Puerto Rico's Economic and Fiscal Crisis

The Economic Situation is Challenging

Puerto Rico has experienced a sharper recession than the rest of the United States, and the economy continues to contract. Since Puerto Rico's economy began to contract in 2006, the economy has shrunk by more than 10 percent and employment on the island has fallen by 14 percent.[1] Puerto Rico's unemployment rate was 11.6 percent in August 2015, more than twice the national level. The scale and depth of Puerto Rico's downturn stems from many factors, including a boom and bust cycle in real estate and credit prior to the current fiscal crisis, longstanding problems of fiscal governance, deteriorating confidence among all stakeholders, and a structure of taxation and benefits that fails to provide the same reward for work as in the fifty states.

- Poverty levels are the highest in the nation. The number of residents living at or below the federal poverty level exceeds 45 percent, compared to a national average of about 16 percent. The median annual household income in Puerto Rico is approximately $19,000, roughly one-third of the level of median income in the United States.

- The worsening financial crisis has already caused residents to flee the island at an alarming pace. More than 300,000 people have left Puerto Rico in the past 10 years, including 84,000 people in 2014 alone.

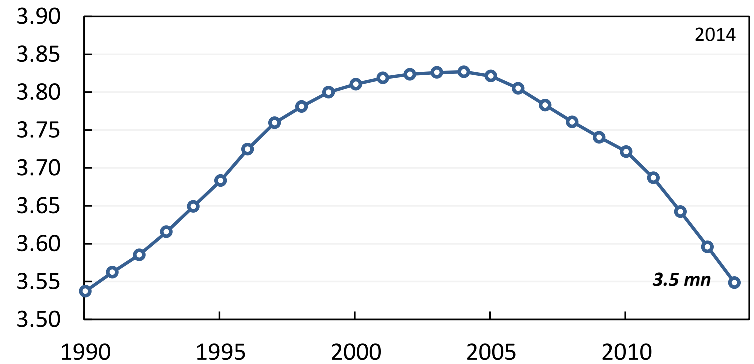
- The remaining population is one that is increasingly older and not actively seeking work. Labor force participation in Puerto Rico, at 39.7 percent, is substantially below the U.S. average of 62.4 percent. Persons 60 years and older represent more than 23 percent of the population – one of the highest in the United States.

Without additional reforms in Puerto Rico and decisive action by Congress, Puerto Rico's economy will continue to contract. Puerto Rico's Planning Board projects that economic output will decline by roughly one percentage point this year due in part to a pronounced contraction in business investment. This trend is likely to continue without real reform and changes in federal policy, as local residents continue to migrate to the fifty states.

[1] As a point of reference, during the Great Recession, the U.S. economy shrank by 4 percent and total employment fell by 6 percent.

Local Population

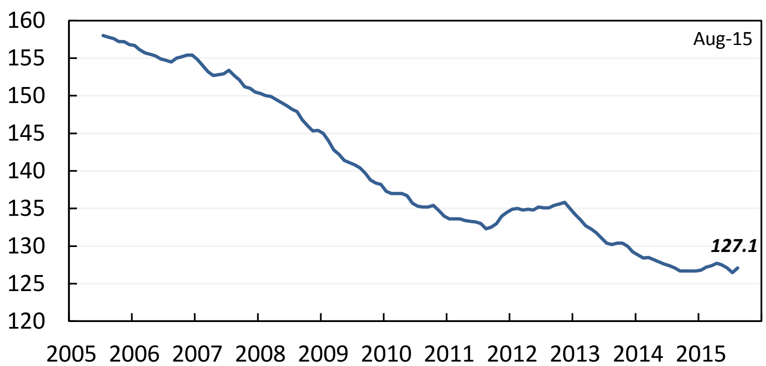
Millions



Source: World Bank.

Government Development Bank Economic Activity Index

Index, Jan. 1980 = 100



Source: Government Development Bank of Puerto Rico.

The Current Fiscal Situation is Unsustainable

Puerto Rico's economic challenges predate its current fiscal crisis. The sustained slump in the economy has contributed to the island's fiscal challenges, and Puerto Rico's fiscal challenges have in turn added to the difficulty it faces attracting private investment and restarting growth.

Puerto Rico has a history of poor fiscal performance. Historically, Puerto Rico's budgets relied on unrealistic revenue estimates, and, as a result, annual budgets masked recurring structural deficits. Moreover, past revenue and expense measures have fallen short because Puerto Rico lacks important fiscal controls to ensure discipline. Poor financial disclosure has impaired the ability to track progress against reforms enacted – reporting is opaque and deadlines have repeatedly been missed.

