



*Chapter*

*First Draft*

# ECONOMIC DEVELOPMENT PLAN FOR THE FINANCIAL SECTOR

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## **I. DIAGNOSTIC FOR PUERTO RICO'S FINANCIAL SECTOR**

### **INTRODUCTION**

#### **OBJECTIVES**

This chapter focuses on the analysis of the financial industry in Puerto Rico. The objective of this chapter is to obtain a comprehensive analysis on the matter, which will begin with a historical analysis and a conceptual framework and work up to an evaluation of current, local and regional, issues in the financial sector. The current characteristics of the sector will also be evaluated, to determine the relevance of the financial sector to the economic activity of the Island, and the risks associated with the sector.

#### **SOURCES OF INFORMATION**

The source of the information used for the purposes of this analysis is the Puerto Rico Planning Board, from the Office of the Commissioner of Financial Institutions, (OCIF, for its Spanish acronym), the Comptroller's Office (OC, for its Spanish acronym) and the U.S. Census Bureau. The "Country Business Patterns" from the U.S. Census Bureau were also used for the sector characteristics analysis, the quotient for the financial sector, comparisons of sector characteristics with other states, and for the salary, employment, and establishment number comparisons with other states.

#### **ORGANIZATION**

This chapter is divided into 3 sections: Introduction, Diagnosis of the Financial Sector in Puerto Rico, and Regional Tendencies.

The Introduction is composed of the following sub-sections: Objectives, Source of Information, and Road Map (Organization). The analysis for Puerto Rico's financial sector can be found in the Diagnosis of the Financial Sector in Puerto Rico. This section is composed of the sub-sections: Overview of the Financial Sector in Puerto Rico Historical Review, Recommendations of Previous Plans, Sector Characteristics, and Relevance of the Financial Sector in the economic activity.

The third section deals with Regional Trends and is composed of the sub-sections: Location Quotient (Puerto Rico/US) of wages, employment, and enterprises, Comparison of the Characteristics of the Sector with Selected States, Comparison of Wages, Employment, and Number of Enterprises with Selected States, and Regional Exports Opportunities.

### **DIAGNOSIS OF THE FINANCIAL SECTOR IN PUERTO RICO**

#### **OVERVIEW OF THE FINANCIAL SECTOR IN PUERTO RICO'S ECONOMY**

Puerto Rico's economy is often described as contradictory and paradoxical, and the financial sector is not an exception to this. On one hand, there is no doubt that the Island boasts a developed and sophisticated financial system, which operates within the practices and processes of the U.S., the most advanced in the world. On the other hand, it is just as true that Puerto Rico still has a financial system which is incomplete and fragmented, in which there is no diversity or amplitude of institutions, markets and products which are characteristics of developed economies.

Even though the local financial system has been established since the 19th Century, while still under Spanish political and economic rule, the financial entities on the Island have been operating under U.S. institutional and regulation standards. And so, it has been an integration process which has taken over a century, even though Puerto Rico shares, not only the U.S.'s institutional and regulation framework, but also, the same currency, the same interest rate structure and, the same framework for monetary policy.

For all of these reasons, it is still puzzling that after a century of operating within the U.S. financial framework, the local financial system remains incomplete and fragmented. The Island's financial system is also a vulnerable one, due to the financial crisis that has weakened it since the past decade. Many researches have pointed to the fact that Puerto Rico relies heavily on commercial banks for financing businesses, since there are no alternative sources for financing that are commonplace in the U.S. and other more developed financial markets (Maldonado-Baer y Walter, 2005; FRBNY, 2012). This kind of dependency is risky for an economy, since commercial banks face structural and short-term challenges which limit their capacity to finance economic activity.

In their analysis on Puerto Rican competitiveness, the Federal Reserve Bank of New York points out the following (2012, p.14):

“A sound financial system that efficiently transforms savings into productive investments is a crucial feature of a well-functioning economy and essential for competitiveness. However, both short-term and longer-term challenges are dampening credit availability to local businesses in Puerto Rico. Bank condition and performance deteriorated sharply in recent years following a boom and bust in real estate lending, leaving banks risk averse and poorly positioned to lend. Loan demand is tepid given Puerto Rico's weak economic outlook, and collateral values have declined significantly, making it more difficult for prospective borrowers to qualify for loans. Over the longer term, banks have faced challenges in growing their core deposit base, particularly given the crowding-out effects of the government's substantial funding needs. As a result, banks have relied on non-core-deposit funding sources, the availability of which has become increasingly constrained. Together, these factors suggest a protracted period of bank deleveraging in Puerto Rico that will continue to weigh on economic activity. Limited alternatives to bank funding for local businesses raise the importance of a recovery in banking system condition and performance and of efforts to cultivate other private financing mechanisms.”

In that same report, the following statement can be found: (p. 15):

“Alternatives to bank funding of local businesses in Puerto Rico are currently limited, underscoring the challenge that firms face obtaining finance against the backdrop of current and longer-term bank constraints. While investment companies and credit unions have gained market share over the past decade, these entities still represent a small percentage of financial system assets, with the former largely deploying assets under management to government securities and the latter focused primarily on consumer lending. Venture capital and private equity are also relatively scarce on the Island. Both government and private sector initiatives—such as direct lending and guarantees by Puerto Rico's two government banks,<sup>45</sup> U.S. Small Business Administration and Export-Import Bank loan programs, and private sector capacity-building initiatives such as Grupo Guayacán, Inc.—have helped mitigate financing constraints, but mainly at the margin.”

On the same subject, Maldonado-Baer and Walter point out the following (2005, p. 454):

“Commercial Banks appeared to have failed to allocate funds to economic development through commercial and industrial loans as much as would seem desirable in an economy such as Puerto Rico's. Moreover, they have not generated sufficient asset gathering in the form of savings and checking deposits from the household sector to underwrite the capital formation needed to create the kind of self-sustained economic development described in chapter 1 of this book.

[...] all banks on the island need to invest less in securities and instead to lend for commercial and industrial purposes at longer maturities. The trade-off between dedicating funds for development and form more liquid investments—securities issued mainly outside Puerto Rico—is a necessity if the banks are indeed going to do their job to stimulate development.”

## **HISTORICAL REVIEW**

### **Conceptual Framework: Financial Intermediation**

The service portfolio provided by the financial sector is vital to the operation of the economy. In addition, in the case of developing countries, this sector plays a critical role in supporting the formation of capital, and its channeling towards strategic projects for economic development. It can be said that financial activity is similar to an infrastructure service, since it is required in order to allow economic activity in all sectors of the economy.

The defining activity of the financial sector is financial intermediation. In essence, the intermediation consists of channeling funds from units with economic surplus (savers) to economic units with deficits (investors), meanwhile, facilitating the saving process and its productive use in the economy. Without a specialized intermediation system, the interaction between the savers and investors would be very similar to trade, and would incur very high transaction costs.

The financial system works as a bridge between savers and investors, however, this is not a passive bridge, but an active one. Intermediation is not simply about “being in the middle” to facilitate contact between savers and investors. What makes financial intermediation so unique and necessary is that it is an active measure in which specialized institutions assume liabilities for the economy as a whole and rely on these liabilities in order to create assets which are then kept in their own balance sheets or transferred to other entities through operations with the financial market. Throughout the constant handling of assets and liabilities, financial entities provide essential services to the economy, which consist on the following:

- Manage and mitigate risk.
- Correct or reduce information asymmetry.
- Reduce the market distortions, such as adverse selection.

