



ASSOCIATION FOR
FINANCIAL
PROFESSIONALS
Puerto Rico

Puerto Rico's debt crisis and economic trends FY2015-2016

August 18, 2015



Puerto Rico's crisis in context

- The origin of the current fiscal and debt crisis was the repeal of Section 936 of the Internal Revenue Code by the US Congress. This section provided a special tax treatment to US manufacturing companies in the Island. Since then, hundreds of manufacturing facilities located in PR left and relocated in other cheaper destinations.
- Since 2006 PR has lost 300,000 direct jobs, (100,000 in the manufacturing industry which pay the highest salaries, average of \$50,000). Industrial facilities and 936 companies in general where important to tax payers, accounting for almost 20% of fiscal revenues.



Puerto Rico's crisis in context

- Since 2006, the government faced an increasing public debt, which led to increase in tax levels to fill the fiscal gap produced by the recession. This became a vicious circle that fueled the current downward spiral.
- Once the rating was downgraded to junk by the credit agencies in 2014, and the recent defaults, PR found itself in the worst crisis since 1930 but the Commonwealth does not have tools to manage the crisis. The government can not file bankruptcy under chapter 9, Puerto Rico can not request financing to international financial organizations like the IMF or the World Bank. The island is part of the US financial system, therefore currency devaluation is not at option.



Recent developments

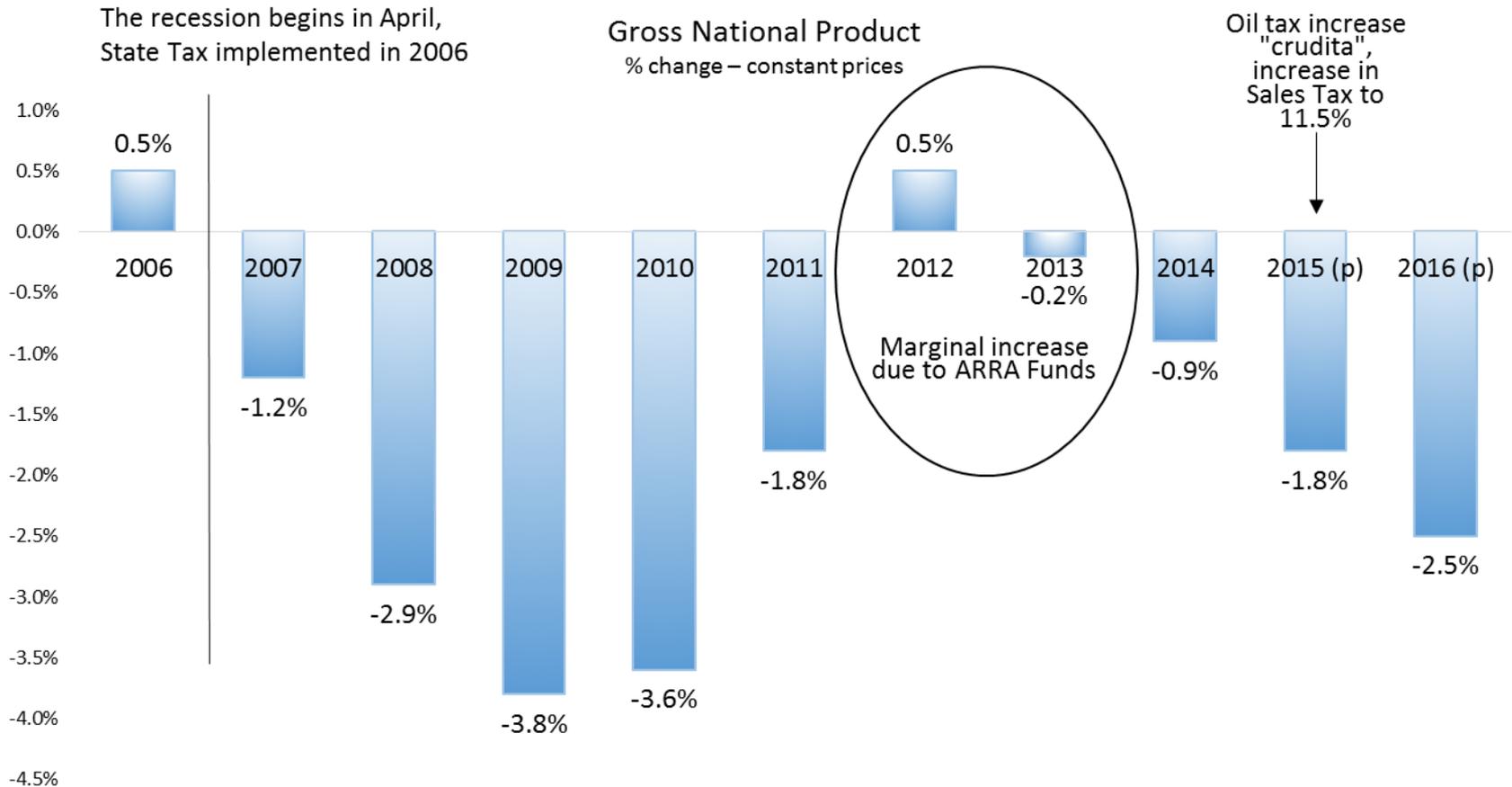
- On February 4 of 2014, Puerto Rico's credit rating was downgraded to junk status by US major credit rating agencies.
- On March 2014, the government issued \$3.5 billion of GO bonds with a coupon rate of 8.3%.
- During the summer of 2014, PR Energy Authority (PREPA) announced to their lenders (banks and bond holders), that the corporation was not able to make a \$671 million payment.
- On December 2014, the government passed a second gas tax increase from \$9 to \$15 per barrel, to back a \$2.9 billion bond issuance. The transaction was crucial to improve the Government Development liquidity position.
- Between January and May of 2015, the government unsuccessfully tried to pass a tax reform based on a VAT of 16%. The fierce opposition of several business sectors defeated the proposed reform.
- On June of 2015, the sales tax of 7% was increased to 11.5%. A new budget of \$9.8 billion was signed into law by the governor.



