Issue Review
August 7, 2015

Puerto Rico's Debt Crisis Continues to Deteriorate - Credit Negative for Domestic Insurers

Partial payment triggers a default, according to many.

A.M. Best has closely monitored ongoing events within Puerto Rico and their resulting impact on insurers domiciled on the island. On May 13, 2015, A.M. Best issued a market briefing "Puerto Rico's Economic Woes Remain a Challenge for Puerto Rico Insurers." On July 2, 2015, A.M. Best issued an additional market briefing "Puerto Rico's Economic Struggles an Ongoing Challenge for Puerto Rico".

Developments occurring since the July 2015 briefing include:

- On July 13, 2015, the Working Group for Economic Recovery of Puerto Rico hosted Puerto Rico's creditors to address the financial conditions and long-term economic growth prospects.
- The findings of The Puerto Rico Fiscal and Economic Recovery Working Group established by Governor Padilla to evaluate potential corrective actions available to the Commonwealth should be presented by the end of August.
- On August, 1, 2015, Public Finance Corporation (PFC) made a partial payment of only $628K of the $58 million due on its outstanding bonds, triggering a default, in the view of many.
- The President of the Government Development Bank (GDB) disputed that a default occurred, stating that Puerto Rico's legislature is not legally bound to allocate funds to satisfy bond payments.
- The GDB, in a notice to its investors, stated that it has temporarily suspended monthly deposits made to the reserve fund used to pay principal and interest on Constitutionally protected debt.

The Commonwealth's inability to maintain timely ongoing coupon payments was not a surprise, as the weak economy has increased liquidity concerns given the lack of access to available cash. The GDB, a funding source for Puerto Rico that lends funds to the Commonwealth and municipalities, previously stated that the possibility exists that the government and the GDB may run out of available cash by September 30, 2015.

The value of Puerto Rico's public bond holdings has declined considerably given ongoing budget constraints and concern that the Commonwealth may default given lack of liquidity, with an additional reduction occurring following the events of this week. (See **Exhibit 1**.)

While Puerto Rico Governor Alejandro Garcia Padilla stated publicly in late June that Puerto Rico is unable to repay its existing ongoing debt obligations as currently structured, restructuring options on the existing debt remain limited, as bankruptcy protection is currently prohibited under federal law for both U.S. territories and commonwealths. While the Puerto Rico Chapter 9 Uniformity Act of 2015 (H.R. 870) was introduced into Congress, it remains unclear how much support this bill may receive. The provisions of the bill would provide the Commonwealth the protection afforded states under U.S. Bankruptcy laws.

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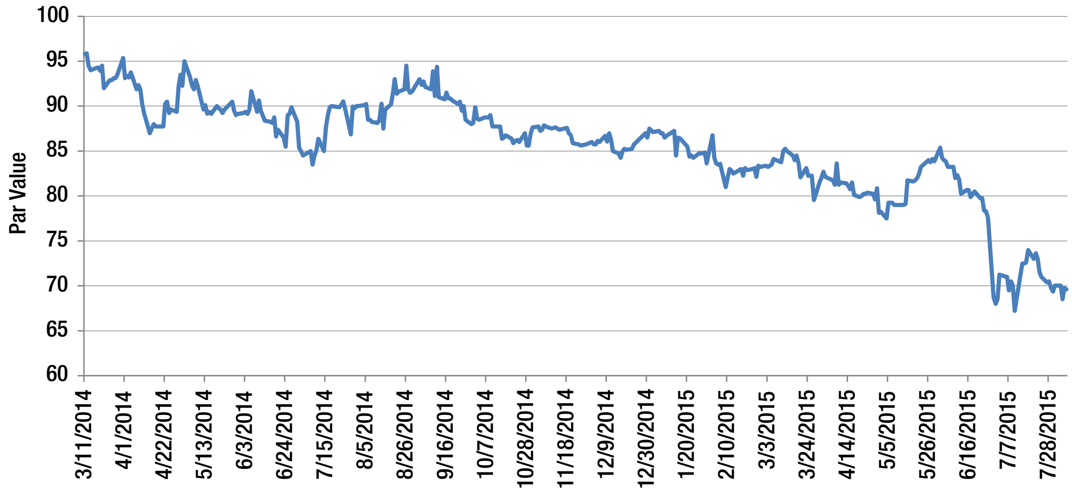
Exhibit 1
Par Value of Puerto Rico General Obligation Bonds Due July 2035 Over Time



Source: Bloomberg

As previously stated, the ongoing uncertainty remains a credit negative for Puerto Rico insurers. These issues pose challenges to the financial strength and capital requirements of the Commonwealth's property/casualty and life/health insurance carriers.

While the market for property/casualty insurers remains highly competitive given the number of cedents operating within a defined market competing for business, carriers for the most part have maintained underwriting discipline while maintaining balance sheet strength, resulting in generally solid earnings produced by Puerto Rican domiciled companies. However, the competitive operating environment and inability of the Commonwealth to grow the economy will hinder carriers' ability to grow over the foreseeable future.

With respect to life/health writers in Puerto Rico, the market remains highly competitive with net premiums written, declining modestly in recent years. Given the ongoing budget challenges and persistently high unemployment rates, companies will face ongoing challenges to increase revenues. Despite the premium decline, total capital (including the asset valuation reserve) has increased at a compounded rate of nearly 10% over the past five years

While companies have stated both an ability and intent to hold Puerto Rico bonds through maturity, those forced to sell Puerto Rico bonds at current depressed values will incur capital losses given the current valuations.

From a balance sheet perspective, the Puerto Rico domiciled insurance companies maintain material bond exposure to lowly rated Puerto Rican fixed income securities. While some carriers maintain more exposure than others, these carriers generally remain adequately capitalized relative to their ratings, inclusive of stressed scenarios that consider an increase in risk factors to reflect the potential for further reductions in the credit quality of Puerto Rico-related investments. The bond rating downgrades result in higher required capital charges to both the NAIC RBC and Best's Capital Adequacy model (BCAR). Although most carriers maintain sufficient capital to support lower bond ratings given the adequate capital positions and manageable exposures to Puerto Rico municipal bond market, there will be circumstances where rating actions may have to be taken.

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