In the process of providing these services, financial entities incur costs, derive income and, under normal circumstances, a profit. In the case of commercial banks, the profit comes from the “financial margin”, also known as net interest income, which is the difference between the financial cost of the liabilities (or cost of funds) and the financial income of the assets. In other words, it is the difference between interests earned and interests paid.

The handling of assets and liabilities is the main source of profits for commercial banks (and similar entities), however, it is not the only source. Banking institutions also derive profits from other services provided to the community, which usually have established costs (for example, money orders).

Some financial institutions, such as insurance companies, participate in the financial intermediation process in a manner which varies from the bank’s approach. Insurance companies charge an insurance premium in order to assume another entity’s risk. Insurance companies pool their funds and draw from it when they have to pay out an insurance claim, and their profits come from the difference between income from premiums and payments made out for insurance claims.

The main role of these entities is to manage and mitigate risks that other economic entities are unable to manage on their own. The existence of the insurance market allows for the existence of other markets, contracts and products that would not be able to exist if the economic entities involved were not able to transfer risk to other specialized entities, which are better able to manage such risks.

In addition to financial intermediation, financial entities provide other essential services such as infrastructure services. Among these, two key functions in the banking system stand out: 1) the management of payment methods in the economy and, 2) serving as a channel for the operation of monetary policy.

In addition to the key functions already mentioned, commercial banks in Puerto Rico fulfill a function which has been essential to the economic development in the Island: serve as a channel in the process of importing short and long term from the U.S. financial market. Puerto Rico lacks a sustainable source of internal savings, for which it depends on having access to U.S. sources of financing. For decades, local banks have been the mechanism for “importing funds” in order to compensate for the financing inability in the local economy.

### **Structure of the Financial Sector in Puerto Rico**

The financial sector in Puerto Rico is composed of more than a dozen industries of different sizes, characteristics and specialties. Some of these have a high level of interaction among themselves, while others work more or less independently from the rest of the sector. The industries are listed below:

- Commercial Banks
- International Banking Entities
- Credit Unions
- Investment Companies
- Mortgage Institutions
- Financial Companies
- Securities Brokers
- Leasing Companies
- Small Loans Companies
- Government Banks
- ELA Employee Association
- Insurance Companies

Last on the list- the insurance companies- behave significantly different to the rest of the industries on the list, since they do not deal with financing (even though they handle large investment portfolios, for both Government and private securities). For this reason, the sector diagnosis will perform the insurance companies analysis separately, included at the end of this chapter.

Institutions categorized as “depository”- because they accept deposits from the general public- compose the majority of the financial system on the Island. The most notable of these institutions are commercial banks, international banking entities and, credit and loan unions. Some non-depository institutions with an important presence in the sector are the mortgage institutions, financial companies (which finance, for example, the purchasing of vehicles), leasing companies, and small loan companies, all of which provide important financing services in the local economy. Small loan companies provide an essential financing service to the low-income population in Puerto Rico.

A very notable gap in the local financial sector, is the lack of a local capital market, in which bonds and stocks are traded and supplied by local issuers. Another underdeveloped area is corporate financing and the financing of high risk new businesses (for example, venture capital funds).

## Diagnosis

The diagnosis for the financial sector in Puerto Rico should begin with a clear understanding of the difference between structural and short-term problems within the system and its components. In almost 9 years since the economic recession began in the local economy (AF 2007), the financial sector has suffered serious setbacks due to events associated with short-term events and the economic cycle. It has, also, faced difficulties of a structural nature that have been present for at least a couple of decades. Because the economic crisis has been so severe and prolonged in this past decade, the short-term and structural problems have come to overlap and interact. Hence, the importance of making a clear conceptual distinction to facilitate economic planning for the financial sector in the short, medium and, long run.

### 1. SHORT-TERM PROBLEMS

This chapter focuses mostly on the discussion of short-term problems, due to the current financial crisis the Island is undergoing. The weakening of the financial institutions due to the economic recession, poor loan repayment, high percentage of foreclosures and mortgage defaults, low deposit rate uptake and, the absence of good financing alternatives, are some of the causes for these short-term problems.

The root of the short-term problems described above, can be traced to the bursting of the housing bubble about a decade ago and, the consequent collapse of the construction industry. But that is not the whole story, financial entities have also been affected by the general decline of the economy, as well as the income reduction and the high unemployment.

### 2. STRUCTURAL PROBLEMS

The most salient of the structural problems Puerto Rico currently faces, rests on the inability of internal savings to sustain a healthy base of core deposits within the system. The areas most strongly affected by this structural problem are commercial banks and other depository entities which, as was mentioned earlier, constitute the majority of the financial sector.

Because of this shortage in core deposits local banks have resorted to importing funds from abroad (mostly the U.S.). As a consequence, local banks have created a dependency on these funds in addition to becoming institutions whose principal function is to facilitate the import of foreign funding.

Current history of the Puerto Rican banking system can be broken down into four periods, based on how the structural problem has been handled.

- Pre-936 Period
- 936 Funds Period
- Post-936: Brokered Deposits Period
- Actual Period

The pre-936 period, was one characterized by limited liquidity. During this time, access to funding from the U.S. was available yet limited and costly. For this reason, banking credit was comparatively more expensive and not easy to obtain.

Section 936 radically changed the commercial banking landscape in Puerto Rico. The Qualified Possession Source Investment Income (QPSII), a provision in the legislation, created a powerful tax incentive for manufacturing firms to deposit substantial amounts of their basic earnings in Puerto Rico's banking system. In addition to this, QPSII made these funds available to local commercial banks at very low cost. This enabled local businesses to obtain bank financing at very competitive rates which, in turn, was reflected in the local economy.

The elimination of section 936, meant the end of the funding that had been made available by this legislation. Some provisions disappeared gradually, while others, such as QPSII, immediately eliminated. It seemed like the local banking system would begin to deteriorate under the limited liquidity, however, an unexpected turn of events took place: the U.S. Federal Reserve enacted a policy of extremely low interest rates and high liquidity in the U.S. financial system. Thanks to this fortuitous event, local commercial banks were able to effortlessly substitute 936 funds with deposits obtained by brokers (brokered deposits) from the extensive U.S. financial market. And it was thus that a major credit contraction, following the elimination of Section 936, was avoided.

Currently, interest rates continue to be low, but the Federal Reserve has announced that it will adopt the policy of gradually raising interest rates in the near future, in order to return to a more normalized environment than what we have seen in the past 10 years. Hence, local banks will not be able to rely on deposits procured by brokers in the same extent that they had since the end of the 1990's. The pressure to cultivate local sources of funding are increasing, particularly in the area of core deposits. The Federal Reserve, along with other regulators, insist that this should be the cornerstone of any economic development plan for the local financial sector (See FRBNY, 2012).

Another structural issue that will play a relevant role in the medium and long run, will be the issue of regulation. Following the 2007 financial crisis in the U.S. there has been a worldwide push for stricter regulation in order to avoid the excesses that allowed for the creation and later burst of the worldwide financial bubble. This new regulation wave is expected to impact the financial sector as a whole. Some industries will be impacted more severely, such as the mortgage loans industry. The Puerto Rican financial system- which is subject to the federal legislation, regulation and, supervision- will have to adjust its practices and operations in order to meet the new requirements that will be entering into force.

