

## **Puerto Rico Hill Update – Comprehensive Annual Fiscal Report**

**March 8, 2016**

### Action is Needed Now

Puerto Rico is in distress. It has begun defaulting on its debt, and it no longer has access to the credit markets. Upcoming debt payments on May 1st threaten a worsening crisis. Health, education, and public safety services have been curtailed because the government cannot pay all of its bills. Hospitals are closing floors and people and businesses are leaving the Island. Congress must take action to assist the 3.5 million Americans living in Puerto Rico.

### The Necessary Tools to Address the Crisis

The Administration has put forward a comprehensive [proposal](#) to help solve Puerto Rico's financial problems. The proposal includes a debt restructuring mechanism paired with fiscal oversight, healthcare transformation, and tax incentives to reward work and encourage economic growth. While we believe all elements of our plan are essential to Puerto Rico's recovery and long-term growth, Puerto Rico urgently needs federal legislation that pairs an orderly process to restructure all of its debts with strong, independent fiscal oversight. This combination has proven effective in responding to past financial crises, costs taxpayers nothing, and is a prerequisite to put Puerto Rico on a sustainable path forward. It is a far better outcome for markets than the cascading series of defaults and litigation that have already begun.

### Financial Disclosures Show a Crisis Already Exists

The Commonwealth's draft FY 2014 financial statement, while delayed and unaudited, is the latest set of detailed financial information released by the Commonwealth. Puerto Rico has issued recent financial information at a detailed account-by-account level, which demonstrates the dire state of its current fiscal condition. Over the last year, the Commonwealth has published:

- A forensic accounting [analysis](#);
- A report on the Commonwealth's financial [condition](#);
- A comprehensive debt sustainability [analysis](#) conducted by former International Monetary fund staff; and
- A detailed 10-year [forecast](#) of revenues and expenses.

This information generally paints a more timely and accurate picture of the scale of Puerto Rico's fiscal challenges.

### Puerto Rico's Comprehensive Annual Financial Report (CAFR)

Puerto Rico publicly released on February 15, 2016, a working draft of the Commonwealth's Fiscal Year 2014 financial [statements](#). These financial statements only confirm that Puerto Rico's fiscal situation is both deteriorating and dire. While the statements have yet to be fully audited, it is important to note

that this is a symptom – not a cause – of Puerto Rico’s poor fiscal condition and troubled fiscal governance. It should not be a reason to delay passage of federal legislation that pairs fiscal oversight with broad territorial restructuring authorities.

### Background on Puerto Rico’s CAFR

In general, a CAFR provides a snapshot in time of a government’s financials, including its assets and liabilities, cash flows, and accounts payable balance. It includes detailed information for all departments, agencies, funds, functions, and public corporations of a state, municipality, or government entity. It is important to note that governments prepare the financial reports and auditors render an opinion on them. The auditors do not prepare the numbers.

Puerto Rico’s draft CAFR for the fiscal year ended June 30, 2014 contains fully audited financial information for all but three of the Commonwealth’s seventy component units, public corporations and retirement systems. Draft financial statements that have not yet been audited are included for the Government Development Bank for Puerto Rico (GDB), the Employees Retirement System (ERS) and the Retirement System for the Judiciary (JRS). The draft financial statement as a whole still needs to undergo final review by the auditors. KPMG, the Commonwealth’s independent auditor that has reviewed the working draft, estimates that the final audited statements should be completed by early April.

### Highlights – The State of Puerto Rico’s Finances

Although the working draft contains financial information only for the fiscal year ended nearly two years ago, the report does devote a section to concerns over the Commonwealth’s current inability to maintain government operations, provide essential services, and ensure adequate funding to the government pension systems. These concerns include -

- Continued Deficits at the Central Government - The central government reported a “Governmental Funds” deficit of \$4.1 billion for FY 2014, which was financed primarily through \$3.5 billion new debt in March 2014. This deficit is in line with recent trends – for the previous five fiscal years, the Commonwealth reported deficits averaging \$4 billion a year. Most of the basic services provided by the Commonwealth are funded through governmental funds.
- Worsening Fiscal Position for the Public Corporations - The Commonwealth's public corporations reported a net position of \$7.8 billion as of June 30, 2014, a \$1.7 billion decrease from its net position of \$9.5 billion at the beginning of the fiscal year, which reflects a continued deterioration in their financial condition as well.
- Warning on Possibility of Default - In the working draft’s initial disclaimer, the Commonwealth makes clear the near-term possibility of default:

“... to the extent that the Commonwealth or any entities related to the Commonwealth are unable to materially improve their financial position in the immediate future, such entities and/or the Commonwealth may need to seek relief under existing or potential future laws regarding receivership, insolvency, reorganization, moratorium and/or similar laws affecting creditors’ rights, to the extent available, and may resort to other emergency measures including nonpayment of debt obligations.”

- Risk of Default Across Multiple Entities - This “going concern” regarding the Commonwealth’s ability to operate applies not only to the central government but also to more than ten other government entities, including the Puerto Rico Electric Power Authority (PREPA), the Island’s sole electricity provider; the Puerto Rico Highways and Transportation Authority (HTA), the Island’s major highway and road operator; the Puerto Rico Health Insurance Administration, which oversees the Medicaid-funded programs for low-income individuals; and the Island’s three public pension systems, with 330,000 members.
- Particular Risk to the Commonwealth’s Key Fiscal Agent - The working draft also warns that the ability of the Government Development bank (GDB) to continue operating is a “going concern”. The GDB is the key fiscal agent of the Commonwealth, responsible for holding government deposits, clearing payments, and managing the central government’s finances. The report notes that the GDB projects its liquidity may be insufficient to meet all of its financial obligations in the second quarter of this calendar year. Consequently, the report warns:

“If GDB were to be placed in receivership or if its liquidity falls below a level necessary to operate in the ordinary course, the Commonwealth and its instrumentalities may have limited access to their funds deposited at GDB, which could in turn affect the provision of essential government services.”

- Danger to the Delivery of Essential Public Services - The working draft also points out that, given GDB’s key role in supporting the Commonwealth and its instrumentalities, the Commonwealth may need to propose emergency legislation that includes a moratorium on the payment of the GDB’s debt service, powers to determine claims and prioritize payments, or other remedies that could potentially affect the rights of creditors. The GDB has sizeable debt payments due on May 1st, 2016.