Recent developments

- On June 2015 a GDB report indicated that the bank's liquidity position decreased from \$3 billion to \$775 million in a 12-month period. The Board of Directors said that the government might not be able to pay some short term financial obligations.
- On June 29th 2015, the Governor's said in the NY Times that Puerto Rico's public debt was "not payable".
- On August 1st 2015 the government missed a \$57 million payment of the Public Financing Corporation (PFC) bond. However, the a payment of \$159 million of the GDB notes was made.
- On August 3rd the government halted monthly payments to the reserve of the General Obligation Bonds. This measure was taken to prevent a cash flow problem (The source for payments of GO's is the General Fund which has a current deficit of \$604 million).
- It is clear that the Administration's fiscal team is trying to avoid a government shutdown.

Gross National Product (GDP) economic growth



Source: Statistical Appendix 2014, Planning Board

Total Employment

	2013		2014		2015
January	927.5		908.7		902.5
February	928.2		911.5		907.7
March	932.4		915.9		911.9
April	928.1		911.3		911.0
May	929.0		912.3		912.4
June	926.1		901.8		902.2

Source: Department of Labor

Employment is stagnant and the labor participation rate is in the lowest level since 2005, 39.7%. Low formal employment levels and demographic trends are affecting major consumers industries.



Fiscal Collections

Categories	Projected	Collected	Difference
Personal taxes	\$2,356	\$2,295	-\$61
Corporate taxes	\$2,085	\$1,735	-\$350
Tax on foreign corporations	\$1,890	\$1,942	\$52
Sales tax	\$735	\$626	-\$109
Excise tax	\$281	\$258	-\$23
Vehicles tax	\$380	\$298	-\$82

