

The Office of the Commissioner of Financial Institutions of Puerto Rico (OCIF by its Spanish acronym) groups all these institutions in 22 financial industry sectors (see Figure 3), one of which is the Commercial Banks sector. Just to mention a few, these sectors include Puerto Rico Credit Unions, Mortgage Institutions, Pawn Shops, International Banking Entities, Venture Capital Companies, Leasing Companies, Money Transmitters and Check Cashers. In total, there were 856 active licenses registered with OCIF as of December 2019. That is a good proxy of the universe of institutions that comprise the financial industry.

Not all institutions are required to submit quarterly data to the OCIF online system. That explains why the available aggregated data for the financial industry in Puerto Rico is not complete. However, as can be observed in Figure 3 most financial industry sectors that provide similar services to commercial banks (Credit Unions, Securities Brokers, Mortgage Institutions, Small Loans Companies, Leasing Companies, Finance Companies and International Banking Entities), are included in OCIF's statistics.

Figure 3: Financial industry sectors (December 2019)

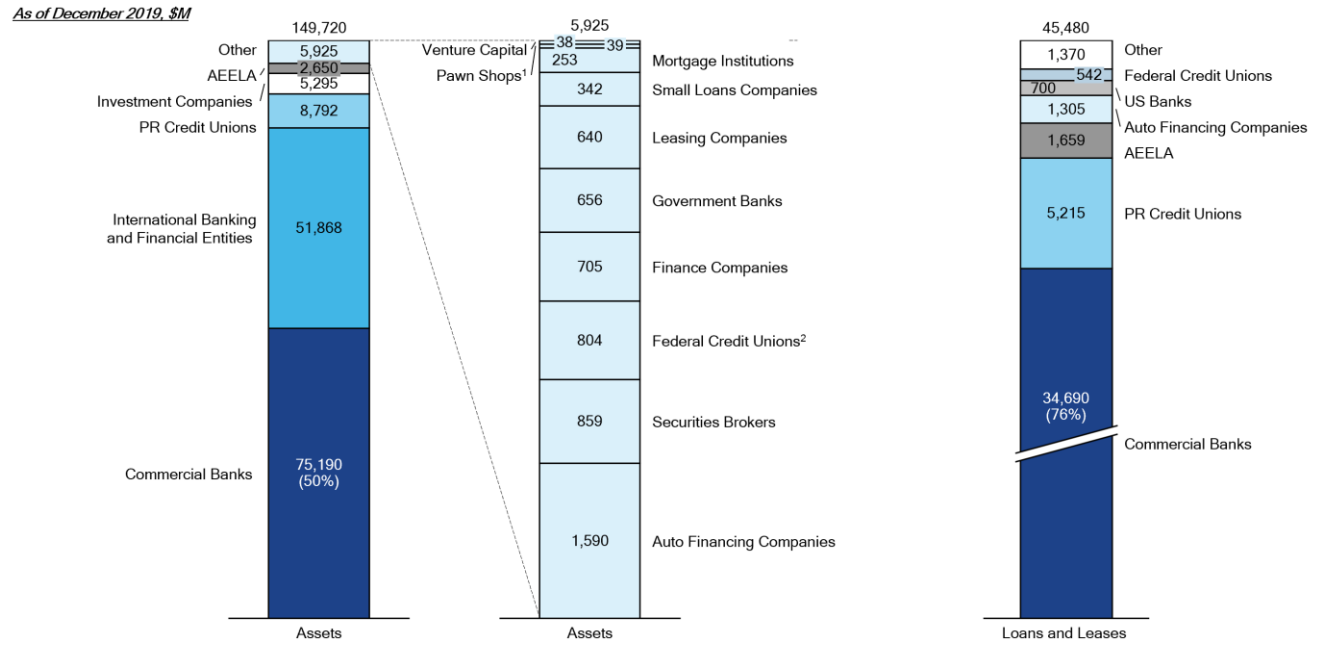
Financial Industry Sectors	Licenses	Data available in OCIF?
PR Credit Unions	114	Yes - Quarterly
Mortgage Institutions	93	
Pawn Shops	79	
International Financial Entities[1]	51	
Securities Brokers	48	
Investment Companies[1]	43	
International Banks Entities[1]	28	
Federal Credit Unions	7	
Small Loans Companies	7	
Commercial Banks	6	
Venture Capital[1]	2	
Government Banks	2	
AEELA	1	
Leasing Companies[2]	75	Institutions with >$1M in L&L balances - Quarterly
Finance Companies[2]	68	
Money Transmitters	69	No
Investment Advisors	60	
Financial Intermediaries	41	
Check Cashers	40	
Casinos	16	
Trust Companies	2	
Non-Profit Organizations	2	
Total	**854**	

Sources: Office of the Commissioner of Financial Institutions (OCIF)

Notes: [1]By Law OCIF is not allowed to provide data by institution [2]Auto Financing licenses are included in Finance and Leasing Companies

In Figure 4 we can observe how the financial industry assets in Puerto Rico were ~150B as of December 2019 (excluding the aforementioned sectors that do not report their numbers quarterly). Local commercial banks manage half of those assets ($75B), followed by International Banking and Financial Entities (IBEs and IFEs, ~$52B). Puerto Rico Credit Unions represent the third largest financial sector in terms of total assets (~$8.8B), followed by Investment Companies (~$5.3B), and the "Asociación de Empleados del Estado Libre Asociado" (AEELA, ~$2.7B). The "Other" category included in Figure 4 includes the following sectors: Auto Financing Companies (excluding Popular Auto, ~$1.6B), Securities Brokers (including the securities businesses of Commercial Banks, $859M), Federal Credit Unions (excluding PenFed, $804M), Finance Companies ($705M), Government Banks ($656M), Leasing Companies ($640M), Small Loans Companies ($342M), Mortgage Institutions ($253M), Pawn Shops (including title loans companies, $39M), and Venture Capital Companies ($38M).

Figure 4: Total assets and loan & lease balances by financial industry sector



Sources: Office of the Commissioner of Financial Institutions (OCIF)

Notes: [1]Includes Title Loans Companies [2]Data is as of Dec. 2018 and does not include PenFed

However, the impact on the day to day life of civilians and on the local economy varies substantially across financial sectors. As can be observed in Figure 5, Commercial Banks are the only financial entities that provide a full range of financial products and services to their customers. On the other hand, sectors like the PR Credit Unions or AEELA, provide lending and deposit products to their customers but, in general, do not provide other products and services like brokerage accounts and financial advisory. Similarly, some financial sectors specialize in specific lending products and do not offer other products and services. This is the case of Mortgage Institutions and Leasing Companies. Finally, while Commercial Banks located in the US may offer a wide range of financial services, most people rely on local banks given their proximity and their physical network.

As a consequence, the number of customers that Puerto Rico Commercial Banks serve is much higher than any other financial sector. Approximately 2M citizens benefit from the local banks products and services, twice the number of PR Credit Unions members, which is the second largest financial sector in terms of customers. It is important to mention that, while IBEs and IFEs represent the second largest financial sector in terms of assets managed, their focus is on serving non-residents, which makes their impact on the Puerto Rico society and economy much lower.

Unlike many other financial sectors, Commercial Banks also serve private and public businesses, including small and middle companies, and large corporations. It is no surprise that they employ the largest workforce among financial institutions with approximately 13.7k employees as of December 2019.

Finally, it is important to highlight the large tax contribution of Commercial Banks with operations in Puerto Rico. Several large financial sectors like the IBEs and IFEs, the local Credit Unions, and AEELA are exempt from income and other tax contributions. Puerto Rico Commercial Banks generate approximately 90% of the financial industry income tax contributions. While US commercial banks may have banking products and services available to Puerto Rico residents, they do not have operations in Puerto Rico and, consequently, do not contribute to the local economy in terms of employment and taxes.

Figure 5: Selected metrics to compare financial industry sectors

Financial Sector[1]	Range of services provided to PR residents*	Focus of PR operations		Customer Type in PR		Employment in PR (Dec. 2019)	Income Taxes in PR (2019)
		PR Residents	Outside Residents	Individuals	Businesses		
PR Commercial Banks	FULL	V (~2M)		V	V	~13,735	~$96.1M
IBEs and IFEs	NONE		V	V		~900	Exempt
PR Credit Unions	LIMITED	V (~1M)		V	V	~2,943	Exempt
AEELA	LIMITED	V (~200k)		V		~400	Exempt
Auto Financing	VERY LIMITED	V		V		~768[2]	~$5.7M[2]
Securities Brokers	VERY LIMITED	V		V		Not Available	Not Available
Federal Credit Unions	LIMITED	V		V		Not Available	Not Available
Finance Companies	VERY LIMITED	V		V	V	~1,149	~$5.4M
Leasing Companies	VERY LIMITED	V		V	V	~1,124[2]	~$6.4M[2]
Small Loans Companies	VERY LIMITED	V		V		~672	~$0.0M
Mortgage Institutions	VERY LIMITED	V		V		~577	~$3.2M
Commercial Banks in US	FULL	Not Applicable	Not Applicable	V	V	0	0

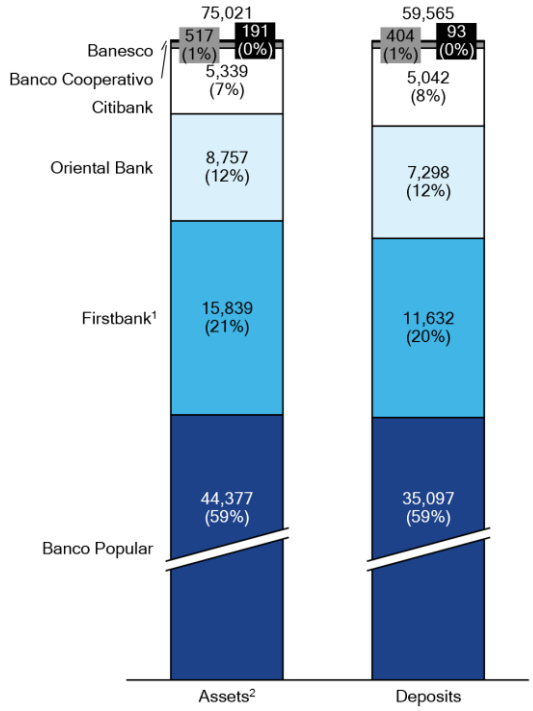
***FULL**: Lending and deposit products and services, transactional services like wire transfers and ACH, financial advisory services and asset management, trust services, insurance products
***LIMITED**: Only lending and deposit products and services
***VERY LIMITED**: All other cases

Sources: OCIF, banks, financial sectors' websites
Notes: [1]Investment Companies, Government Banks, Venture Capital Companies and Pawn Shops have been excluded [2]Popular Auto is included

Puerto Rico Commercial Banks: Main Players and Recent Trends

As of December 2019, there were six commercial banking institutions active in Puerto Rico (excluding Bank of Nova Scotia). Figure 6 details the total banking assets and deposits in Puerto Rico by banking entity at the end of 2019. Banco Popular had a market share of 59% in both assets and deposits, followed by FirstBank, Oriental Bank, and Citibank which together held 40% of the banking assets and deposits. Banco Cooperativo and Banesco have a smaller business in Puerto Rico than the rest of the banks.

Figure 6: Assets and deposits in Puerto Rico by commercial bank ($M, December 2019)



Sources: Office of the Commissioner of Financial Institutions (OCIF)
Notes: [1]FirstBank's numbers include Banco Santander; [2]As of Dec. 2019 there were ~$170M in assets under Bank of Nova Scotia that have been excluded

As mentioned in the introduction, the year 2016 represented an inflection year for the commercial banks sector in terms of growth. Since then, both total assets and total deposits have shown strong growth, with assets increasing by 28.3% between 2016 and 2019, and deposits growing by 17.0% during that period of time (see Figure 7). The loan portfolio also increased but moderately (4.2% between 2016 and 2019) thanks to both organic and inorganic sources. Loan originations, particularly consumer and commercial, increased moderately in 2018 and 2019 after reaching bottom in 2017. Banks also increased inorganically through acquisitions like Banco Popular's purchase of the Reliable Auto operations.

Given the nature of part of the additional deposits and the still precarious economic environment, the growth in deposits was also channeled to investments of various types on the asset side. The securities portfolio of banks more than doubled between 2016 and 2019.