Puerto Rico effectively has been shut out of the traditional municipal bond market since 2013. Puerto Rico, like any other U.S. state or territory, has historically relied on the municipal markets for relatively low-cost financing. However, over the last two years it has relied on a high-cost bond placed with nontraditional lenders and the sale of assets – including pension assets – to meet ongoing commitments and cover fiscal gaps. In the past year, the Commonwealth has completely lost access to market funding; it no longer can raise even short-term financing.

- Most of Puerto Rico's uninsured bonds trade at between 30 and 70 cents on the dollar, prices that imply a high probability of a restructuring.

- Even the most highly-valued Puerto Rico bonds yield 11 percent, making long-term market financing prohibitively expensive. Prior to its crisis, Puerto Rico issued at yields in line with the rest of the market: for example, its 2006 General Obligation (G.O.) bonds were priced to yield 4.8 percent.

- Puerto Rico's bonded indebtedness is approximately $71 billion (over 100% of GNP), including close to $50 billion (70% of GNP) in tax-supported debt.[2]

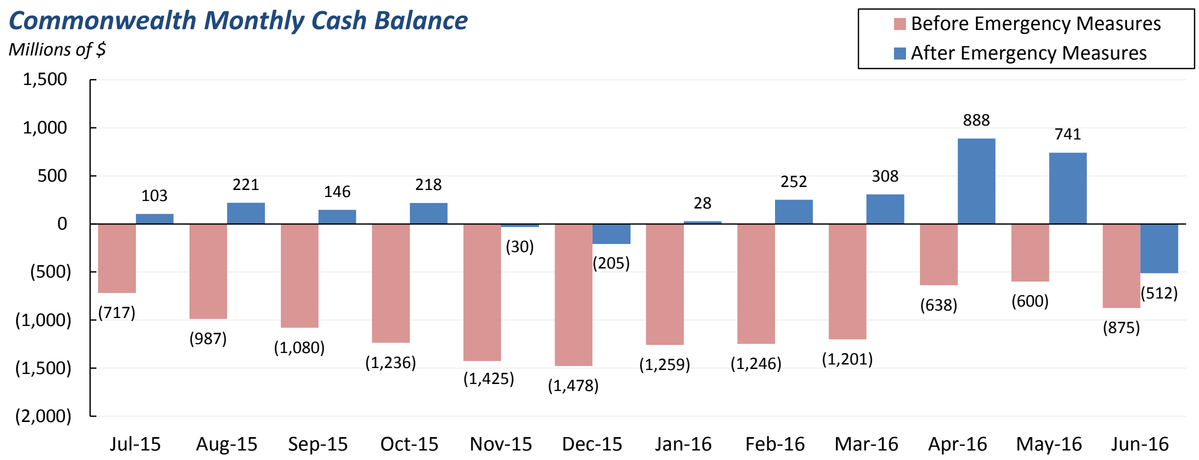
- As of FY2014, Puerto Rico's three public pension funds held just $2 billion in net assets against a combined estimated pension liability of $46 billion.

Puerto Rico's government is out of cash and is increasingly out of options.

- Government services and debt payments have only continued because Puerto Rico is deploying onerous and unsustainable emergency liquidity actions. These measures include delaying payment of tax refunds to residents, liquidating pension assets early to fund working capital, borrowing from Puerto Rico's proprietary insurance funds, failing to pay certain appropriation debts, withholding monthly set-aside funds for debt service, and stretching payment of accounts payables to vendors and other third parties.

- Even with these emergency actions, Puerto Rico forecasts it will completely run out of liquidity before year end. Once that happens, Puerto Rico will face the unenviable and difficult choice between repaying its debts and maintaining vital public services.

[2] Gross National Product (GNP) as opposed to Gross Domestic Product (GDP) is typically a more representative measure of Puerto Rico's economy, as it includes the income accruing to island residents but excludes the significant portion of income generated on the island that accrues to non-island residents, particularly in the manufacturing sector.



Source: Puerto Rico Fiscal and Economic Growth Plan, pgs. 13-14.

Significant Challenges Remain Despite Reform Efforts

Puerto Rico's recently released Fiscal and Economic Growth Plan outlines the scale of the fiscal challenges it faces. The Fiscal and Economic Growth Plan draws on the independent forensic accounting report of Conway MacKenzie and presents a consolidated picture of the public sector finances prepared with the support of former staff from the International Monetary Fund (IMF) led by Anne Krueger. It presents an accurate measure of Puerto Rico's contracted debt payments, without "scoop and toss" off-budget refinancing of various debts. The numbers continue to be refined, but there is no doubt that there is a large gap between Puerto Rico's required operating expenses, contractual debt obligations and its available financial resources.