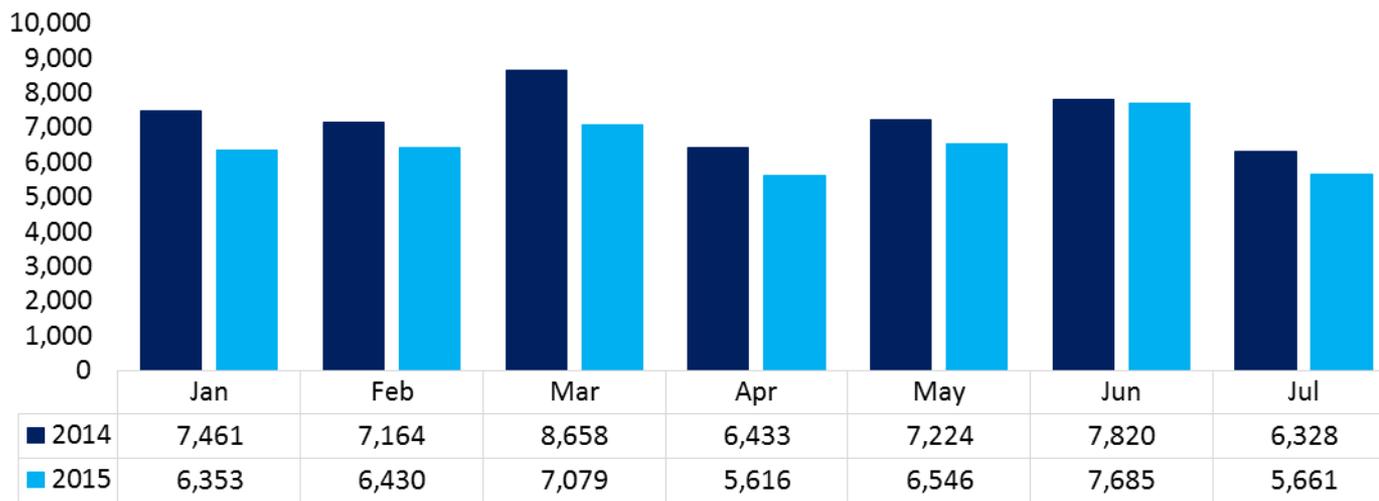
Source: Treasury Department

Fiscal year 2014-15 ended with a revenue shortfall of - \$604 million. New taxes had a negative impact on business and consumers and accelerated the economic contraction.

Economic Activity Index
(% change) - As of June 2015



Total sales of car units



Public Debt and GNP

GNP and public debt



Source: Statistical Appendix 2014, Planning Board

Fiscal Years

In the past fifteen years the public debt has increased over \$43.5 billion. In 2006, the beginning of the recession, public debt accounted for 69.0% of total GNP, in 2014 public debt accounts for 97.2%, ascending to over \$67 billion.