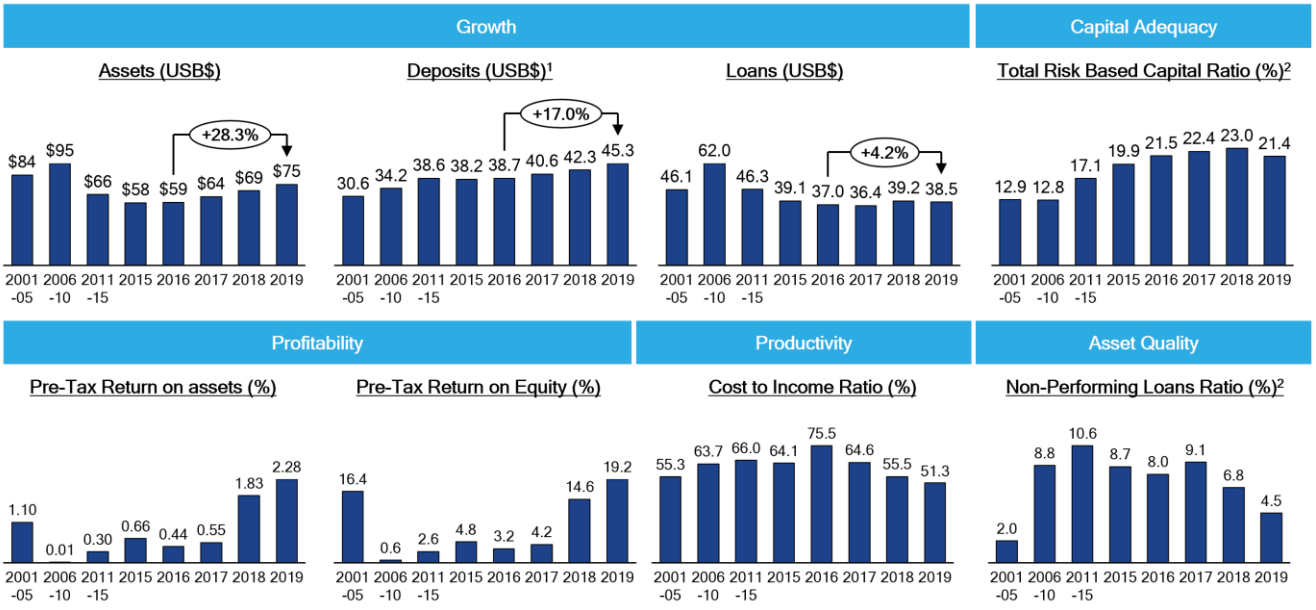
The increase in deposits shown in Figure 7 does not consider brokered deposits nor large government funds that are deposited in commercial banks. Government deposits, which require collateralization, have increased substantially in the past years (from $1.5B in 2015 to $13.7B in 2019). The higher non-brokered and non-government deposits reflect the increase in available funds after many years of economic difficulties in which individuals and companies improved their financial position and reduced their debt levels. It is also the result of large inflows coming from the Federal government and insurance companies to finance the recovery and reconstruction efforts after Hurricane María.

Banks have also worked intensely to reduce their exposure to non-performing assets, which is clearly reflected in the decrease of the Non-Performing Loans Ratio from an average of 10.6% in the 2011-15 period to 4.5% in 2019. They have also embarked in a digitalization journey that has provided new digital tools and products to banking customers, and also reduced lead times in key banking processes like loan originations or account openings.

Both the credit risk reduction and the digitalization efforts have translated into an increase in profitability with the Pre-tax Return on Equity increasing from 2.6% on average in the 2011-15 period to 14.6% in 2018 and 19.2% in 2019. However, delinquency levels are still higher in Puerto Rico than in the US and, despite a timid economic recovery in 2019, the COVID-19 pandemic is having an important negative impact on consumer and business confidence. As a result, the banking sector will have to continue navigating a challenging economic environment in the near future, and that may have an impact on profitability that is still uncertain.

Finally, commercial banks have reached historically high capitalization levels in recent years. As can be observed in Figure 7, the Total Risk Based Capital Ratio has increased from an average of 12.8% in the 2006-10 period to 23.0% in 2018 and 21.4% in 2019. Other capital adequacy ratios like the Tier 1 Leverage Ratio and the Tier 1 Risk Based Capital Ratio have shown similar trends. This capitalization level puts the banking sector in a very strong position to face uncertain times like the aftermath of Hurricane María or the current COVID-19 pandemic period.

Figure 7: Banking sector trends in selected metrics



Sources: Office of the Commissioner of Financial Institutions (OCIF), Federal Deposit Insurance Corporation (FDIC)

Notes: [1]Do not include brokered deposits nor PR Gov. deposits that are collateralized as required under State law

[2]Based on FDIC data which does not include Citibank, Banesco and Banco Cooperativo

International Banking and Financial Entities (IBEs and IFEs)

There is a total of 28 IBEs and 51 IFEs operating in Puerto Rico. Since the 1980s, legislation has been enacted (Act 16-1980; Act 52-1989; Act 121-1996; Act 273-2012) that provides attractive tax incentives and a favorable regulatory environment to incentivize the establishment and growth of these entities in the Island.

IBEs and IFEs are authorized by the OCIF to engage in offshore financial activities in Puerto Rico and provide financial services mostly to non-residents. Like all US-based financial entities, they are required to file reports of suspicious financial activities and assist government agencies investigate potential money laundering activities. However, these entities do not report information about non-US individuals if the assets are held in offshore companies or trusts, providing considerable discretion and protection for foreign individual investors.

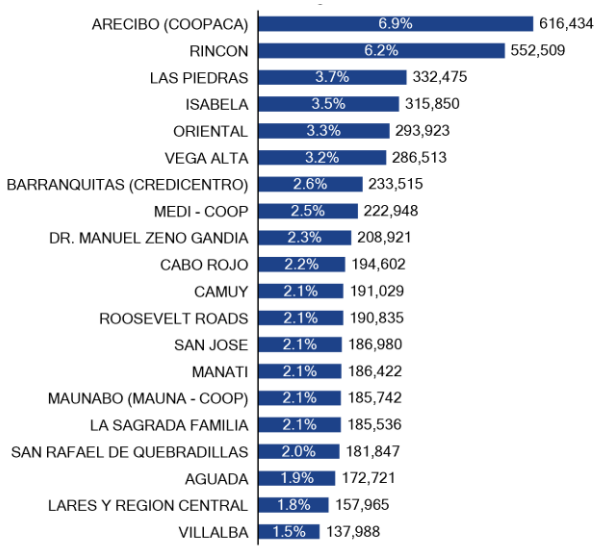
Based on a report published in Q1 2018 by V2A, 35% of IBEs had strong ties to Latin America, particularly with Venezuela, including Activo International Bank, AndCapital Bank International, Arca International Bank, Banco San Juan Internacional, Bancredito Inter-national Bank, BNC International, Facebank International, and Nodus International Bank. Bancolombia Puerto Rico Internacional, Inc., incorporated in 1997, operates as a subsidiary of the Colombian bank Bancolombia. However, the majority of licensed IBEs (i.e. 59% in Q1 2018) operate as subsidiaries or have strong ties with US-based and local entities. Some, including Majis International and UBS Overseas of Puerto Rico, have affiliations with Europe-headquartered firms.

IBEs and IFEs provide employment to island habitants but their impact on the local economy is limited because most of their customers are located outside of Puerto Rico. Additionally, they do not pay taxes to the Puerto Rico Treasury and CRIM, and their operations are subject to relocation if they find other jurisdictions with even better fiscal concessions and favorable legal systems.

Puerto Rico Credit Unions

Local credit unions represent the third financial industry sector in terms of total assets ($8.8B). Based on OCIF data, there are 114 active Credit Union licenses in Puerto Rico, which reflect the geographic and fragmented nature of this sector. This financial sector is much less concentrated than the commercial banking and other financial industry sectors. Nonetheless, the 20 largest credit unions accumulate approximately $5,035M in assets, representing 56% of the total credit unions' assets (see Figure 8).

Figure 8: Largest 20 credit unions in Puerto Rico ('000, December 2019)[1]



Sources: Office of the Commissioner of Financial Institutions (OCIF) Notes: [1]Percentage is based on the total PR credit unions' assets, not just the top 20

The cooperative system plays an important role in providing deposit and credit facilities to local people. With approximately 1M cooperative members, local credit unions mostly serve low to middle income populations, and they are very active outside San Juan and other large municipalities. However, some local credit unions have a large exposure to Puerto Rico Government bonds and other instrumentalities, and there is concern about the financial viability of some of them. Based on the latest COSSEC fiscal plan submitted to the Federal Oversight and Management Board on June 29th 2020, COSSEC is expected to identify and address currently insolvent and undercapitalized credit unions within the next 24 months. Consequently, there could be some consolidation in that sector in the coming years and other financial industry players could also see the opportunity to fill any service gaps arising during that process.

Investment Companies

Investment companies represent the fourth largest financial industry sector in terms of total assets. They are legal vehicles created to invest private and public savings through investment funds (Closed End, Open End and Money Market). Some of these are precisely managed by the securities divisions of commercial banks, while others are managed by other securities brokers like UBS Financial Services. Figure 9 has a complete list of Investment Companies registered in the OCIF.

Figure 9: Investment Companies registered with OCIF

Investment Companies		
CLOSED END FUNDS	CLOSED END FUNDS (CONT.)	OPEN END FUNDS
PR Investors Tax Free Fund, Inc.	First PR Target Maturity Income Opportunities	First Puerto Rico Tax Exempt Fund, Inc
PR Investors Tax Free Fund II, Inc.	PR Fixed Income Fund II, Inc.	IRA Select Growth & Income PR
PR Investors Tax Free Fund III, Inc.	First PR Tax-Advantaged Target Maturity Fund II,	Popular Total Return Fund, Inc.
PR Investors Tax Free Fund IV,	Inc.	Puerto Rico Short Investment Fund, Inc.
PR Investors Tax Free Fund, V Inc.	First PR AAA Target Maturity Fund I, Inc.	Popular High-Grade Fixed Income Fund
PR Investors Tax Free Fund V1, Inc.	Puerto Rico Fixed Income Fund III, Inc.	Multi Select Securities Puerto Rico Fund, Inc.
PR Investors Flexible Allocation (Puerto Rico	First Puerto Rico AAA Target Maturity Fund II, Inc	Popular Core Equity Fund, Inc.
Investors Bond Fund)	Puerto Rico Mortgage Backed & US Government	Universal Life Insurance Company Fortune V
Tax Free PR Fund, Inc.	Securities Fund, Inc.	Separate Account
Tax Free PR Target Maturity Fund, Inc. Tax Free	Puerto Rico Fixed Income Fund IV, Inc.	Popular Income Plus Fund
PR Fund II, Inc.	First Puerto Rico Target Maturity Income	X2 Alternative Dividend Alpha Fund, Inc.
PR AAA Portfolio Bond Fund, Inc.	Opportunities Fund II, Inc.	Atlas U.S. Tactical Income Fund, Inc.
PR AAA Portfolio Target Maturity Fund, Inc.	Puerto Rico AAA Portfolio Bond Fund II	U.S. Municipal & Income Fund, Inc.
First PR Tax-Exempt Target Maturity Fund V, Inc.	Puerto Rico Axed Income Fund V Inc.	
PR GNMA &US Government Target Maturity Fund,	First Puerto Rico AAA Fixed Income Fund, Inc.	
Inc.	Puerto Rico Fixed Income Fund V1. Inc.\	MONEY MARKET FUNDS
First PR Tax-Advantaged Target Maturity Fund I	First Puerto Rico Tax-Exempt Target Maturity	Popular Money Market Fund, Inc.
Puerto Rico Fixed Income Fund, Inc.	Fund VII, Inc.	