Debt service now consumes more than one-third of annual revenues when looking comprehensively at the full range of debt supported primarily by the Commonwealth's taxing authority. This compares to a U.S. median of approximately five percent for states in fiscal year 2014, according to Moody's Investors Service. Building on the work of Anne Krueger and her IMF team, the Fiscal and Economic Growth Plan provides, for the first time, a transparent accounting of Puerto Rico's tax-supported debt service beyond what is presented in its general fund budgets.

Important fiscal adjustments have been implemented in recent years:

- Operating expenses are shrinking after taking into consideration debt payments. In fact, general fund expenses for the current fiscal year, net of debt service, are currently at their lowest level since 2005, both in nominal terms and as a share of GNP.

- A strict fiscal sustainability act (Law 66) has been enacted to reduce government expenses. Among other measures, the law froze collective bargaining agreements already in place that involve salary increases and other benefits.

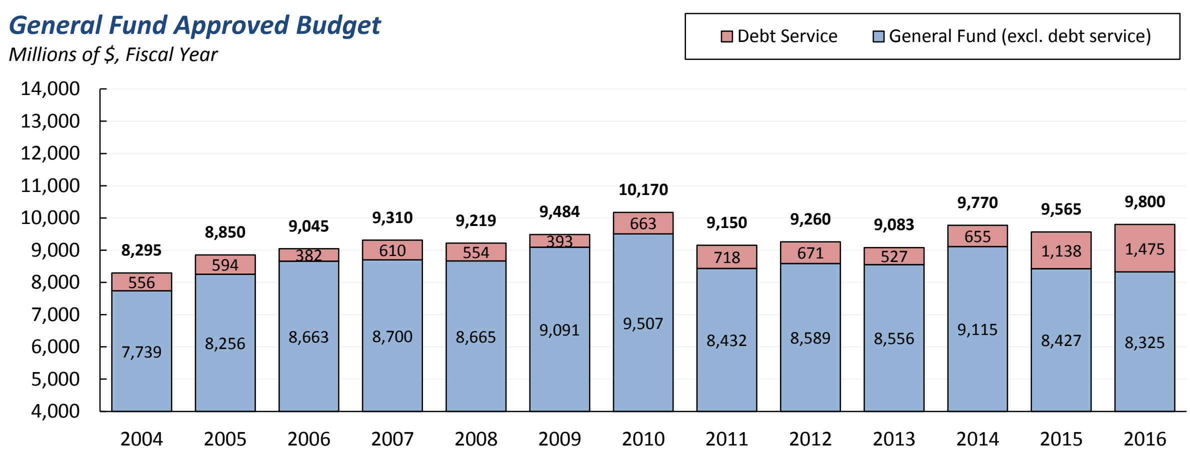
- The tax on petroleum and petroleum products was quintupled from $3.00 to $15.50/barrel – projected to generate approximately $360 million a year in additional revenues.

- The local sales and use tax was increased from 7.0 percent to 11.5 percent (now the highest in the nation) – a measure that is expected to generate well over a $1.0 billion a year in additional revenues.

Nevertheless, additional fiscal adjustment remains necessary, building on the measures proposed in the Fiscal and Economic Growth Plan. In addition to implementing the sales tax hike and transitioning to a value-added tax, the Fiscal and Economic Growth Plan also proposed changes to Puerto Rico's safety net, reforms to improve tax collections, permitting simplification, the consolidation of public schools and reduced subsidies for municipalities and higher education.

However, there are practical limits on the scale and pace of fiscal adjustment in an economy that is significantly smaller than in 2005. Too much adjustment could push Puerto Rico into a downward spiral, with the successive rounds of fiscal consolidation pulling the economy down, encouraging more outmigration, reducing revenues and requiring additional taxes or cuts. Only a return to growth can end this vicious cycle.

Stronger fiscal governance is critical. While the Fiscal and Economic Growth Plan is a welcome first step towards increased transparency, there is more work to do. The Plan proposes a new accounting system, a new budgetary process, reforms to the structure of Puerto Rico's Treasury Department, and steps to improve budget execution across Puerto Rico's many agencies. These steps need to be reinforced by independent and credible fiscal oversight to provide sufficient safeguards to ensure Puerto Rico adheres to its reforms. Doing so would likely restore confidence among stakeholders.



Note: Debt service for FY16 includes $275M from Special Economic Development & Debt Service Fund.
Source: Puerto Rico Office of Management & Budget FY2016 Proposed Budget Presentation.

Debt Restructuring is Unavoidable

Puerto Rico's Fiscal and Economic Growth Plan outlines a $28 billion fiscal gap over the next five years in the absence of any policy changes. This exceeds the $18 billion in contracted debt service, underscoring the need for improved fiscal controls and additional fiscal adjustment.