## **RECOMMENDATIONS OF PREVIOUS PLANS**

The establishment of cooperatives in rural areas with training programs and productive economic activities focused on agriculture and manufacturing is one of the main objectives in the report titled Puerto Rico's Economic Development: A Strategy for the Next Decade, authored by Miguel Echenique (1975). Other important objectives in this analysis were to increase public and private savings to increase national equity, as well as to review regulations. Some of the new regulations established included enacting a selective policy for bank regulation in favor of industry loan exempting them from contributions as well as eliminating contribution deductions over personal loans.

In 1994, the New Model of Economic Development, identifies new strategies to follow, such as obtaining capital to work through the mobilization and channeling of financial resources towards productive investments through efficient capital markets.

Project Puerto Rico 2025 (PPR), a study published in 2004, seems to encompass a broader approach compared to previous economic development plans for the Island. The PPR provides in its recommendations for the development of educational and cultural activities and programs, as well as research and technological development programs. It also includes the development of local businesses, improvements in land transportation, the health sector, and the reduction in the process of utilities (water and power).

The last study performed, published in 2013, focuses on strategies to attract investments to Puerto Rico, both local and foreign, in addition to promoting that cooperatives play a bigger role in the Puerto Rican economy. This and other strategic economic plans can be found in the following table.



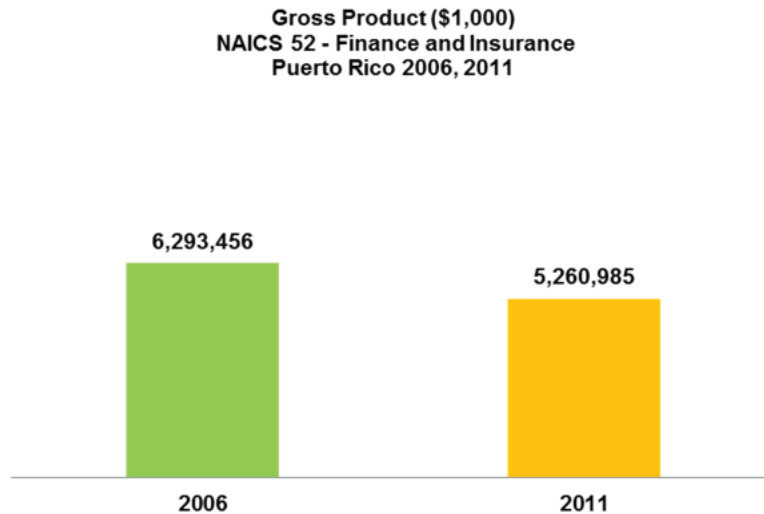
Finance and Insurance (NAICS - 52)	
Strategy or Recommendation	Paper
<p>Increase public and private savings to increase national equity.</p> <p>Create a private retirement plan complementary to the Social Security.</p> <p>Issue new savings bonds with low denominations available to the public.</p> <p>Fix maximum interests on saving deposits for commercial banks and credit unions.</p> <p>Eliminate contribution deductions over personal loans.</p> <p>Revise law regulations for investment companies.</p> <p>Consider grants over guaranteed loans by the Government Development Bank.</p> <p>Selective policy for bank regulation in favor of industry loan exempting them from contributions.</p> <p>Allow wholesale banking to participate with international banks.</p> <p>Establish cooperatives in rural areas with training programs and productive economic activities focused on agriculture and manufacturing.</p>	1975 - Puerto Rico's Economic Development: A Strategy for the Next Decade (Informe Echenique)
<p>Capital to Work - Propitiate the mobilization and channeling of financial resources towards productive investments through efficient capital markets.</p> <p>Redefining Responsibilities - Obtain the fiscal resources that will stimulate business activities, and productivity with efficiency.</p>	1994 - New Model of Economic Development
<p>Improve financing for cultural activities in Puerto Rico</p> <p>Reform University budget and incentive structure to promote research and development and technology transfer</p> <p>Increase funding for laboratories, research centers and other research and development infrastructure at universities</p> <p>Improve financial management of the education system</p> <p>Expand direct government funding for independent research and development centers and initiatives</p> <p>Enhance and expand indirect government support and incentives for private sector research and development</p> <p>Expand the availability and effectiveness of private equity funding for start-up businesses and small and medium enterprises</p> <p>Increase support to small and medium enterprises in accessing federal and other external funding sources</p> <p>Fund major scientific infrastructure projects needed to attract more private sector research and development</p> <p>Reduce the tax burden and other financial costs that government imposes on small and medium enterprises</p> <p>Improve the effectiveness of existing entities designed to promote the growth and formation</p> <p>Enhance use of public equity funding for local enterprises</p> <p>Increase the agility and reduce the financial cost of government</p> <p>Overhaul the systems for promoting investment in Puerto Rico</p> <p>Raise participation of low-income populations in formal financial networks</p> <p>Guarantee the effectiveness of programs that receive public funding through external assessment</p> <p>Increase investment in electricity infrastructure and systems to improve efficiency and</p> <p>Optimize the use of financial resources in promotion and prevention activities</p> <p>Optimize the use of financial resources for health treatment</p> <p>Invest in new land freight systems</p> <p>Promote job creation by small and medium enterprises, community businesses and cooperatives</p> <p>Redefine water and sewage pricing structure</p> <p>Redefine electricity pricing structure</p> <p>Enhance debt financing options available to small and medium enterprises</p>	2004 - Project Puerto Rico 2025
Public funds to provide financial assistance directly to students	2006 - Restoring Growth
<p>Promote local businesses by providing support to local business owners in the form of financing alternatives, and access to internal and external markets.</p> <p>Advance and upgrade infrastructure, facilitate private investments with a new financial method focused on efficiency and agility.</p>	2006 -Economic Development And Government Transformation Plan For Puerto Rico
Promote a strong and healthy financial system to facilitate the efficient flow of capital to the economy and develop exporting capacities.	2009 - Strategies of a Strategic Model
<p>Reducing the Costs of Doing Business</p> <p>Streamline Business Regulation - Mobilizing Finance for Business Development and Growth</p>	2012 - Report on the Competitiveness of Puerto Rico's Economy
<p>Promote and formalize a high quality entrepreneur and investor community that resides locally in Puerto Rico.</p> <p>Promote change in the business and investment paradigm.</p> <p>Allow cooperatives to be the motor of economic development.</p>	2013 - A New Puerto Rico

Source: Puerto Rico Planning Board, 2014.