Sources: Office of the Commissioner of Financial Institutions (OCIF)

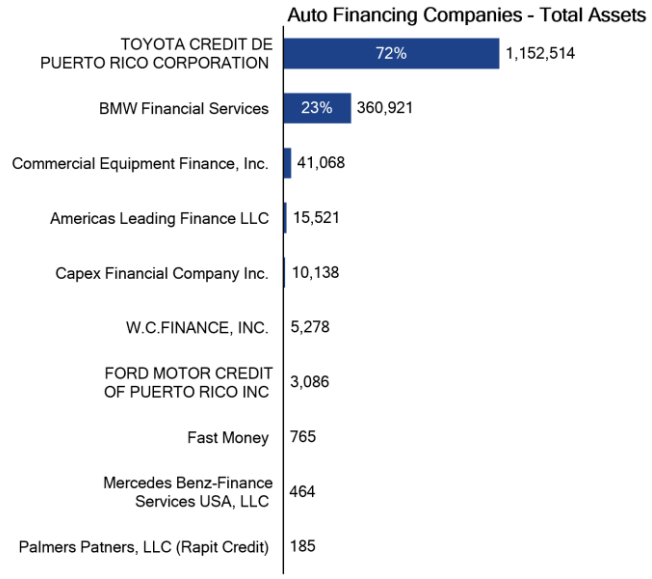
"Asociación de Empleados del Estado Libre Asociado" (AEELA)

AEELA is another important financial industry player. It is a private institution that provides savings and lending facilities like personal loans, mortgage loans, and credit cards to its members, that is Puerto Rico Government active and retired employees. It has approximately 200k members, employs ~400 people, and manages ~$2.65B in assets. Its contribution to the local economy is limited by the fact that it enjoys income and other tax exemptions, like local credit unions.

Auto Financing Companies

Based on OCIF data, there are 10 auto financing companies in Puerto Rico excluding subsidiaries and business units of commercial banks (e.g. Popular Auto). "Toyota Credit de Puerto Rico Corporation" and "BMW Financial Services" concentrate 95% of the auto financing companies' total assets (see Figure 10). Reliable Auto was the largest player in the auto financing industry until it was acquired by Popular Auto. As we will see in a subsequent section, these non-depository institutions hold 14% of the total auto loan volumes in Puerto Rico.

Figure 10: Auto financing companies total assets ('000, December 2019)

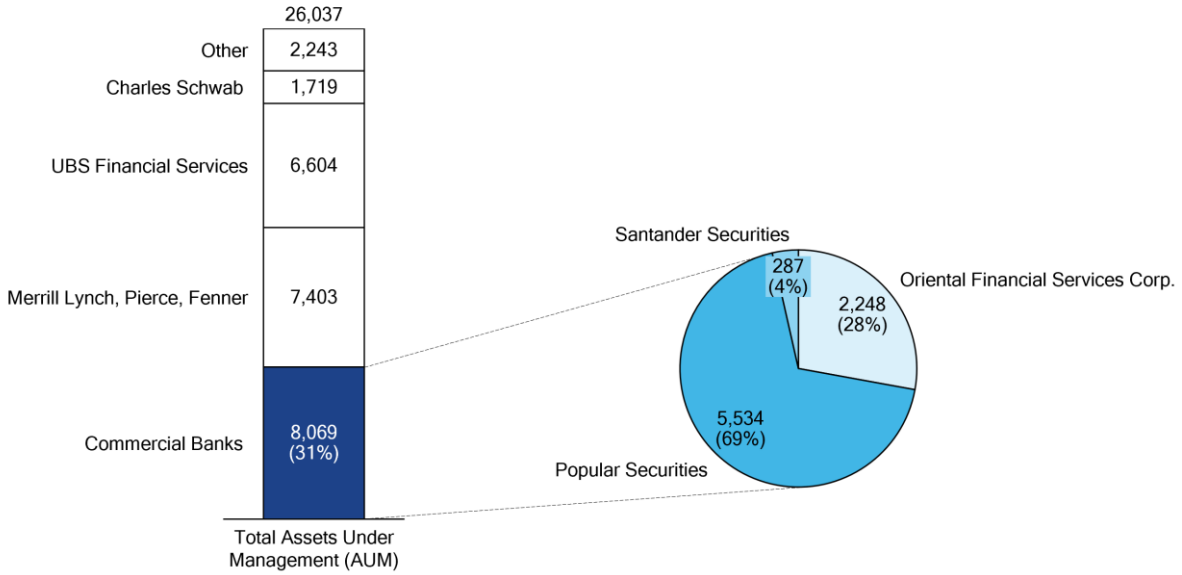


Sources: Office of the Commissioner of Financial Institutions (OCIF)

Securities Brokers

The Securities Brokers financial sector accumulated assets of ~$859M as of December 2019. Securities Brokers manage funds for people in Puerto Rico through investments in securities, fixed income, and various savings vehicles. Local banks compete in the provision of these services through their securities divisions. Banco Popular, Santander Securities, and Oriental Bank manage 31% (~$8.1B) of total Customer Assets under Control in Puerto Rico, followed by "Merrill Lynch, Pierce, Fenner" (~$7.4B), "UBS Financial Services" (~$6.6B), and "Charles Schwab" (~$1.7B).

Figure 11: Customer assets under control ($M, December 2019)

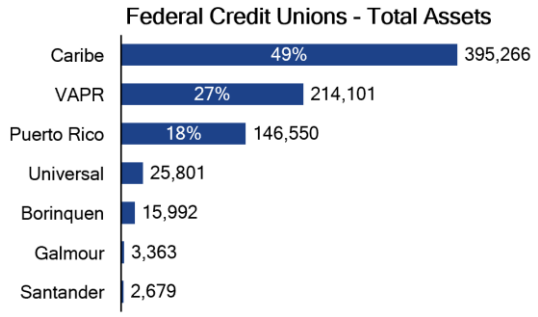


Sources: Office of the Commissioner of Financial Institutions (OCIF)

Federal Credit Unions

Federal Credit Unions are also an important player in the Puerto Rico financial industry with a total of $804M in assets. This number is understated by the fact that it does not include the activities of PenFed Credit Union in Puerto Rico. The OCIF does not have jurisdiction over Federal Credit Unions and, therefore, the information it provides is incomplete. In Figure 12 we can see the information that OCIF provides for Federal Credit Unions which is only updated to December 2018. Caribe, VAPR, and Puerto Rico accumulate 94% of total Federal Credit Unions assets in Puerto Rico (excluding PenFed).

Figure 12: Federal credit unions total assets ('000, December 2019)



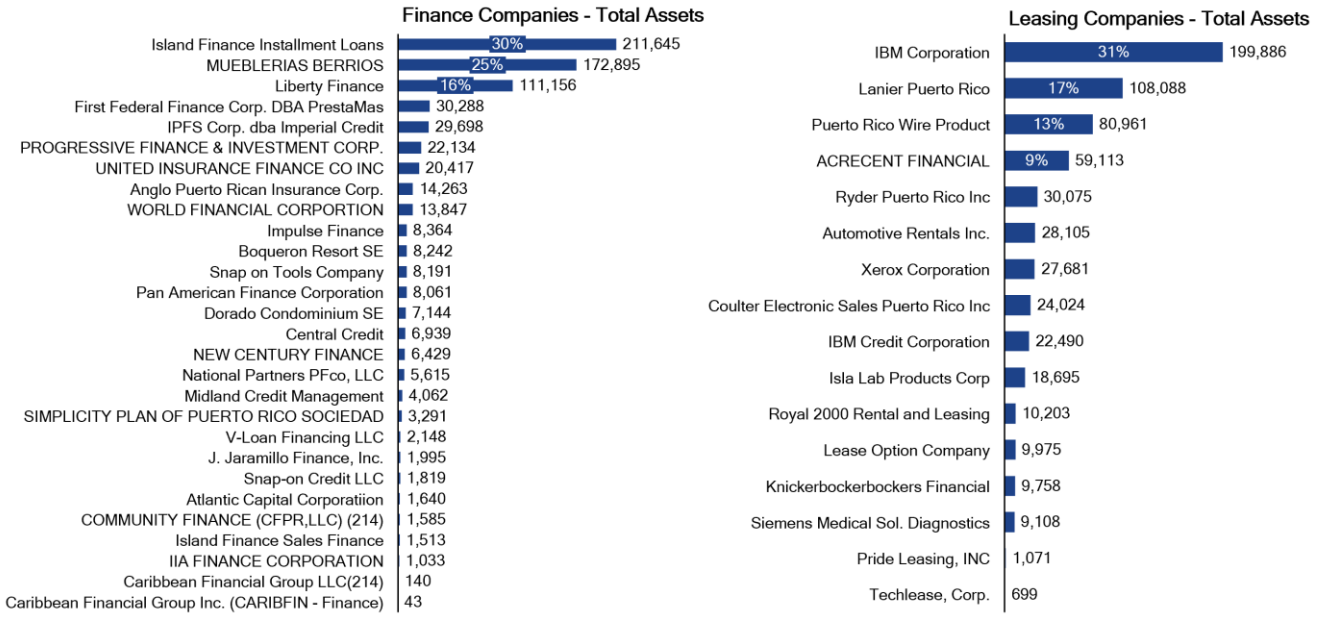
Sources: Office of the Commissioner of Financial Institutions (OCIF)

Finance and Leasing Companies

The Finance Companies sector includes a total of 68 active licenses in Puerto Rico, but 71% of the assets are concentrated in three institutions (see Figure 13), "Island Finance Installment Loans", "Mueblerías Berríos", and "Liberty Finance". Likewise, the Leasing Companies sector includes 75 licenses, and 70% of assets are concentrated in four institutions, IBM Corporation, Lanier Puerto Rico, Puerto Rico Wire Product, and Acrecent Financial.

Figure 13: Finance and Leasing Companies total assets

As of December 2019, '000s



Sources: Office of the Commissioner of Financial Institutions (OCIF)

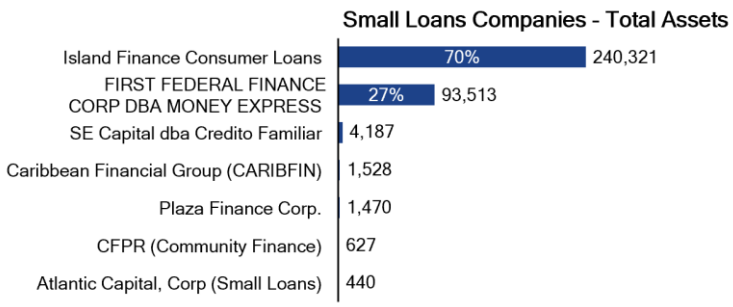
Government Banks

There are two Government Banks in Puerto Rico that provide financing to Puerto Rico individuals and companies, and together they accumulate $656M in total assets (as of December 2019). One of them is the Puerto Rico Housing Finance Authority which finances mortgage loans to low- and moderate-income citizens and manages ~$484M in assets. The Puerto Rico Economic Development Bank provides financing to small and medium local companies and manages ~$172M in assets.

Small Loans Companies

The Small Loans Companies sector originates consumer loans of up to $5,000, and its total assets are heavily concentrated in two institutions (see Figure 14), "Island Finance Consumer Loans", and "First Federal Finance Corp." (Money Express).

Figure 14: Small Loans Companies total assets ('000, December 2019)

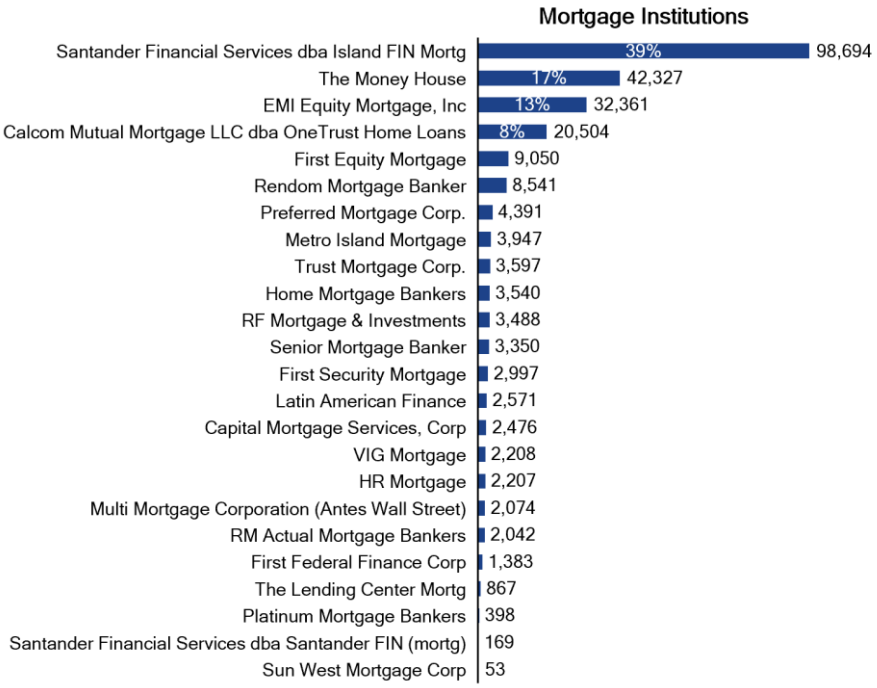


Sources: Office of the Commissioner of Financial Institutions (OCIF)

Mortgage Institutions

The last financial industry sector with substantial assets consists of the non-depository Mortgage Institutions. Most of the mortgage loans originated by these institutions are sold to commercial banks. While these institutions manage a small amount of assets compared to other financial industry sectors (most originated loan balances are sold) they represent a powerful origination engine with approximately 45% of total mortgage loans originated in Puerto Rico in 2019 (26% of loan balances originated).