Puerto Rico's major debt issuers

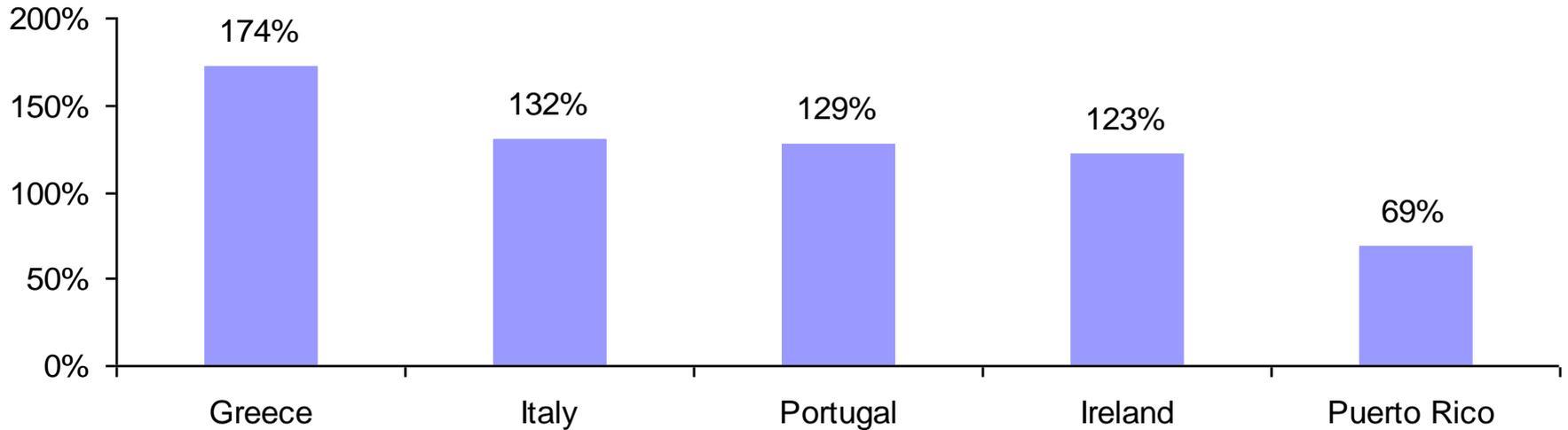
Issuers	Debt	Debt service
COFINA (Bonds backed by the sales tax revenues)	\$15,524	\$619
Central Government (GO)	\$13,383	\$1,226
PREPA	\$9,287	\$617
Puerto Rico Highways	\$7,406	\$804
Government Development Bank	\$7,166	\$852
PRASA (Water Authority)	\$4,756	\$349
Public Buildings Authority	\$4,296	\$284
Pension Obligation Bonds	\$2,948	\$167
Total	\$64,766	\$4,918

Source: Government Development Bank

Debt issuers have their own particular legal and financial structure. The problem is concentrated in the public corporations and GDB, which is the Fiscal Agent. All together their outstanding debt is \$28,255 million and estimated debt service is \$1,695 million.

Debt to GDP Ratio

**Debt to GDP Ratio
Eurozone and Puerto Rico**



Source: IMF and Government Development Bank

Puerto Rico

- Puerto Rico's public debt is \$72 billion, (69% of GDP).
- \$50 billion is held by municipal funds and hedge funds. \$20 billion is held by banks, credit unions, insurance companies, private companies and individuals.
- The island is the third largest issuer in the municipal market.
- The debt problem is concentrated in three issuers, PREPA, GDB and PR Highways (\$20 billion in total).
- Puerto Rico, is not allow to borrow money from the IMF or the World Bank The government can not devaluate its currency.

Greece

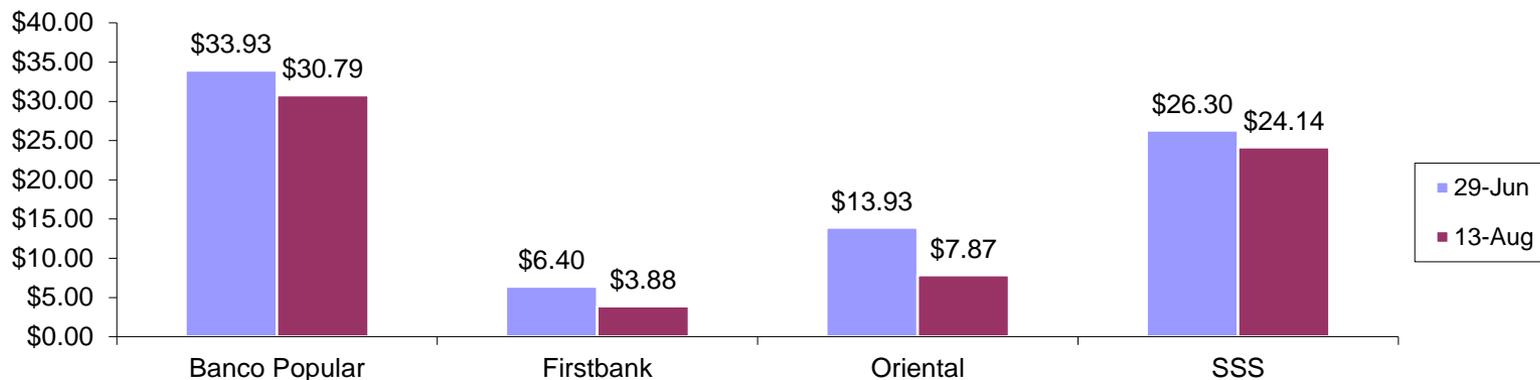
- Greece sovereign debt is 323 billion Euros, (174.9% of GDP).
- Major lender is the international bailout fund 246 billion Euros. Also includes foreign banks and Euro-zone countries.
- Greece had already received two bailouts from international lenders and the IMF.
- Greece missed a 1.8 billion payment on June 30 to the IMF.
- The European country is likely to leave the Euro and reinstate their currency. Russia and China might help Greece.