## SECTOR CHARACTERISTICS

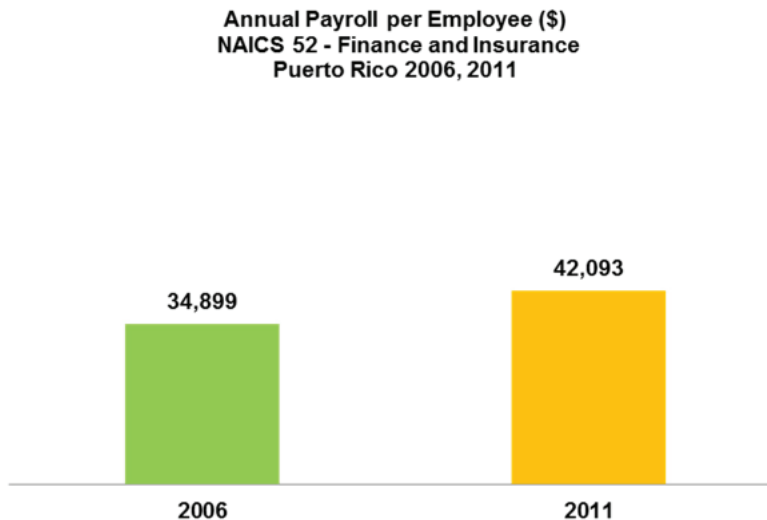
### 1. GROSS NATIONAL PRODUCT/ GROSS DOMESTIC PRODUCT

As can be seen in the following graph, the GDP for the Financial and Insurance Sector in Puerto Rico for 2011 is approximately \$5.3 billion, or around 16.4% less than the GDP for the year 2006 (\$6.3 billions).



### 2. SIZE OF WAGES

In the Finance and Insurance Sector, even though there is a reduction in the GDP between 2006 and 2011, there is an increase in the Annual Payroll per Employee, for the period between 2006 and 2011, of approximately 20.6% (from \$34,899 in 2006 to \$42,093 in 2011). These figures can be seen in the following graph.

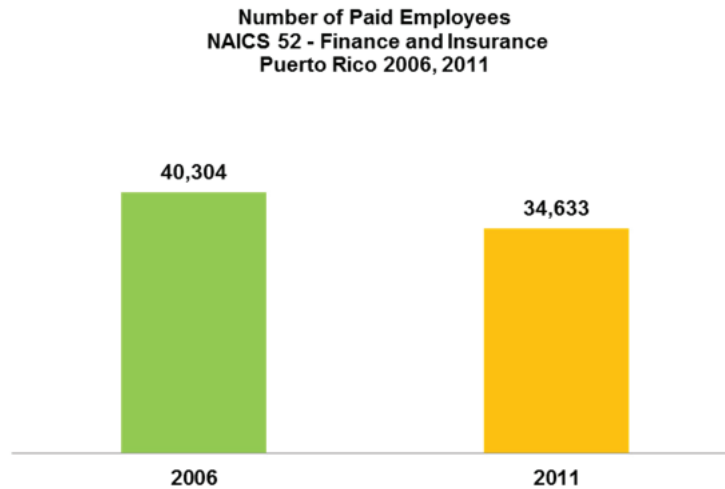


Source: U.S. Census Bureau, County Business Patterns



### 3. NUMBER OF PAID EMPLOYEES

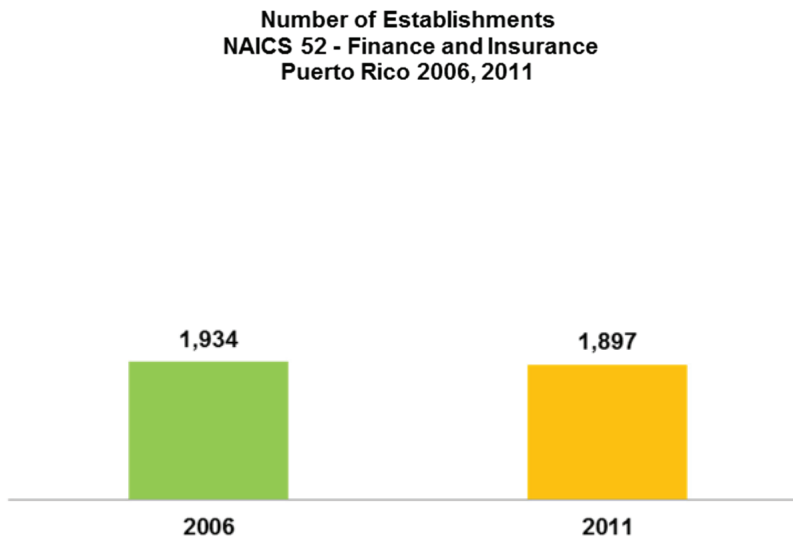
The number of employees for the sector declines 14.1% between 2006 and 2011, as can be seen in the following graph.



Source: U.S. Census Bureau, County Business Patterns

### 3. NUMBER OF ESTABLISHMENTS

The Number of Establishments remains constant in the sector; there is only a small decline in the number of establishments of a total of 2% (37 establishments).



Source: U.S. Census Bureau, County Business Patterns

## RELEVANCE OF THE FINANCIAL SECTOR IN THE ECONOMIC ACTIVITY

### 1. CURRENT TRENDS: ALL INDUSTRIES

In the decade that has transpired between 2004 and 2013, the banking system has suffered a severe contraction as a result of the economic crisis on the Island. There have been three notable exceptions to this rule- credit unions, AEELA and, government Banks- the sector industries have recorded a considerable fall in their total assets.

The fall in the financial system's assets is not part of or due to a normal process, which only serves to highlight the severity of the crisis that has plagued the Puerto Rican economy in the last decade. What normally occurs with assets in an economy is that the assets grow as time passes, and they grow faster than the economy itself, thus, increasing the financial assets as a percentage of the GDP. This process is called "financial deepening" and is considered fundamental to the economic development of a country.

With this said, it is important to note that Puerto Rico has been going through a financial "decline in financial deepening" in the past decade. One of the obligatory goals then for the economic plan is to revert this process and to reach acceptable metrics in the coming decade.

All Financial Institutions- Total Asset Percentage*					
Type of Institution	2004	2007	2010	2013	Cumulative Growth
Commercial Banks**	39.0	41.2	43.1	41.2	-17.9
International Banking Entities	35.1	35.5	24.2	28.5	-37.0
Credit Unions	3.3	3.0	4.5	5.6	31.9
Brokers Securities	1.3	0.6	2.2	1.0	-38.5
Mortgage Institutions	5.5	2.8	2.8	1.2	-83.4
Investment Companies	6.2	6.6	8.4	6.4	-19.4
Leasing Companies	1.1	1.2	1.0	1.3	-10.7
Financial Companies	2.5	2.2	2.3	2.6	-18.6
Government Banks	4.5	5.2	9.8	10.4	80.7
Small Loan Companies	0.7	0.7	0.4	0.3	-59.7
AEELA	0.8	0.9	1.3	1.5	40.2
Total	100.0	100.0	100.0	100.0	
Total (in millions)	\$190,511	\$213,301	\$168,109	\$148,125	-22.2

Source: OCIF

\* Updated December 31 every year

\*\* Internationals excluded

NOTE: There is no mention of the number of assets in the alternative investments in Puerto Rico. Data for the financial activity from Hedge Funds, Private Equities, etc. is currently unavailable due to the fact that it is not collected (according to OCIF officials). Some of the companies which operate in alternative investments in Puerto Rico are: Caribbean Property Group (CPG), Operating Partners Co. (OPC), Lone Star Funds, Encanto Group, among others. During the recession, many commercial banks sold non-performing loan portfolios to these private equities, which has caused the financial asset market to be undervalued.

Another example of the decrease in activity in the sector- correlated with the decrease in assets- is the loss of profitability of institutions in many financial industries. The net income of commercial banks decreased by two thirds between 2005 and 2007, and became negative in 2010. Most recent data (2013) shows that the net income of the banking system was a little over \$70 million, only 6% of the net income in 2004, before the crisis took place.