Figure 15: Non-depository Mortgage Institutions total assets ('000, December 2019)



Sources: Office of the Commissioner of Financial Institutions (OCIF)

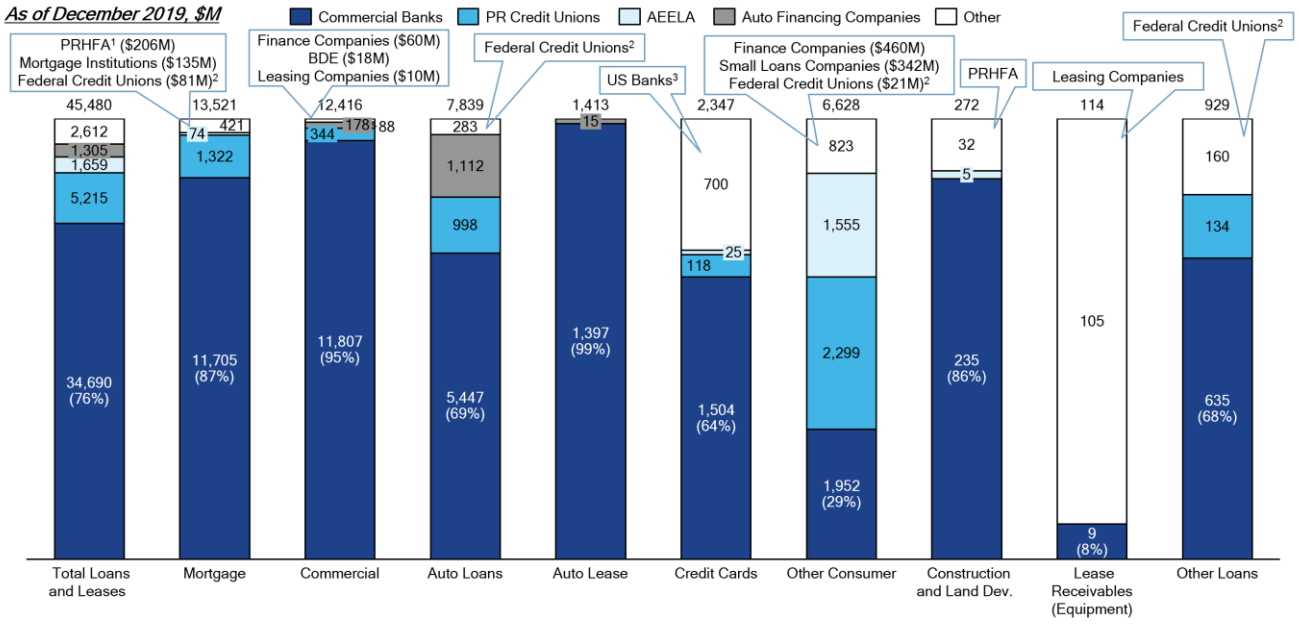
2. The lending activity: markets shares by lending business

As we have mentioned previously, one of the key roles of the banking sector is the facilitation of credit to finance purchases and investments. While local banks concentrate a large portion of the lending balances in Puerto Rico (~76%, see Figure 15) there are other sectors that compete with commercial banks in the lending activity, particularly in the consumer portfolios. These other players promote competition in the marketplace, which is ultimately beneficial for the final consumer.

As can be observed in Figure 16, commercial banks concentrate ~76% of the loan and lease balances in Puerto Rico which reached $45.5B as of December 2019. After commercial banks, local Credit Unions, AEELA and Auto Financing Companies were the main loan and lease providers with $5.2B, $1.7B, and $1.3B in loan and lease balances, respectively.

When looking at specific products, the mortgage portfolio is the largest loan portfolio with $13.5B as of December 2019. Commercial banks have ~87% of the mortgage loan balances, followed by PR Credit Unions ($1.3B), the Puerto Rico Housing Finance Authority (~$206M) and the non-depository Mortgage Institutions (~$135M). However, this information does not provide the whole picture of the mortgage business in Puerto Rico, because it does not include loans that are pooled, securitized, and actively traded, and which are guaranteed by GSEs (Government Sponsored Enterprises). FHA, VA and conventional conforming mortgage loans (which are normally securitized and sold by banks) represented 83% of total loan originations in 2019. When it comes to the origination activity, local banks generate approximately 55% of total mortgage loans, with the other 45% coming from non-depository Mortgage Institutions. Together with the Federal rules and regulations, the activity of non-depository Mortgage Institutions and the PR Housing Finance Authority, provide competitive pressure and protection to the final consumer.

Figure 16: Loan and lease portfolio by financial industry sector and by product type



Sources: Office of the Commissioner of Financial Institutions (OCIF)
Notes: ¹Puerto Rico Housing Finance Authority ²Data is as of Dec. 2018 and does not include PenFed ³Citibank US

The second largest portfolio in Figure 16 is the Commercial loans portfolio. The local banking sector has an overwhelmingly large market share in this lending business with 95% of the loan balances. However, US banks represent an important player in the corporate lending segment that is not included in OCIF's numbers. As we will see in Section IV, US banks provided 17% of the syndicated lending volumes to corporations in Puerto Rico as of December 2019. Those volumes exclude credit facilities provided by US Banks outside syndicated loans. In other words, commercial lending volumes in Figure 16 overstate the market share of local commercial banks.

The auto financing business has three important players outside commercial banks that hold a sizeable market share. These are: 1) Auto Financing Companies like Toyota Credit de Puerto Rico Corporation and BMW Financial Services with ~$1,112M in loan balances, 2) Local Credit Unions with ~$998M in loan balances, and 3) Federal Credit Unions with ~$283M in loan balances. The Federal Credit Unions piece is understated because it does not include PenFed, a very active player in Puerto Rico. The auto lease financing business, on the other hand, is clearly dominated by local commercial banks, mainly Popular Auto, FirstBank, and Oriental Bank.

Based on the information available, local commercial banks hold approximately 64% of total revolving credit card balances. Local Credit Unions and US Banks hold an important piece of the local credit card activity. In fact, the ~$700M balances categorized as "Other" in Figure 16 only include Citibank cards issued in the United States. If balances from other US Banks were available (e.g. Bank of America, JP Morgan Chase, Capital One), the share of local commercial banks would reduce further.

Commercial banks hold a relatively reduced percentage (29%) of other unsecured consumer loans like personal loans or personal lines of credit. Local Credit Unions manage a large personal loans portfolio of ~$2.3B, and the portfolio of loans provided to public employees by AEELA reached $1.56B in December 2019. Other important players in the consumer loans business are Finance Companies (particularly Island Finance Installment Loans, "Mueblerías Berríos", and Liberty Finance) and Small Loans Companies which focus in the up to $5,000 loans niche. The Small Loans Companies portfolio is small compared to that of other finance industry sectors, but they cover a market that is not the focus of other financial entities.

The portfolio of Construction and Land Development loans is significantly smaller than the mortgage, commercial, and consumer portfolios ($272M as of December 2019, see Figure 16) and it is concentrated in commercial banks (86% of total). This portfolio has reduced significantly since the start of the Puerto Rico economic crisis and reflects the reduced construction activity in the Island in the past years outside of reconstruction projects financed with Federal funds. In 2008, the Construction and Land Development loan portfolio of commercial banks was $6.2B. This represents a 96% drop between 2008 and 2019.

Like the Construction and Land Development portfolio, the Lease Receivables portfolio (mainly Equipment) is small compared to other products. This portfolio is dominated by Leasing Companies, particularly IBM Corporation, Lanier Puerto Rico, Puerto Rico Wire Product, and Acrecent Financial.

IV. PR BANKING INDUSTRY CONTRIBUTION TO THE ISLAND'S SOCIOECONOMIC WELLBEING

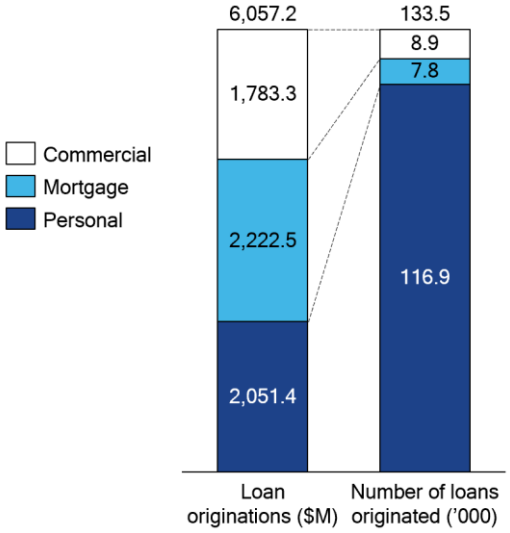
The banking sector is a key component of any economic structure because it connects financing supply and demand. But that is not the only contribution of banks to the socioeconomic wellbeing. For example, they process checks and provide access to cash through their network of branches and ATMs across Puerto Rico, provide mortgage servicing to other depository and non-depository institutions (including Federal Government Sponsored Enterprises like Ginnie Mae, Fannie Mae and Freddie Mac), perform community donations and community service activities, and also make philanthropic contributions, among other activities. In this chapter we will detail some of the contributions that banks provide to the broad society of Puerto Rico:

1. **Economic development:**
   - 1.1. Economic activity facilitation and employment
   - 1.2. Syndicated loans
   - 1.3. Mortgage servicing activities
2. **Contributions:**
   - 2.1. Purchase of products and services to local providers
   - 2.2. Community financing, investments, and services under the Community Reinvestment Act (CRA)
   - 2.3. Philanthropic contributions
3. **Public sector:**
   - 3.1. Tax contributions and other fees
   - 3.2. Embargoes
   - 3.3. Public services

1.1. Economic activity facilitation and employment

Puerto Rico commercial banks manage approximately 5.2M deposit accounts with ~$59B in deposit balances for Puerto Rico individuals, businesses, and the public sector. These funds are used to finance their lending activity. In 2019 commercial banks provided approximately 117k personal consumer loans and lines of credit, and ~7.8k mortgage loans to Puerto Ricans, and 8.9k commercial loans to Puerto Rico small, medium, and large businesses (see Figure 17). In total these loans amounted to approximately $6.1B in originated balances. As of December 2019, local commercial banks owned or serviced approximately 3.1M outstanding credit facilities.

