

Recent Developments in the Puerto Rican Debt Crisis (05/17/2016)

On May 2, Puerto Rico failed to repay almost \$400 million in bonds issued by the Government Development Bank (GDB), Puerto Rico's main government bond issuer, intergovernmental bank, fiscal agent, and financial advisor. It was the largest missed principal payment so far by the island. The recent default is particularly significant because it means Puerto Rico is now heading towards defaulting on bonds deemed more secure. That is, in Jan. 2016, Puerto Rico defaulted on roughly \$37 million in bonds issued under the Puerto Rico Infrastructure Financing Authority (about \$36 million) and Puerto Rico Public Finance Corp. (about \$1 million), which are considered lower priority bonds by the government as they are not backed by the Puerto Rican constitution. Puerto Rico's economic crisis has intensified with this most recent missed bond payment because it has been enduring an ongoing economic crisis that seems to have reached a critical stage. Furthermore, if Puerto Rico defaults on its next payment, due July 1, it will have defaulted on approximately \$800 million general obligation bonds, which were issued directly by the Puerto Rican government and are protected by the Puerto Rican Municipal Financing Act which states that holders of municipal general obligation bonds shall have the right to compel the municipality to exercise its power to levy taxes for the payment of the principal, interest and premiums of early redemption, if any, of said bonds. While the Puerto Rico debt crisis is not expected to impact the U.S. economy or its \$3.7 trillion municipal bond market, a default of this magnitude could lead to years of court proceedings since Puerto Rico currently lacks the ability to file for bankruptcy. The U.S. Congress has been debating whether to grant Puerto Rico the ability to file for bankruptcy. Unless that happens, the only avenue investors will have to resolve their issues will be through the courts.

BACV of U.S. Insurer Exposure to Bonds Issued by Puerto Rico (\$)

| BACV | 2015 | % of Total | 2014 | % of Total | % Change 2014 to 2015 |
|--------------|----------------------|---------------|----------------------|---------------|--------------------------|
| Life | 361,517,923 | 31.0% | 507,993,019 | 36.3% | -28.8% |
| Property | 780,777,727 | 66.9% | 834,734,875 | 59.6% | -6.5% |
| Health | 19,323,665 | 1.7% | 51,388,089 | 3.7% | -62.4% |
| Title | 4,690,043 | 0.4% | 5,948,158 | 0.4% | -21.2% |
| Fraternal | 228,512 | 0.0% | 338,016 | 0.0% | -32.4% |
| Total | 1,166,537,870 | 100.0% | 1,400,402,157 | 100.0% | -16.7% |

Par Value of U.S. Insurer Exposure to Bonds Issued by Puerto Rico (\$)

| PAR | 2015 | % of Total | 2014 | % of Total | % Change 2014 to 2015 |
|------------------|---------------|-------------------|---------------|-------------------|----------------------------------|
| Life | 660,646,899 | 18.8% | 673,561,147 | 22.4% | -1.9% |
| Property | 2,827,018,045 | 80.4% | 2,267,139,545 | 75.6% | 24.7% |
| Health | 25,414,000 | 0.7% | 54,143,123 | 1.8% | -53.1% |
| Title | 4,540,000 | 0.1% | 5,540,000 | 0.2% | -18.1% |
| Fraternal | 305,000 | 0.0% | 335,000 | 0.0% | -9.0% |
| Total | 3,517,923,944 | 100.0% | 3,000,718,815 | 100.0% | 17.2% |

Average Book Price of Aggregate Insurer Exposures

| | 2015 | 2014 |
|------------------|-------------|-------------|
| Life | \$ 54.72 | \$ 75.42 |
| Property | \$ 27.62 | \$ 36.82 |
| Health | \$ 76.04 | \$ 94.91 |
| Title | \$ 103.30 | \$ 107.37 |
| Fraternal | \$ 74.92 | \$ 100.90 |
| Total | \$ 33.16 | \$ 46.67 |

As of year-end 2014, direct ownership of Puerto Rican bonds by U.S. insurers was \$1.4 billion in book/adjusted carrying value (BACV). As of year-end 2015, it dropped to \$1.16 billion, a decrease of 16.7%. Over the same period, the par value of these bonds increased, mostly due to purchases by bond guarantors. Purchases at deep discounts allow the bond guarantors to reduce their net exposure. In addition to the purchases in the last year at deep discounts, the aggregate BACV was also impacted by Other Than Temporary Impairments (OTTI) taken by insurers, reflecting low trading prices and expectations of defaults. From year-end 2014 to year-end 2015 the BACV of property/casualty (P/C) bonds decreased about 6.5% while the par value increased almost 25% (note that bond guarantors file as P/C companies). Recent prices for bonds not benefiting from a guarantee have ranged from \$15 to \$60, with most trading in the mid-\$30s, depending on the specific issuer. U.S. insurance companies' year-end 2015 exposure consisted primarily of Puerto Rico Sales Tax Financing Corporation (COFINA) bonds, or \$788 million BACV representing 67.6% of total U.S. insurer Puerto Rico bond exposure. COFINA bonds are currently trading around \$20 to \$60. Regulators should consider where insurance companies are valuing bonds issued by Puerto Rico, especially those not insured by one of the bond guarantors.

The Capital Markets Bureau will continue to monitor trends with Puerto Rico's debt crisis as it evolves.