It's important to note, also, that the commercial banking system has considerably shrunk in size, not only in terms of assets and profitability, but also in the number of institutions. In the year 2010, Federal Deposit Insurance Corporation (FDIC) ordered the liquidation of three banking institutions.

Commercial banks were not the only entities affected as other entities have also suffered record profitability losses, such as international banking entities, mortgage institutions, investment companies and, brokers. Particularly noteworthy, was the investment companies' loss of over \$2 billion in 2013, which can be partially attributed to the decline in investment funds with high quantities of official bonds in Puerto Rico and other jurisdictions.

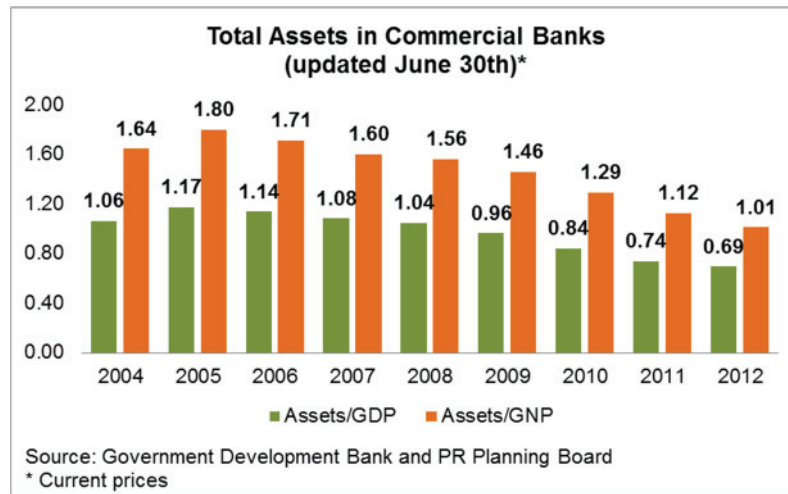
Financial Sector Net Income by Type of Institution- in Millions				
Type of Institution	2004	2007	2010	2013
Commercial Banks	\$1,176,284	\$402,557	(\$747,041)	\$70,308
International Banks Entities	\$650,065	\$886,241	(\$339,468)	\$100,036
Credits Unions				
Brokers Securities	(\$5,196)	\$4,981	(\$19,113)	(\$85,816)
Mortgage Institutions	\$237,561	(\$184,639)	(\$273,255)	(\$123,486)
Investment Companies	\$403,283	\$494,880	\$425,781	(\$2,382,047)
Leasing Companies	\$36,258	\$11,584	\$39,483	\$16,197
Finance Companies	\$69,411	(\$17,595)	\$115,824	\$70,596
Government Banks	\$403,043	(\$78,245)	\$58,915	\$129,547
Small Loans Companies	\$12,694	(\$24,534)	\$42,850	\$37,601
AEELA	\$29,236	\$41,838	\$41,011	\$39,487
Total	\$3,012,639	\$1,537,068	(\$655,013)	(\$2,127,577)

Source: OCFI

\* Updated December 31 every year

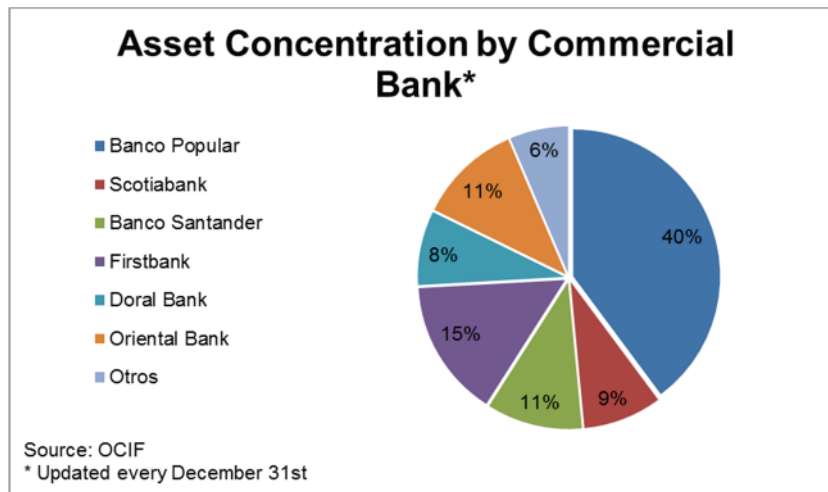
## 2. CURRENT TRENDS: COMMERCIAL BANKS

An important indicator of the general condition of the economy's credit is the total number of assets in commercial banks as a fraction of the GDP. In Puerto Rico, it has been steadily declining since 2005. From a maximum of 1.8 in 2005, this indicator went down to 1.01 in 2012. This is a clear example of the process which has been termed "financial decline in financial deepening". In essence, the deep fall of this ratio indicates that credit has declined considerably and carries less weight in economic activity that what was the norm during more stable times.



The contraction of the total of assets, in addition to the number of active institutions, has led to a heightened concentration in the industry. In 2013, one entity controlled 40% of the assets, while the other 60% was split into almost even parts between another six institutions. For the same year, the Herfindahl-Hirschman Index, which is used to calculate asset distribution for commercial banks, reached 2,248, which indicates a high level of asset concentration.

One important determination that has to be made when drafting an economic plan is what the optimal size of the commercial banking sector ought to be. Some analysts feel that the number of banks before the crisis was too high, and that it is a positive change for the number to be lower now. Others believe that once the economy begins to recover, there will be a need for more participants within the industry. This is an issue which is structural in nature and is one that needs to be explicitly addressed when formulating strategies and goals for this industry.



The decrease in business and income, in addition to the pressure from regulators, has forced banks to submit to a process of financial and operational “improving their portfolios”. This can be seen, particularly, in the structure of liabilities and capital in institutions.

From the onset of the financial crisis, commercial banks have significantly reduced their debts to other entities- act termed “leverage”- and have substantially increased their capital base. This, in addition to the increase in the importance of deposits in the liabilities’ structure, denoted an important strengthening of the balance sheets.