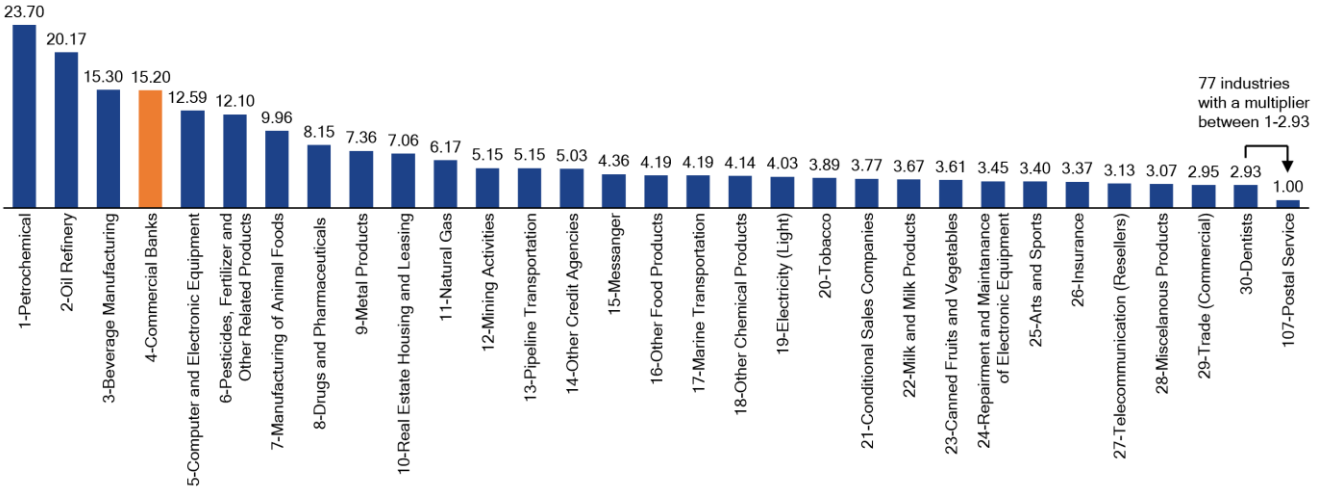
Figure 17: Loan originations (2019)



Sources: Office of the Commissioner of Financial Institutions (OCIF)

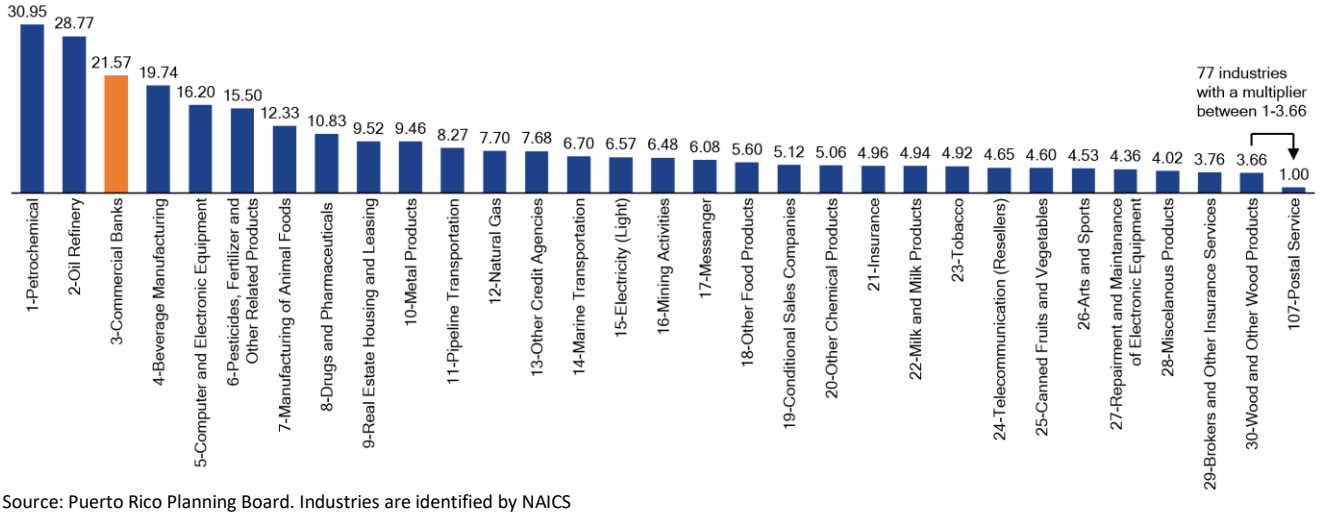
The key role that the banking sector plays in channeling money from depositors and savers to consumers and investors is clearly reflected in the multiplicative effect of having a dynamic banking industry. The type I employment multiplier of Commercial Banks is one of the highest of the 107 industries for which the Puerto Rico Planning Board provides this measurement. As can be observed in Figure 18, the banking sector's type I employment multiplier is ~15.2, which means that for every employment created in the banking sector another 14.2 jobs are generated indirectly through the regular business relationships between banks and other industries' companies. The intensity of banking activity depends largely on the health of the overall economy and the need for financing economic activity. But the large employment multiplier shows how important is the banking sector to fuel the economic engine of any economy, and the Puerto Rican in particular.

Figure 18: Type I employment multiplier by industry



Source: Puerto Rico Planning Board. Industries are identified by NAICS

Figure 19: Type II employment multiplier by industry



Source: Puerto Rico Planning Board. Industries are identified by NAICS

The banking sector scores even higher when we consider the type II employment multiplier (ranking of 3 out of 107 industries, see Figure 19), which considers also the employment created as a result of the additional household spending from the direct and indirect jobs created. That is no surprise because, as can be observed in Figure 21, the banking sector has one of the highest salary levels among Puerto Rico economic sectors. The average salary of Puerto Rico commercial banks was ~48k in 2019, above the salary level of the Finance and Insurance sector as a whole, and above the salary of all other major economic sectors in Puerto Rico with the exception of the "Management of Companies and Enterprises" sector. Not only salaries are high, but the number of people employed in commercial banks is considerable. With approximately 13.5k employees, local commercial banks employ 44% of the workers in the Finance and Insurance sector (see Figure 20).

Figure 20: Employees in Finance & Insurance

As of December 2019

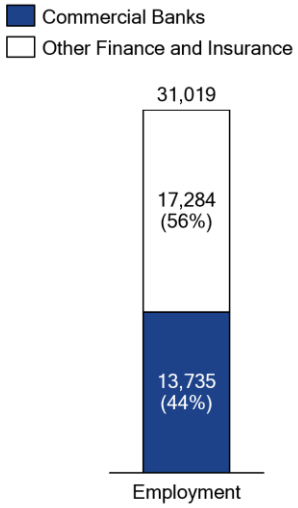
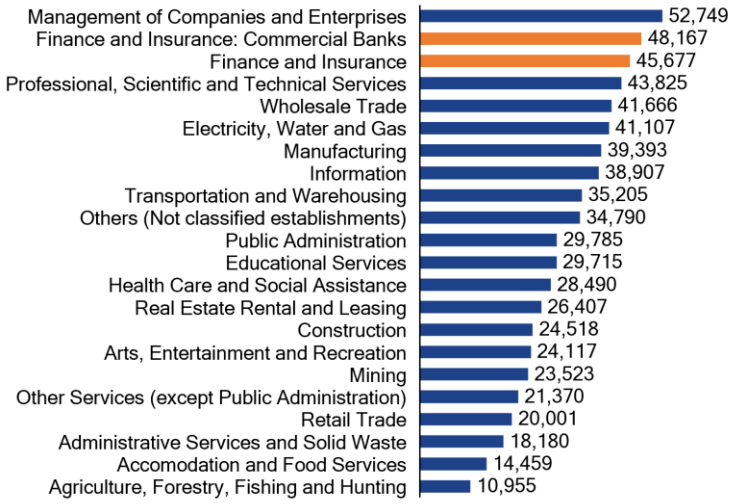


Figure 21: Annual salary of PR economic sectors

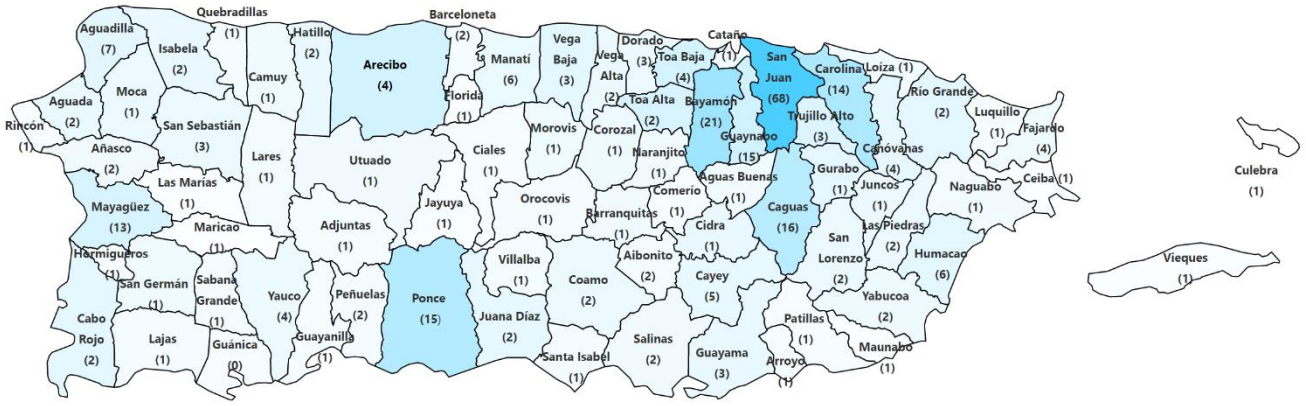
Year 2019



Sources: PR Department of Labor and Human Resources - Labor Market in Puerto Rico

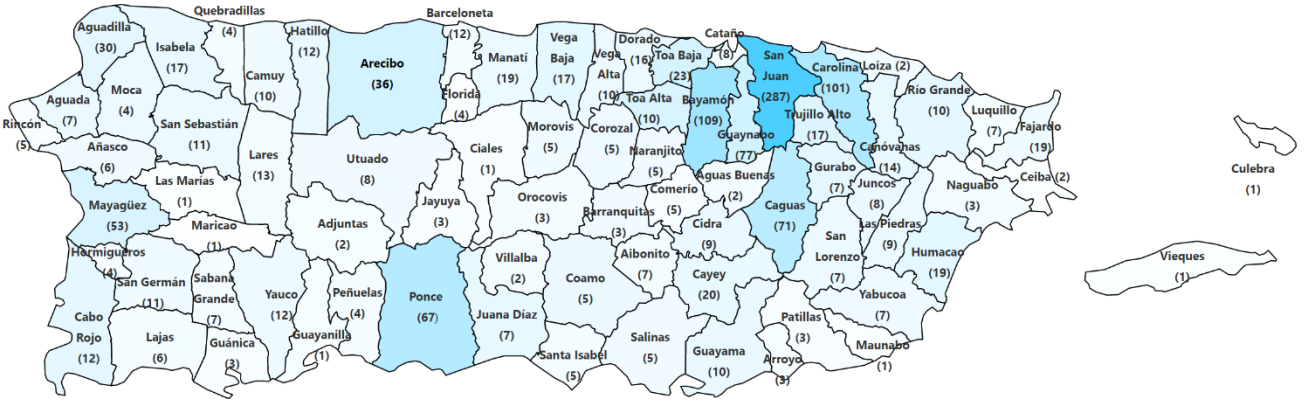
The banks' footprint coverage is key to ensure that individuals and businesses fulfill their banking requirements like opening a deposit account, making deposits, obtaining cash, and applying for credit. That is particularly important in Puerto Rico because access to computers and the internet is lower than in the United States. As can be observed in Figures 22 and 23, banks have a wide footprint coverage across the Island with a total of 294 branches and 1,353 ATMs. All municipalities in Puerto Rico have at least one ATM and, except for Guánica, all municipalities also have at least one branch. That is true despite the fact that some municipalities have small populations (four municipalities with less than 10,000 population and 19 with less than 20,000 population).

Figure 22: Number of bank branches by municipality (2019)[1]



Sources: Provided by Banks Notes: [1]Color intensity is based on population

Figure 23: Number of ATMs by municipality (2019)[1]



Sources: Provided by Banks Notes: [1]Color intensity is based on population

In order to see the number of branches and ATMs by municipality and by bank use the following link:

https://app.powerbi.com/view?r=eyJrIjoiZGUzM2ZiNTQtN2UyNS00YTAyLTg2NjgtNzE4ODg5OTE2ODY3IiwidCI6IjIxY2ZmMGY5LWQ1ZGQtNGEzOS04N2NlLTVmNjg4MzFmMjNjZCIsImMiOjF9

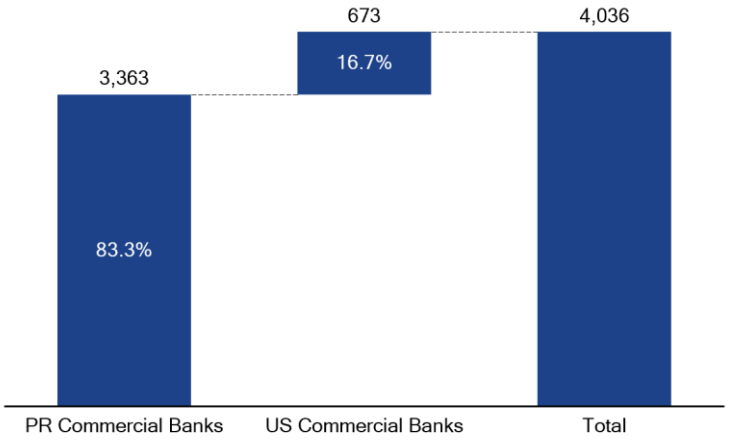
1.2. Syndicated Loans

Local commercial banks provide financing to all types of businesses in Puerto Rico. However, some corporations require credit facilities that are too large for a single bank to underwrite. In those occasions, commercial banks split the large risk associated to a single loan or line of credit by dividing the credit facility in participations. Local and US banks work together in these syndicated loans to ensure large corporations can fulfill their financing needs. As of December 2019, local and US banks shared participations in ~81 credit facilities whose origination amounts totaled ~$4,036M (see Figure 24).