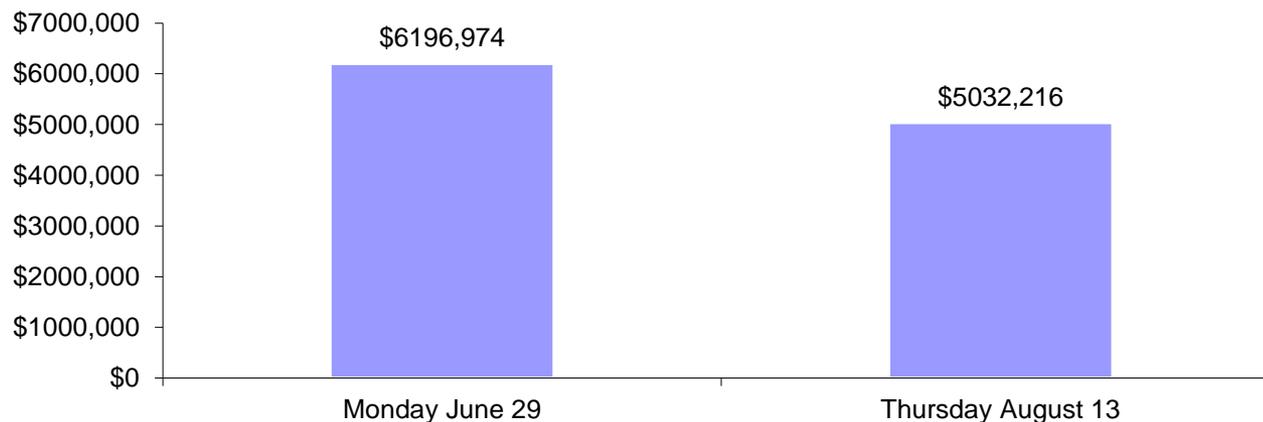
Impact of default in the Financial System

- A default will have a negative impact on the financial system. For instance, credit unions hold \$1,500 million in government bonds. (GDB 47% and GO's 13%). Under a scenario of default the lending capacity could be reduce significantly. Total exposure represents 17% of the coops assets.
- A debt restructuring process of 40% could represent loss of \$600 million on the coops system.
- Commercial banks exposure to government debt is relatively lower 8% of their assets. Nevertheless, a default could increase delinquency rates and stricter controls of the FDIC.