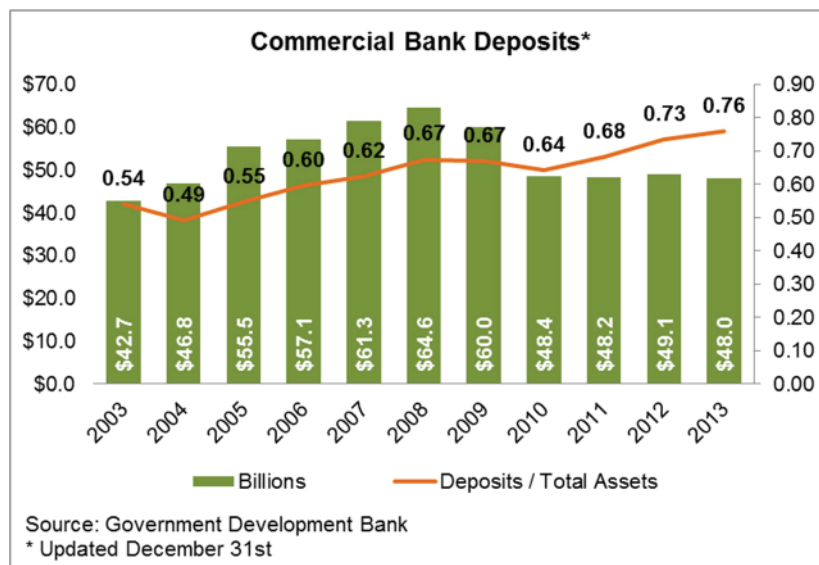
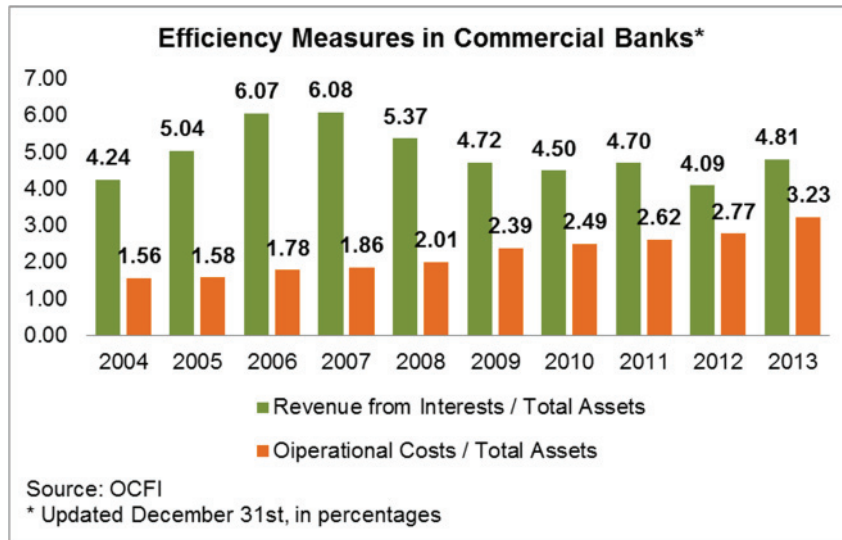
In 2004, commercial banks’ capital represented less than 7% of total liabilities and capital, but by 2013 it was above 11%. On the other hand, short and long-term debts went from comprising 40% of liabilities in 2004, to represent less than 10% in 2013. Meanwhile, deposits went from constituting less than half of liabilities to over three quarters of the total. This constitutes a dramatic change in the in the balance sheet structure, which promises to bring more robustness to the banking industry.

Commercial Banks Balance Sheet- Percentage of Total Liabilities and Capital *					
	2004	2007	2010	2013	Cumulative Growth
Total Liabilities and Capital	100	100	100	100	-33.7
Total Liabilities	93.5	93.0	91.0	88.5	-37.3
Deposits	49.0	62.2	64.2	75.8	-33.7
Short Term Debt	26.2	15.3	9.8	2.7	-93.1
Long Term Debt	13.4	10.8	13.0	6.7	-66.8
Other Liabilities	4.9	4.7	4.1	3.2	-56.7
Total Capital	6.5	7.0	9.0	11.5	18.1
Preferred Stock	0.4	0.4	0.5	0.6	-8.3
Common Stock	0.5	0.8	1.0	0.9	11.6
Surplus	2	3	6	8	135.3
Undistributed Profits	3.2	2.7	1.4	1.9	-60.6
Total Liabilities and Capital (thousands of dollars)	\$95,487,153	\$98,580,902	\$75,473,752	\$63,335,852	-33.7

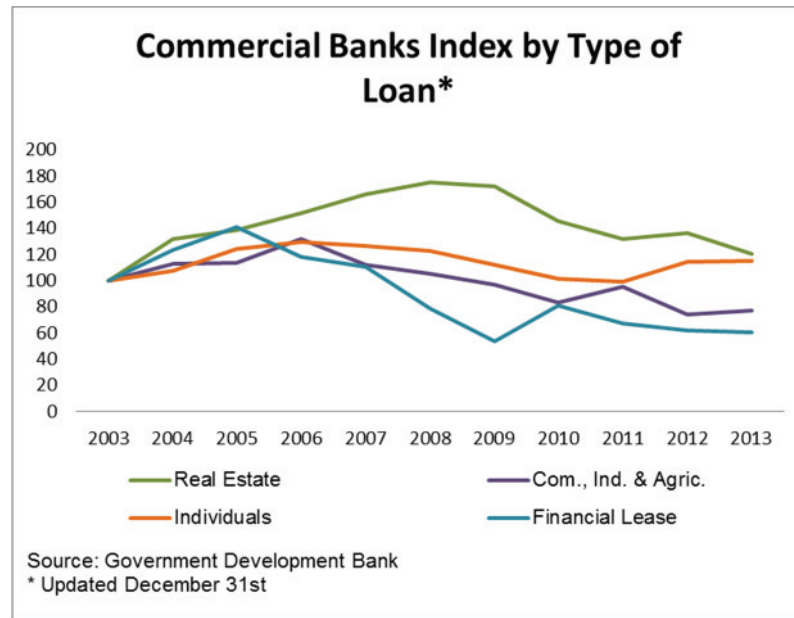
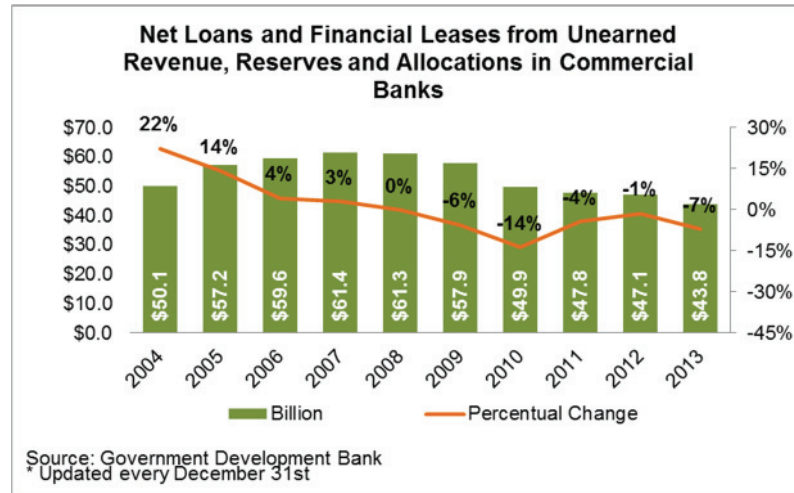
Source: OCIF

\* Updated December 31 every year

The “improving their portfolios” process in banking can also be seen in the industry efficiency indicators. Since 2007 there has been a steady reduction of income resulting from interests as a percentage of the total assets, except for an upturn in 2013m which was a reflection of decrease in loan yields caused by the deterioration in the quality of the loan portfolio (for example, the increase of late payment). This decrease in performance, added to the fact that banks cannot decrease their operational costs, has led to the increase of operational costs as a percentage of assets. The combination of both these trends, has inevitably led to the reduction of profitability, which, as discussed, is evident in the evolution of net income.