US commercial banks without banking operations in the Island play an important role in providing financing to large corporations in Puerto Rico. As can be observed in Figure 24, they provided 17% of the active syndicated financing as of December 2019 (~$673M). These syndicated loans are just part of the financing they provide to local corporations since they also underwrite loans and lines of credit that are not participated by local banks. The total size of that financing is not available because it is not captured by the OCIF reports.

In summary, both local and US banks play an important role in providing large credit facilities to local businesses. However, there is an important difference between the impact of their activities: while they all fulfill credit needs of local corporations, only the business carried by local banks generate employment and tax contributions in Puerto Rico.

Figure 24: Syndicated loans as of December 2019 (origination amounts, $M)



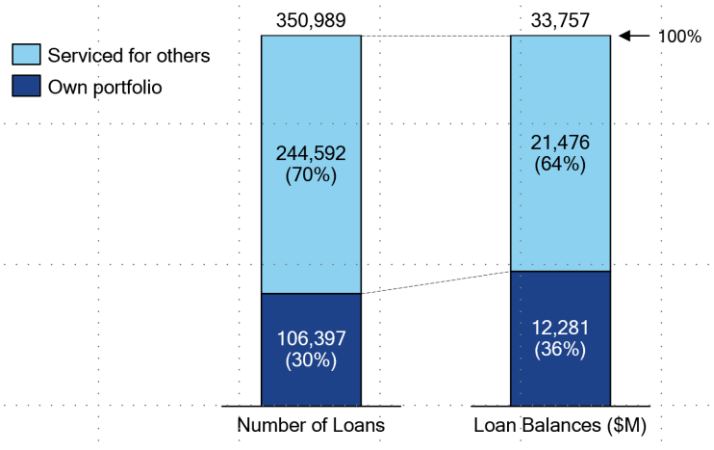
Sources: Provided by Banks

1.3. Mortgage Servicing Activities

An important business line for banks is the mortgage servicing business which consists of, among other activities, processing mortgage payments for customers, managing their insurance and real estate tax

escrow accounts, and performing the payment collection activities. Banks not only perform the servicing activities for their own portfolio of mortgage loans, but they also provide servicing for other organizations like the Government Sponsored Enterprises (Ginnie Mae, Fannie Mae, and Freddie Mac). As can be observed in Figure 25, local banks service approximately $351k mortgage loans (as of December 2019), of which 70% (~245k) are not owned by them.

Figure 25: Mortgage loans and loan balances serviced by commercial banks (Dec. 2019)[1]



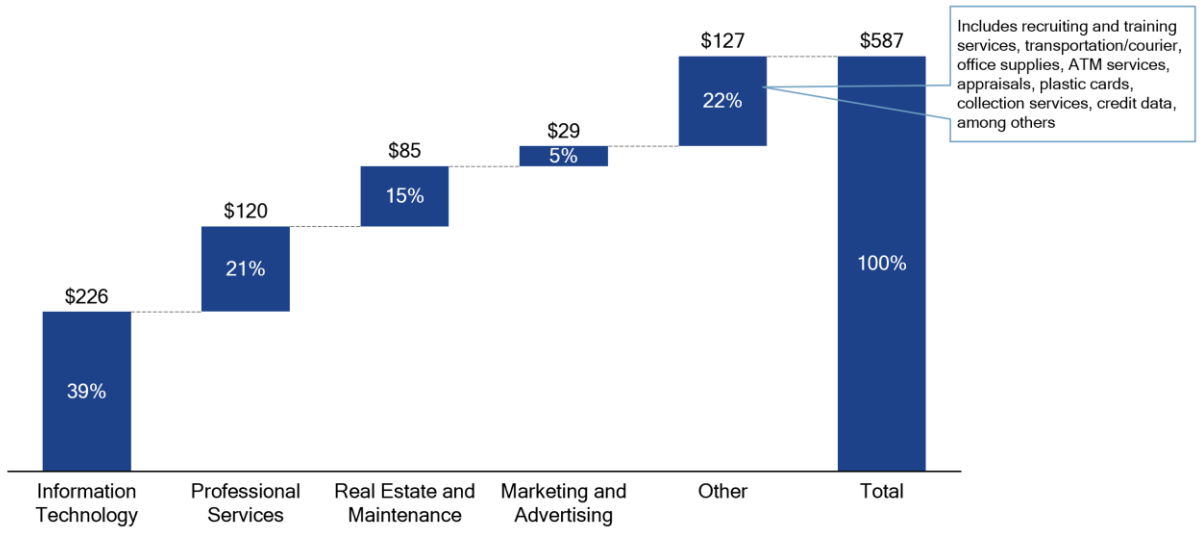
Sources: Provided by Banks Notes: [1]Oriental Bank data not available but it was estimated

Based on estimates from the US Census Bureau, in 2018 there were approximately 302k housing units with a mortgage out of ~794k total owner-occupied units in Puerto Rico. That means that local banks provide the servicing activities for the vast majority of citizens that have a mortgage. All moratoriums provided by banks or ordered by the Government as a relief after natural disasters or during the COVID-19 pandemic are implemented by local commercial banks regardless of whether they originated or own those mortgage loans.

2.1. Purchase of products and services to local providers

Local commercial banks make large purchases of products and services to local providers. In 2019, these purchases amounted to approximately $587M and benefited local companies in various economic sectors. The main categories of local providers' purchases are detailed in Figure 26 and they include "Information Technology" (39%), "Professional Services" (21%, including consulting fees, legal fees, accounting and auditing, and staffing agencies, among others), "Real Estate and Maintenance" (15%), and "Marketing and Advertising" (5%).

Figure 26: Purchases of products and services from PR vendors by main categories (2019, $M)[1]



Sources: Provided by Banks Notes: [1]Oriental Bank data not available but it was estimated

2.2. Community financing, investments and services under the Community Reinvestment Act (CRA)

The Community Reinvestment Act (CRA) is a law enacted in 1977 that "requires the Federal Reserve and other federal banking regulators to encourage financial institutions to help meet the credit needs of the communities in which they do business, including low- and moderate-income (LMI) neighborhoods" (www.federalreserve.gov › consumerscommunities › cra_about).

For most of the commercial banks in Puerto Rico (those with assets of $1.252B or greater), the CRA evaluation components are:

- Lending test
- Investment test
- Service test

Lending test:

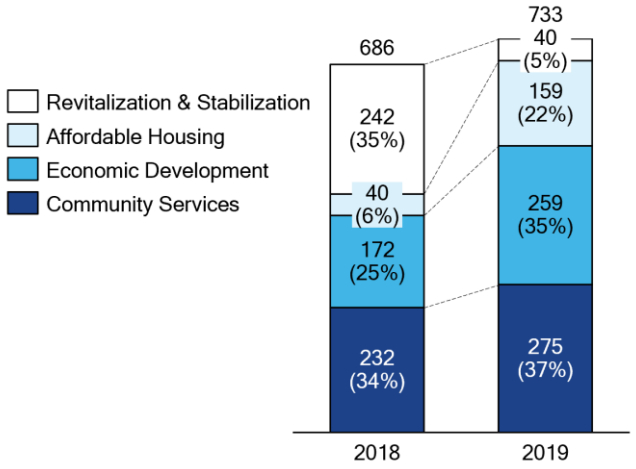
Based on the Code of Federal Regulations (§ 228.22), "the lending test evaluates a bank's record of helping to meet the credit needs of its assessment area(s) through its lending activities by considering a bank's home mortgage, small business, small farm, and community development lending". The assessment area typically encompasses the geographic area that can reasonably be served by each of a bank's locations, including its main office, any branches, and deposit-taking ATMs. It also usually includes the surrounding areas in which the bank originated or purchased a substantial portion of its loans (Source: Minneapolisfed.org).

The following are typical factors considered as part of the lending test:

- Whether the bank's volume of lending reflects good responsiveness to the credit needs of the assessment areas.
- The percent of the bank's loan originations that are originated within the assessment areas.
- Whether the geographic distribution of loans reflects adequate penetration throughout the assessment areas.
- Whether the distribution of borrowers reflects adequate penetration among retail customers of different income levels and business customers of different sizes.
- The bank number and amount of community development loans.
- The use of innovative or flexible lending practices in order to serve the assessment areas' credit needs.

All commercial banks in Puerto Rico with assets of $1.252B or greater scored either "High Satisfactory" or "Outstanding" in their most recent lending tests. The community development lending activity by Puerto Rico commercial banks reached $686M in loan balances originated in 2018 and $733M in 2019 (see Figure 27). In 2018, 35% of the community development originations provided financing for revitalization and stabilization activities given the damage made by Hurricanes Irma and María to the Island. Community services activities and economic development accumulated 34% and 25% of community development loans, respectively. In 2019, the funding requirements for revitalization and stabilization activities were lower, and most of the community lending was used to finance community service activities (37%), economic development (35%), and affordable housing (22%).

Figure 27: CRA loans originated (2018-19, $M)[1]



Sources: Provided by Banks Notes: [1]Includes Banco Popular, FirstBank, Citibank and Banco Santander

Investment test:

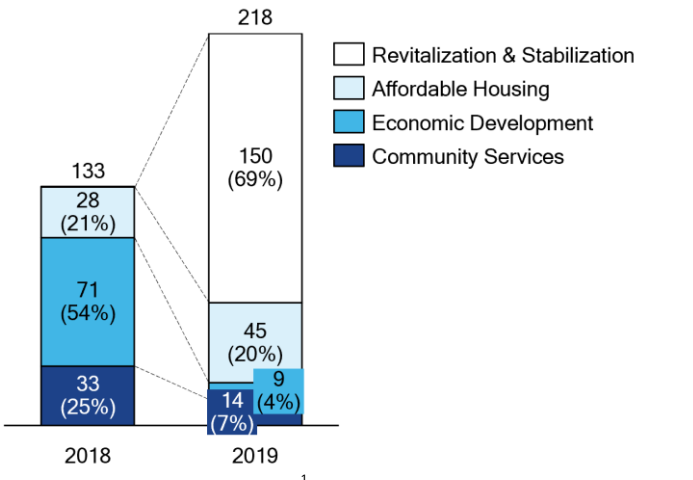
Based on the Code of Federal Regulations (§ 25.23), "the investment test evaluates a bank's record of helping to meet the credit needs of its assessment area(s) through qualified investments that benefit its assessment area(s) or a broader statewide or regional area that includes the bank's assessment area(s)".

The following are typical factors considered as part of the investment test:

- The level of qualified community development investments and grants, particularly those that are not routinely provided by private investors.
- The bank's responsiveness to credit and community economic development needs.
- The bank's use of innovative and/or complex investments to support community development initiatives.

All commercial banks in Puerto Rico with assets of $1.252B or greater scored either "High Satisfactory" or "Outstanding" in their most recent investment tests. The community development investment activity by Puerto Rico commercial banks reached $133M in 2018 and $218M in 2019 (see Figure 28). In 2018, economic development, community service, and affordable housing activities represented 54%, 25%, and 21% of the commercial banks' CRA investments, respectively. In 2019, CRA investments were highly concentrated in revitalization and stabilization (69%) due to a $150M investment made by a US division of a commercial bank with operations in Puerto Rico. Affordable housing, community services, and economic development accumulated 20%, 9%, and 4% of the CRA investments, respectively.

