Issue Review
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Puerto Rico's Economic Woes Remain a Challenge for Puerto Rico Insurers

The Puerto Rican economy has been in a recession since 2006.

As a U.S. Territory, the Commonwealth of Puerto Rico controls financial decisions inclusive of budgets and discretionary spending, in a similar manner to any of the 50 U.S. States. However, the current economic situation facing Puerto Rico reflects the combined effect of weak economic conditions which have existed for years, a declining population base with many choosing to relocate to the U.S. mainland, and the resulting negative impact on taxable revenues. In addition, Puerto Rico also contends with tax revenue short-falls due to a sizeable underground economy. These issues, combined with the stubbornly high unemployment rate, have negatively affected the government's taxable revenue base. As a result, it has been difficult for the government to generate sufficient revenues to cover ongoing expenses through the existing tax structure.

Exacerbating the economic issues is the existing significant public debt of approximately USD 73 billion carried by the Commonwealth which restricts further access to external debt markets. With no possibility to restructure its debt through bankruptcy protection, which is prohibited under federal law for territories and commonwealths, Puerto Rico faces significant hurdles to reduce this burden. The government has attempted to get its finances in order in recent years through new legislation, but so far, has not been successful.

One example was the passage of The Puerto Rico Public Corporations Debt Enforcement and Recovery Act (Recovery Act) on June 28, 2014, which was intended to permit financially distressed state owned agencies to seek bankruptcy protection. However, on February 6, 2015, the Recovery Act was overturned by Judge Francisco Besosa of the U.S. District Court for the District of Puerto Rico stating that it violated the federal Bankruptcy code, leaving the Commonwealth unable to restructure its debt as intended. The ruling was subsequently appealed by the Puerto Rico government and remains under appeal. Also in February 2015, Puerto Rico's Governor Padilla introduced proposed legislation intended to restructure the Commonwealth's current tax system in an effort to increase tax revenues while reducing collectability issues. Generally , the proposed tax legislation would replace both the 7% Sales and Use Tax (SUT), and the Gross Receipts Tax with a Value Added Tax (VAT) of 16% which would tax consumption rather than income. Under the proposed legislation, effective personal income tax rates would have declined, while revenues would have benefitted from the VAT tax. However, Puerto Rico's House of Representatives voted down the proposed legislation in April 2015, heightening concerns about Puerto Rico's debt paying ability.

The Puerto Rican economy has been in a recession since 2006, with local economic conditions weakening prior to the economy of the mainland United States, and has been slower to recover than the mainland. Puerto Rico's long term budget pressures reflect the aforementioned weak economic environment, combined with high debt levels and ongoing costs associated with the debt service. Over the near term, the economic growth outlook remains weak as evidenced by the December 2014 Economic Activity Index published by Puerto Rico's Government Development Bank (GDB), an indication of general economic activity, which declined 1.4% when compared with the prior year.

Given the economic environment and limitations to restructure its debt, Puerto Rico's creditworthiness remains challenged at this time. Although A.M. Best does not rate Puerto

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Rico's public debt, the February 2015 ruling that declared the Recovery Act unconstitutional was closely followed by multi-level downgrades of Puerto Rico's debt by various rating agencies. Despite the impact of budget deficits and weak economic factors, the government of Puerto Rico has not defaulted on the interest or principal payments of public debt. However, based on its most recent quarterly filing, the possibility exists that the government and GDB may run out of available cash by September 30, 2015.

Despite these challenges, the financial strength of the Commonwealth's property / casualty insurance carriers remain generally solid. While the market remains highly competitive due in part to the number of carriers operating within a limited market space competing for business, balance sheets remain strong and underwriting discipline has been maintained, resulting in generally solid earnings produced by Puerto Rican domiciled companies. However, the competitive operating environment and lack of economic growth will continue to constrain carriers' ability to grow.

With respect to life and health writers in Puerto Rico, the market is likewise highly competitive. In general, net premium written has declined modestly in recent years. On the positive side, total capital (including the asset valuation reserve) grew at an annual compound rate of nearly 10% over the past five years. Given the recent pressures stemming from the budget challenges and a high unemployment rate, both property / casualty and life / health companies are likely to continue to face challenges with respect to meaningful growth.

From a balance sheet perspective, the Puerto Rico domiciled insurance companies have some bond exposure to low rated Puerto Rican fixed income securities. However, these carriers generally remain well capitalized relative to their ratings, inclusive of stressed scenarios which 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 translate to higher required 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 the Puerto Rico municipal bond market, A. M. Best notes there may be limited circumstances where rating actions may have to be taken.

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