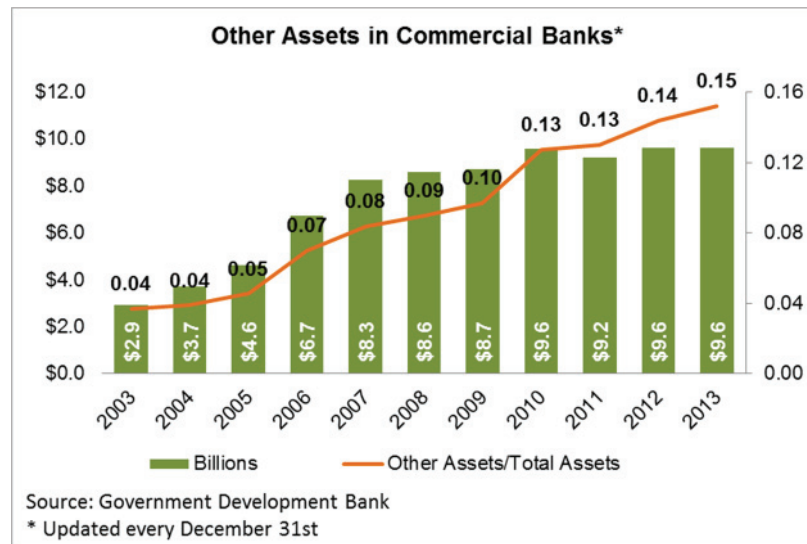
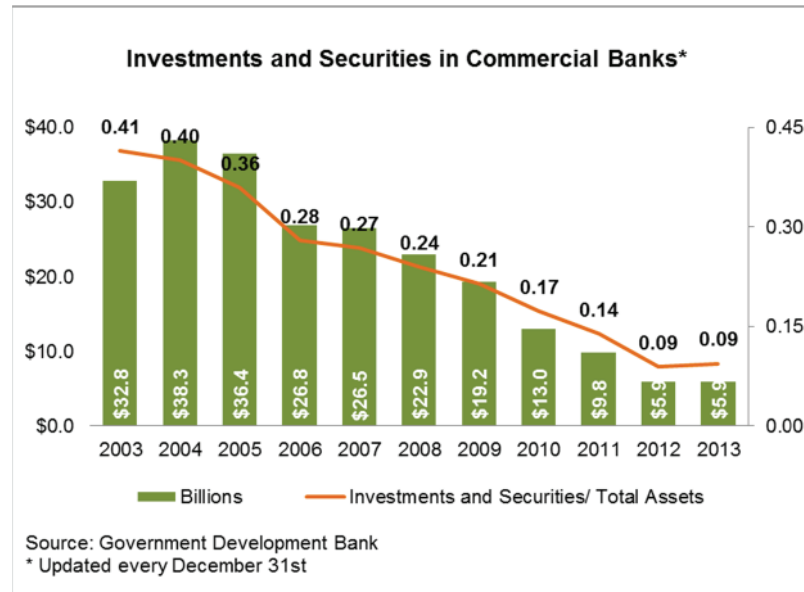


From the point of view of the general economy, this “improving their portfolios” process has had the effect of limiting credit availability and raising its cost. The past seven years have constituted a period of strong rationing of banking credit on the Island, which has had a negative impact on many businesses which depend on financing in order to meet their operational costs. Loans and financial leases in the banking industry have been limited on both ends, supply and demand. On the supply side, the lending capacity of banks has been reduced due to the need to clear failed loans from portfolios and strengthen the capital base of institutions. On the demand side, the credit of many firms and businesses has been negatively impacted as a result of the recession, thus, shrinking the eligible population (good candidates) for loans.

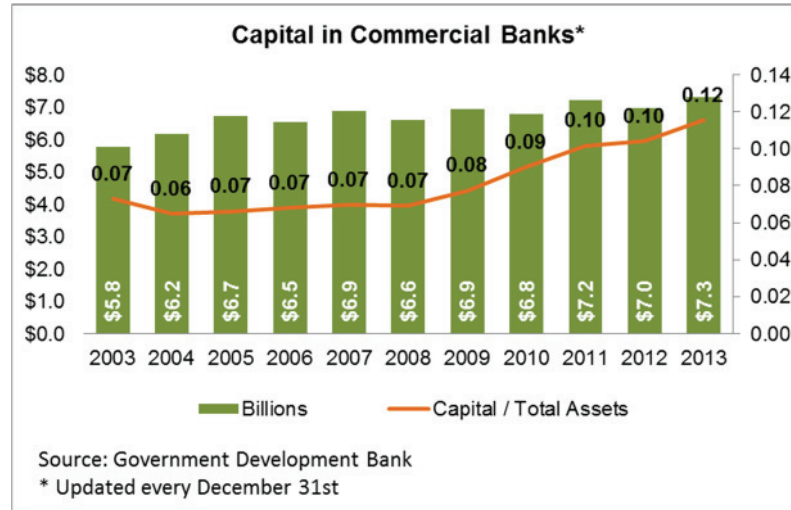


Lastly, the banking “improving their portfolios” process also signified a thorough asset restructuring. One of the most notable results is the intense contraction of investment portfolios in securities, which have dropped from comprising 41% of the total assets in 2003, to representing only 9% of the total assets by 2013. The securities investment portfolios registered up to \$38 billion in assets in 2004. Nine years later, in 2013, the volume of said portfolios was under \$6 billion.

Conversely, there was a substantial increase in the relevance of other assets. These increased to 15% of the total in 2013, while, ten years earlier in 2003, they only constituted 4% of the assets. These trends are the reflection of the strong process of deleveraging that is taking place in the sector.







### 3. CURRENT TRENDS: INTERNATIONAL BANKING ENTITIES

The international banking entities (IBEs) compose quite a large industry, judging by the amount of assets that they manage. Nevertheless, their impact on the local economy is much smaller than that of commercial banking, since the IBEs were designed to operate primarily, if not exclusively, in the international arena.

In broad terms, the recent behavior of these entities has been similar to commercial banking: they have both shown a sharp decline in their total assets and their profitability. The industry indicators show that the IBE's have also undergone a process of "deleveraging".

The total IBEs' assets were \$66.9 billion in 2004, and by 2013, they had been reduced to \$42.2 billion. Even more noteworthy was the sharp decline in the net income as a percentage of the total assets. The ratio in 2007 was 5.5%, and by 2013 it declined to 0.7%, showing a sharp decline in the profitability of investments.

International Banking Entities Balance Sheet in Percentages*					
	2004	2007	2010	2013	Accumulated Growth
Total Assets	100	100	100	100	-37.0
Cash	0.8	1.6	1.0	0.8	-33.4
Bank Placements	1.1	0.7	1.5	0.6	-62.8
Securities	42.3	33.3	17.5	7.5	-88.8
Loans and Leases	27.4	23.3	20.4	4.2	-90.4
Federal Funds Sold	0.7	1.5	0.4	1.8	66.2
Due From Related Parties	23.3	34.3	51.1	79.4	114.6
Other Assets	4.5	5.3	8.2	5.6	-20.9
Total Liabilities and Capital	100	100	100	100	-37.0
Total Liabilities	82.0	77.0	87.7	87.3	-33.0
Deposits	13.5	21.2	24.5	24.3	13.6
Deposit Demand	1.3	1.5	2.3	0.9	-56.6
Time Deposits	12.2	19.8	22.2	23.4	20.9
Liabilities	68.5	55.8	63.2	62.9	
Federal Funds Purchased	2.4	0.3	0.0	0.0	-100.0
Borrowings	41.6	23.3	15.3	4.6	-93.0
Due to Related Parties	23.3	31.6	47.4	58.2	57.1
Other Liabilities	1.1	0.6	0.5	0.1	-95.3
Total Capital	18.0	23.0	12.3	12.7	-55.5
Total Assets (thousands of dollars)	\$66,947,590	\$75,807,188	\$40,607,688	\$42,151,960	-37.0