PR Institutions Common Shares Price



Market Capitalization local banks

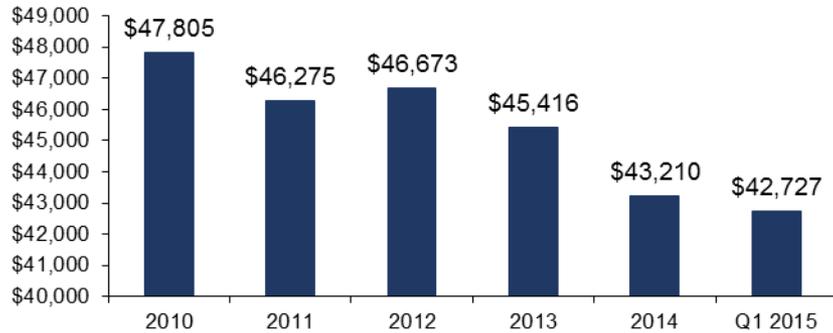


Short term challenges

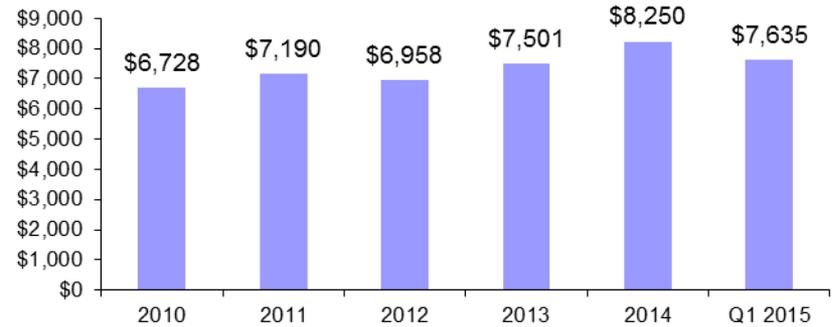
- A potential massive default could affect local and US investors. Mainland municipal funds and Hedge Funds, hold \$50 billion of the island's debt.
- The White House and other elected officials have said that they are not considering a bail out for PR.
- The House of Representative is considering a bill to amend the U.S. Bankruptcy code to allow Puerto Rico to use chapter 9, like Detroit did. Nevertheless, high ranking members of the committee are opposing the bill (HR 870).
- The US Court of Appeals for the First Circuit confirmed the decision of Federal judge that the local bankruptcy act approved by the local government, was unconstitutional.
- A government shutdown with default on debt payments is the worst case scenario that could trigger a systemic shock on the local economy. Government payroll is \$6.4 billion and total debt service reached \$4.8 billion in 2015.

Key Banking Indicators

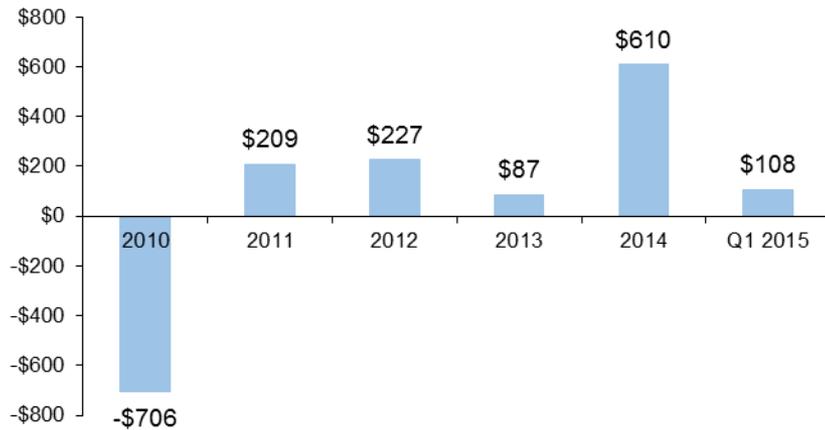
**Total deposits
(million)**



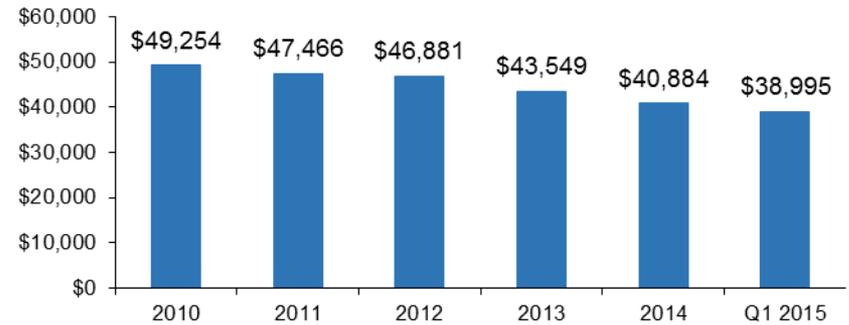
**Total Capital
(million)**



**Net Income
(million)**



**Securities
(million)**



Source: Commissioner of Financial Institutions

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