The full implementation of the measures outlined in the Fiscal and Economic Growth Plan, including, critically, the increase in the sales tax and transition to a value-added tax, is estimated to close the financing gap by half. This estimate includes sizeable projected revenue gains from an assumed return to stronger growth in 2019 and 2020. Even with these projected gains, there is a five-year gap of $14 billion – a gap that likely will need to be filled, in part, through a renegotiation of the Commonwealth's large and complex debt burden.

Puerto Rico's Pension Systems are Also at Serious Risk

Puerto Rico's public pension system is also in crisis, and can no longer be used to help finance government operations. There is a long-standing discrepancy between what the Commonwealth contributes to the system and the annual required contribution stipulated by the systems' actuaries. As part of a 2013 reform, required employer contributions will gradually be raised from 10 to over 20 percent of payroll, bringing total employee and employer contributions to 30 percent of payroll, and changes were made to the accrual of future benefits in the largest public pension fund. Nevertheless, Puerto Rico's public pension funds have the lowest funded ratio of any state or territory.

- <u>While legislation designed to comprehensively the Island's largest public pension system, the Employee Retirement System (ERS), was enacted in 2013, the portion of the legislation related to its second largest system, the Puerto Rico's Teachers Retirement System (TRS), was partially overturned by Puerto Rico's Supreme Court.</u>

- <u>Furthermore, the Commonwealth has not made the additional contributions to the public pension system required and contractually mandated under the 2013 reform</u>. In FY2014, the Commonwealth was only able to pay current pension benefits through the sale of close to one billion in assets from its three public pension funds.

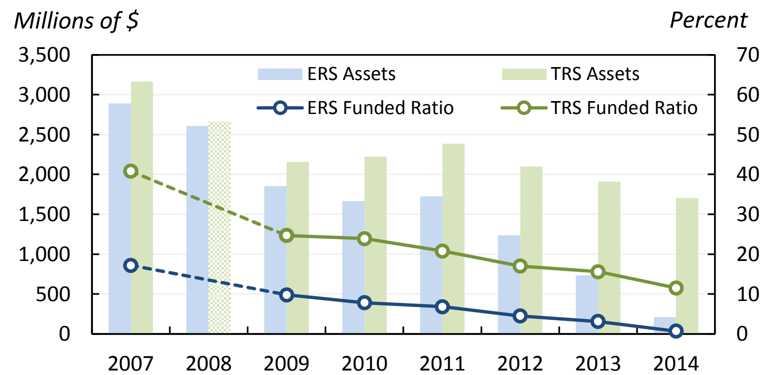
- <u>The unsustainable drawdown on pension fund assets has continued.</u> At current drawdown rates, the assets of the two main public pension funds will be depleted before the end of the decade. At the end of FY2014, Puerto Rico's three public pension funds held just $2 billion in net assets against a combined estimated pension liability of $46 billion.

- The Commonwealth recently accelerated public pension fund asset sales to help provide short-term financing for core governmental operations as part of its emergency actions.

- The Commonwealth's forward-looking fiscal plan cannot rely on the sale of pension assets to help the Commonwealth meet its other contractual obligations; future budgets will need to raise contributions to the pension systems to protect the Commonwealth's ability to pay retiree's benefits.

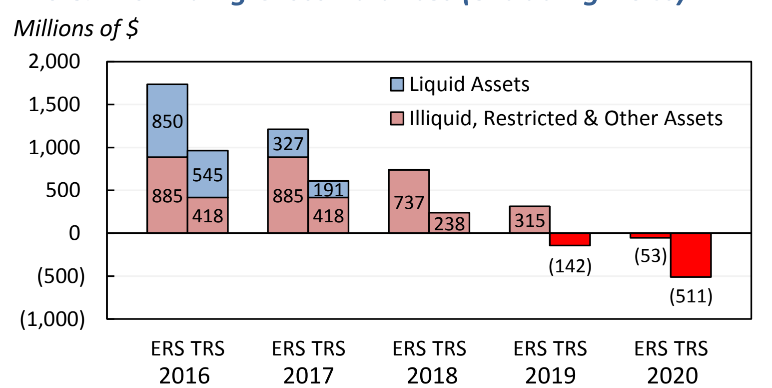
Any restructuring of Puerto Rico's financial liabilities should account for the promises the Commonwealth has made to its public servants.

Pension Assets (left axis) & Funded Ratios (right axis)



Note: Reflects net assets. 2014 ERS estimates are preliminary. 2008 TRS assets are interpolated.
Source: ERS, TRS Actuarial Reports; Commonwealth Quarterly Report, May 2015.

ERS & TRS Ending Gross Balances (excluding AUCs)



Note: AUC denotes additional uniform contribution.
Source: Puerto Rico Fiscal & Economic Growth Plan, pg. 77.