Figure 28: CRA investments (2018-19, $M)[1]



Sources: Provided by Banks Notes: [1]Includes Banco Popular, FirstBank and Citibank

Service test:

Based on the Code of Federal Regulations (§ 345.24), "the service test evaluates a bank's record of helping to meet the credit needs of its assessment area(s) by analyzing both the availability and effectiveness of a bank's systems for delivering retail banking services and the extent and innovativeness of its community development services".

All commercial banks in Puerto Rico with assets of $1.252B or greater scored either "High Satisfactory" or "Outstanding" in their most recent service tests. Figure 29 provides the number of community development services performed by several commercial banks on a consolidated basis. These services are grouped in the following categories: "Financial Education", "Technical Assistance", "Mortgage Education Seminars", "Board Participation", and "Small Business". Local commercial banks for which this data was available performed a total of 987 and 876 community development services in Puerto Rico in 2018 and 2019, respectively. Most of these services were related to financial education (820 in 2018 and 771 in 2019) which included, among other, the following activities:

- Financial education workshops about saving, credit, personal budget, and bank products for low- and medium-income public school and college students.
- Financial education programs to create awareness about the importance of effective management of personal finances including first-time homebuyer education, retirement education, and saving plans for funding children's education.
- National campaigns (sponsored by the American Bankers Association) which raise awareness about the roles that banks, and bankers play in helping young people to develop lifelong savings habits (primarily offered in the public-school system).
- Trainings and seminars related to homeownership and affordable housing products and programs to professional groups, community-based organizations, and government agencies.

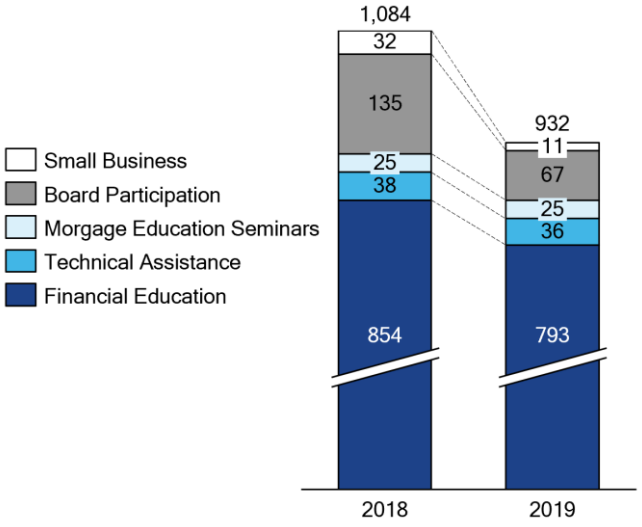
Commercial banks also performed 32 technical assistance activities for the community in 2018 and 34 in 2019. The following are examples of technical assistance activities provided by commercial banks:

- Summits to provide guidance to non-profit organizations on how to become less reliant on government funding and individual philanthropy.
- Trainings on community and workplace leadership.
- Projects to strengthen the administrative and financial structure of non-profit organizations to become self-sustaining.
- Entrepreneurship workshops for teachers to develop business clubs in their respective schools.
- Activities, tutorships, and services designed to improve education, encourage entrepreneurship, and reduce the school absentee rate in specific communities.

In 2018 and 2019 banks conducted 25 seminars to provide mortgage education to low- and medium-income communities. They also had employees serve on boards or as key members of committees of community service organizations. Finally banks also provided services for small businesses including:

- Financial education workshop about saving, credit, personal budget and bank products for low- and medium-income business owners/entrepreneurs.
- Conferences for business customers on different business topics including re-engineering strategies and the available financial alternatives.
- Summits to provide mentoring and professional guidance to female small business owners, entrepreneurs, students, and unemployed parties throughout Puerto Rico looking to start a small business or improve an existing one.
- Projects to strengthen the business models of start-ups, and to provide education and mentoring in terms of investments and access to capital.

Figure 29: CRA community development services (2018-19)[1]

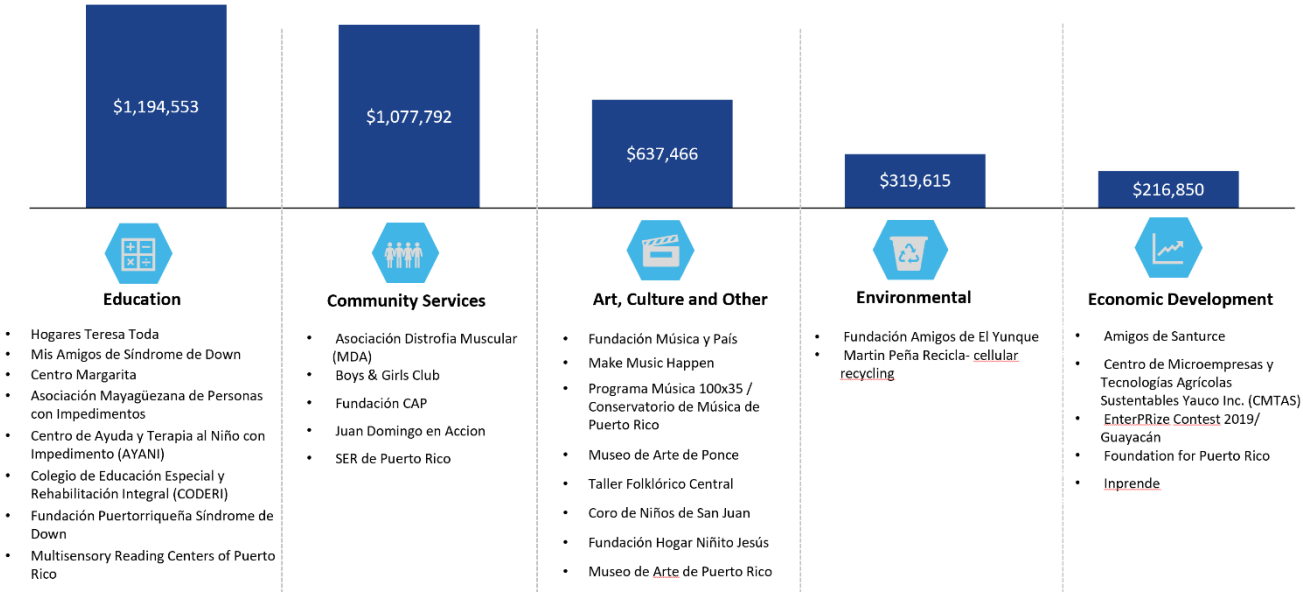


Sources: Provided by Banks Notes: [1]Includes Banco Popular, FirstBank, Citibank and Banco Santander

2.3. Philanthropic contributions

Aside from the investments and donations that local commercial banks provide as part of the Community Reinvestment Act (CRA), they also perform philanthropic contributions to multiple organizations of the Puerto Rico society. In total local banks dedicated approximately $3.5M to philanthropic contributions in 2019. The most impacted area was education with ~$2.2M, followed by community services with $1.1M, art and culture with $637k, environmental activities with $320k, and economic development with $217k. Figure 30 provides some examples of organizations that received funds as part of the philanthropic initiatives of Puerto Rico commercial banks.

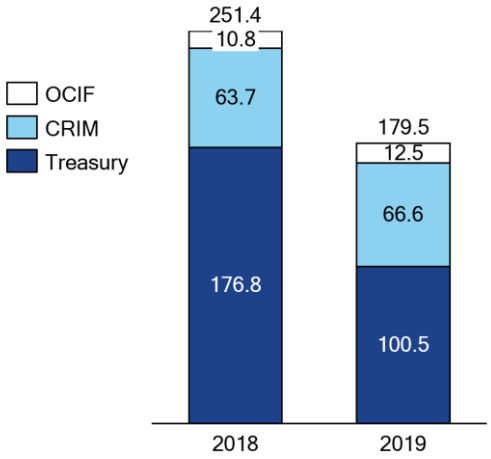
Figure 30: Philanthropic contributions (2019)



3.1. Tax contributions and other fees

Another contribution of local banks to the overall Puerto Rico economy and society are the taxes and fees they pay. Local banks contributed to the Puerto Rico Treasury with approximately $100.5M in 2019, which represents approximately 5% of total income tax from corporations in PR (see Figure 31). They also paid approximately $67M in taxes to the "Centro de Recaudación de Ingresos Municipales" (CRIM) in 2019, which represents approximately 6% of total CRIM tax collections in 2019. Finally, banks helped finance OCIF operations and examination activities with approximately $12.5M in 2019.

Figure 31: Tax contributions[1]



Sources: Banks Notes: [1]CRIM-Treasury not available for Banesco. OCIF estimated for B. Santander, Oriental Bank, Banesco, Citibank and B. Cooperativo

3.2. Embargoes

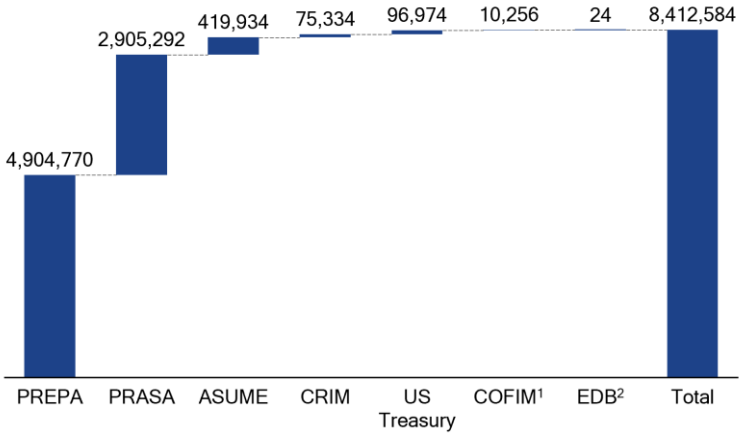
The Puerto Rico and Federal Courts, as well as the Department of the Treasury of Puerto Rico and the Internal Revenue Service (IRS), may order local commercial banks to freeze, deliver, or freeze and later deliver funds of customer accounts for legal or tax related issues. Banks process these embargoes and levies for the competent authorities on a daily basis as part of their regular ongoing operations. In 2019, commercial banks in Puerto Rico processed approximately 23.6k embargoes and levies of customer accounts for legal or tax related matters.

3.3. Public services

Local commercial banks have a broad physical network, and online and call center capabilities that are leveraged by the public sector to facilitate transactions and license renewals to local residents. For example, they can purchase "marbetes" for their auto license renewals, buy Treasury Department stamps and vouchers, and also pay traffic fines in some of the 294 bank branches located in Puerto Rico.

Commercial banks also process payments for public utilities and government agencies. For example, customers can pay their electricity and water bills through the banks' online systems, by phone or in person at the branch. As can be observed in Figure 32, the commercial banking sector processed ~4.9M electricity bill payments in 2019, which represents more than a third of the total retail bill payments to the Puerto Rico Electric Power Authority (PREPA) in that year. Similarly, the Puerto Rico Aqueducts and Sewers Authority (PRASA) received ~20% of its bill payments through local commercial banks. In total, banks processed approximately 8.4M payments for public agencies and corporations in 2019.

Figure 32: Number of public services payments processed by PR banks (2019)



Sources: Provided by Banks Notes: [1]Corporación de Financiamiento Municipal [2]Economic Development Bank

4. CONCLUSIONS AND RECOMMENDATIONS

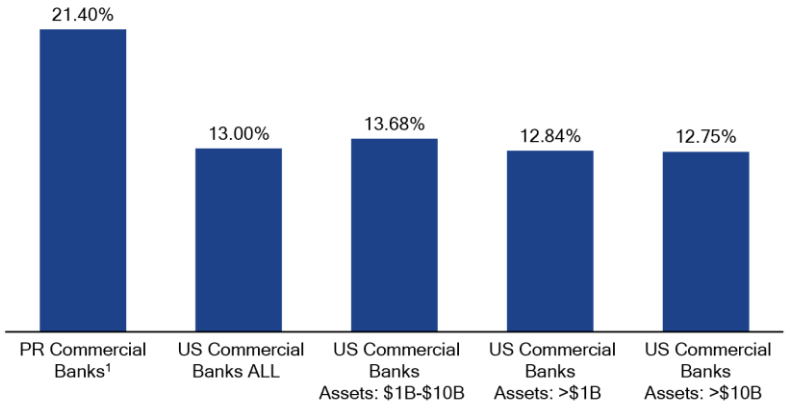
In chapters II, III and IV of the report we have provided an overview of the history of the banking sector in Puerto Rico, an analysis of the various sectors that are included in the financial industry of Puerto Rico, and an overview of the main contributions of the banking sector to the local economy. The main messages that arise from the first three chapters can be summarized in three overall conclusions:

1- The Puerto Rico banking sector has a very solid capital and financial position
2- It is, by far, the largest contributor to the local economy among Puerto Rico financial sectors
3- It has a solid track record of looking after the Puerto Rico consumer interests

Solid capital and financial position

The Puerto Rico banking sector showed a Total Risk Based Capital Ratio north of 20% in each of the past four years and above any other year in the past 25 years. As of December 2019, the Total Risk Based Capital Ratio of US peers fluctuated between 14.28% and 14.67% (depending on the asset size, see Figure 33), significantly below the capitalization level of local commercial banks. In Puerto Rico, there is no other financial sector with such high capitalization levels.

Figure 33: Total Risk Based Capital Ratio (December 2019)



Sources: Federal Deposit Insurance Corporation (FDIC) Notes: [1]Based on FDIC data which does not include Citibank, Banesco and Banco Cooperativo

Additionally, the banking sector has managed to control the exposure to investments in Puerto Rico Government bonds and its instrumentalities as opposed to other financial sectors like the local credit unions. Furthermore, despite the historical support in providing liquidity to the Puerto Rico Government and the municipalities, the volume of loans and credit facilities to the Puerto Rico public sector represents a small portion of the total lending portfolio of local banks.

The local banks in Puerto Rico have shown an admirable resilience against the economic struggles and the unprecedented series of external shocks like Hurricanes Irma and María, the 2020 tremblors, and the COVID-19 pandemic. During this difficult period, the sector has been able to provide support to the local families through moratoriums and increase loan originations and deposits, contributing to a slow economic recovery. That could have not been possible unless banks had been in a healthy financial and capital position.

As we saw in Chapter II, it took a long period of restructuring for the local banking sector to achieve its current solid financial position. The banking sector is under constant scrutiny from regulators but also from very active investor groups. The largest three banks in Puerto Rico are publicly traded companies subject to numerous and detailed reporting obligations that provide clear visibility and transparency of their financial condition. The fourth bank in Puerto Rico, Citibank, is part of one of the largest global financial institutions and is also publicly traded. Given the ties of the banking sector to the rest of the economy and the importance of having a healthy banking system for the overall economy, this sector is one of the most regulated in the United States. In Puerto Rico, it is far more regulated than other financial sectors. As can be observed in Figure 34, there are seven federal and local regulators that monitor local banking activities and examine local banks to test their financial and capital strength as well as their fair treatment of consumers. These regulators include the Federal Reserve Board (FED), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Financial Industry Regulatory Authority (FINRA), the Securities and Exchange Commission (SEC), the Consumer Financial Protection Bureau (CFBP), and the Office of the Commissioner of Financial Institutions (OCIF).

Figure 34: Federal and Puerto Rico regulators by financial sector

Financial Sector	Main Financial Regulators									Total
	FED	OCC	FDIC	FINRA	SEC	CFPB	COSSEC	NCUA	OCIF	
PR Commercial Banks	V	V	V	V	V	V			V	7
IBEs and IFEs									V	1
PR Credit Unions						V	V			2
AEELA						V			V	2
Auto Financing						V			V	2
Securities Brokers				V	V	V			V	4
Federal Credit Unions						V		V		2
Finance Companies						V			V	2
Leasing Companies						V			V	2
US Commercial Banks	V	V	V	V	V	V				6

Largest financial sector contributor to the Puerto Rico economy

The banking sector is, by far, the largest direct employment contributor among financial sectors in Puerto Rico. The salaries it pays are very high compared to most economic sectors. Given the key role it plays in connecting savers with investors and consumers, the banking sector is also a large contributor in terms of indirect and induced jobs, with Type I and II multipliers in the Top 5 among 107 economic subsectors. That is also reflected in the large total purchases made by local banks to local product and service providers, which generate additional indirect jobs like lawyers, accountants, appraisers, engineers, consultants, security professionals, and advertising experts.

The Puerto Rico banking sector is also the top tax contributor among financial sectors given its large business volume but also given the exemptions granted to other financial sectors. In 2019, the banking sector paid ~$96M in income tax, which represents ~90% of the total income tax paid by the financial industry in Puerto Rico.

Through the Community Reinvestment Act (CRA), which does not apply to the other financial sectors in Puerto Rico, local banks provided more than $700M in loans to finance revitalization and stabilization projects, affordable housing, economic development, and community services activities in 2019. They also invested ~$218M in community development projects and provided $3.5M in philanthropic contributions in 2019.

In Chapter IV we saw how the banking sector supports the public sector in providing services, and how it implements legal, tax, and compliance tasks for federal and local regulators. For example, banks have an active role in the detection and prevention of money laundering activities as well as in the implementation of levies and embargoes for tax and legal purposes. The large physical and digital network of banks and their transaction and payment capabilities are leveraged by the public sector to provide public services and process payments.

Finally, local banks have been historically an important source of financing for municipalities and the central government. Although much lower than in previous years given the fiscal problems of the government of Puerto Rico, local commercial banks still have approximately ~$550M outstanding loan balances with the public sector of Puerto Rico

Looking after the consumer

As mentioned previously, the banking sector is one of the most regulated sectors in the United States. Federal regulators are responsible for assessing how well local banks fulfill their obligations to the communities they serve as stated in the Community Reinvestment Act. Examiners assess multiple areas that ultimately ensure protection for the consumers of banking services. Among other, these areas include:

- Responsiveness to the credit needs of the most economically disadvantaged, including low-income geographies and individuals, and small businesses.
- Use of innovative or flexible lending practices.
- Accessibility of product and service delivery systems.
- Changes in branch locations.
- Reasonableness of business hours and services in meeting assessment area needs.
- Use of discriminatory or other illegal credit practices.

As noted in Chapter IV, all banks in Puerto Rico that are subject to the CRA were rated either "Outstanding" or "High Satisfactory" in the three performance tests: Lending, Investment and Service.

Additionally, the Consumer Financial Protection Bureau (CFPB), which began operation on July 21 of 2011 and was a legislative response to the financial crisis of 2007-08, is responsible for consumer protection in the financial sector. It writes and enforces rules for financial institutions and examines both bank and non-bank financial institutions. According to the United States Treasury Department, the CFPB is tasked with the responsibility to "promote fairness and transparency for mortgages, credit cards, and other consumer financial products and services". Thus, the Puerto Rico commercial banks are subject to the close monitoring and examination of the CFPB, and Puerto Rico consumer complaints are collected and tracked by the federal regulator.

As stated in Section II, the banking sector in Puerto Rico has a solid track record of ensuring that customers continue to receive banking services in an adequate fashion amid banking restructuring. In 2010, the 3rd, 7th and 9th largest banks in Puerto Rico closed operations as a result of the local and international financial crises, and their customers were transitioned to the acquiring banks with minimal service impact. Likewise, customers were transitioned seamlessly to acquiring banks after the departure of BBVA in 2012 and the closing of Doral Bank in 2014.

Finally, the banking sector has historically been a vehicle for the Puerto Rico Housing Finance Authority ("HFA") to offer government sponsored programs mainly targeted to low- and moderate-income population. The HFA regularly implements programs that either subsidize the purchase of the primary residence or provide mortgage insurance to low- and moderate-income population. In general, local commercial banks and credit unions originate these mortgage loans and provide the back-office servicing.

Recommendations

The overall recommendation of this report is that all stakeholders of the Puerto Rico society, including regulators, the executive branch, the Legislature, the Fiscal Oversight and Management Board, the press, and the public in general, acknowledge: 1)The key role of the local banking sector in the well-functioning of the Puerto Rico economy, and 2) That it makes a big contribution to the wellbeing of the

Puerto Rico society. Having a dynamic, competitive, and flourishing banking sector is not only beneficial for the banking sector itself but for the economy in general. Public policy should focus on having a banking sector that thrives, that is not overregulated, and that is not subject to unfair competition from outside and local financial players.

The following is a list of additional recommendations that arise from the research and analyses presented in this report:

- **Leverage the banking network further**. As we have presented in this report, the banking sector channels some of the services performed by the public sector including utilities corporations. But there is a lot of margin for expanding on additional services. Many of the services and transactions performed by the Treasury Department in "colecturías", and by other agencies (e.g. Department of Transportation and Public Works, CRIM, …) could be performed in banks' branches or through banks' online services and call centers. That applies to both individual and business transactions. This type of collaboration represents a win-win situation for the public sector and the banking system. Banks can charge for the services they provide and leverage potential customer contacts to cross-sell other products and strengthen their brand. The public sector can reduce expenses in customer service operations. Finally, the consumer increases the number of options it has to perform these transactions, and reduces the time spent on performing them.
- **Streamline and digitalize public sector transactions and databases**. The quicker and seamless the interaction between banks and their customers, the larger is the multiplier effect that we reviewed in Chapter IV. However, the products and services banks provide often depend on public sector processes and databases. That is the case, for example, of the title registration in the Department of Transportation and Public Works as part of the auto loan origination process, or the mortgage cancellation in the Puerto Rico property registry when a customer pays off his mortgage. Streamlining public sector processes and having data readily available in digital format translate into lower costs for banks, and quicker and better services for the final banking customer.
- **Do not overregulate a sector that is already very regulated**. As we have presented in this report, the banking sector is the most regulated among financial sectors in Puerto Rico. Federal authorities exert a tight monitoring on banks to ensure that they have a solid financial and capital condition, and that they treat consumers fairly, honestly, and without discrimination. Most of the times there is no need for the Puerto Rico Legislature to regulate the banking sector because there are federal rules and regulations already in place. Overregulating a sector has the undesired outcome of increasing bureaucracy and the cost of operation which, ultimately translates into longer waiting times and higher prices for the final consumer. Additionally, it becomes a burden on local banks that is not shared by outside players providing the same type of products and services.

- **Strengthen the financial sector reporting**. Despite the efforts dedicated in the preparation of this report, there is still not a complete picture of the whole financial industry. There is not an electronic system available in Puerto Rico with the main metrics of all the financial sectors. Additionally, there is no information or research performed to size the business volume of entities that are not regulated by the OCIF, like US Credit Unions, US banks, and online deposit and lending platforms. In this report we have been able to size part of the credit volume provided by US Banks through syndicated loans and part of the credit card business coming from US banks. But further research should be performed by the local regulators to size the financial business from outside players. Additionally, information from the financial sector available online is limited and in pdf format. All the non-confidential information should be available online in a structured format (e.g. excel, CSV) and the public in general should be able to query the data as they please. Currently, whatever data is not available in a pdf report online, it has to be requested to the regulator on an ad hoc basis.
- **Encourage the participation of local banks in the public sector deposit needs**. As part of its regular operations and legal processes, the Puerto Rico Government has to manage liquidity using private banks accounts. When choosing the banking institutions where it will make deposits, the public sector needs to do its due diligence (e.g. assessment of the banks' solvency, interest rates, risk diversification, additional services provided, etcetera). One of the things the Government should consider is the contribution to the Puerto Rico economy. In that respect, if Government funds remain in deposit accounts of local banks, they are likely to impact local economic activity.
- **Promote the bankarization of the Puerto Rico population**. Based on a study performed by Gaither International, approximately 65% of the Puerto Rico population has a bank account. That is a high number compared to other Latin American countries and jurisdictions, but it is low compared to the United States, where financial inclusion is approximately 94%. The economic development literature indicates that financial inclusion is associated with a decline in a household's likelihood of being poor and with reducing a household's exposure to future poverty. Any public-private sector initiatives dedicated to increasing financial inclusion in Puerto Rico could be beneficial in terms of poverty reduction in the Island. By helping and pushing families to formalize accounts with banking and other financial entities, the government will speed up and strengthen the process of sending critical funds targeted to unemployed and low and medium income households (e.g. unemployment benefits, local and federal stimulus package checks, "Programa de Asistencia Nutricional").

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