Source: OCIF

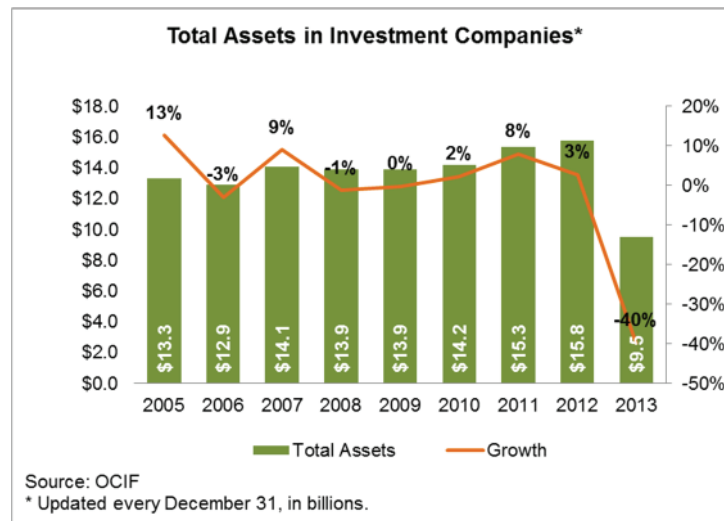
\*Updated every December 31st





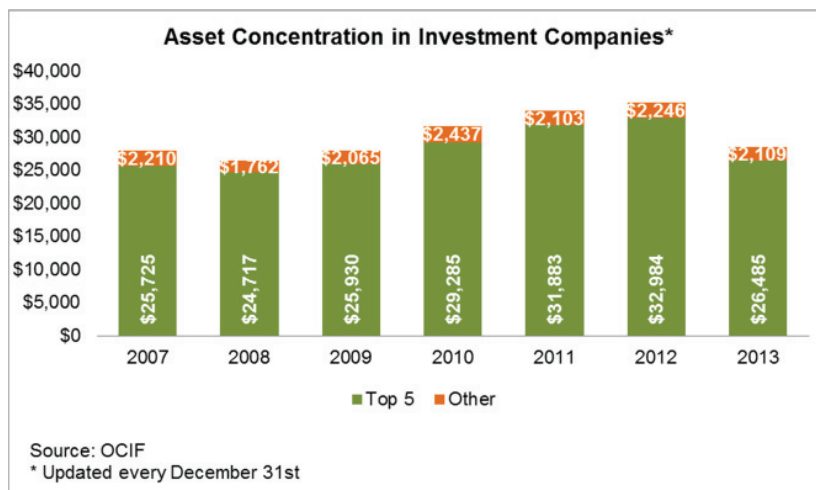
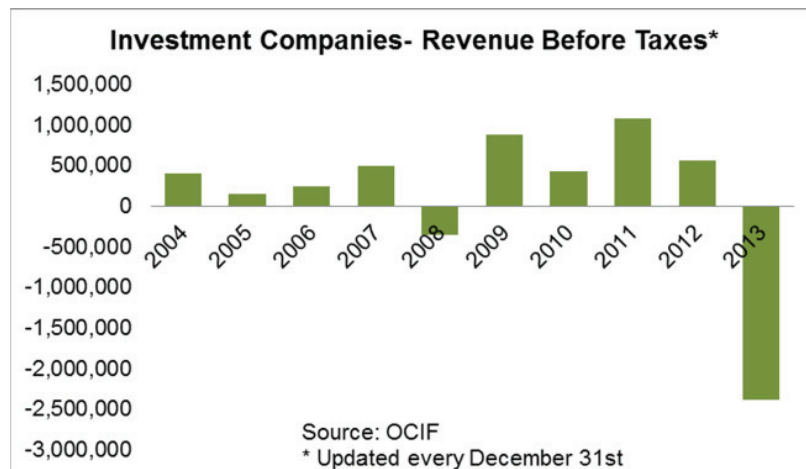
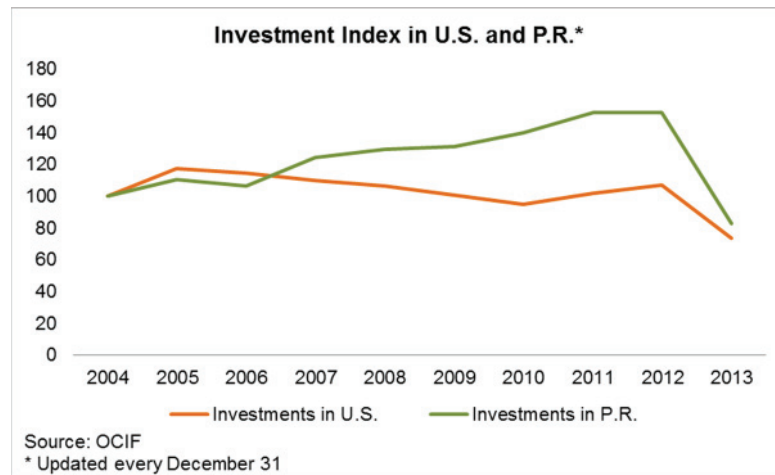
#### 4. CURRENT TRENDS: INVESTMENT COMPANIES

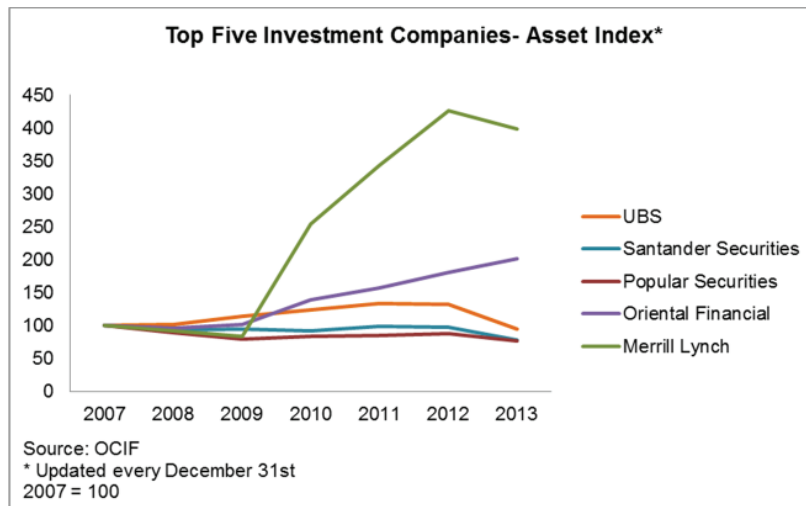
Investment companies were not as adversely affected as other financial industries during the crisis. However, starting in 2013, a string of events occurred which affected this industry in particular. The investment companies' assets maintained a slight yet sustained growth between 2005 and 2012, a period in which many other financial industries suffered a decline in their assets. This could be attributed to savers choosing to place their funds in high-yield instruments- such as investment funds- at times when commercial banks and other entities were paying low interest rates for their deposits.



The sharp decline in investment companies' assets coincided with local investment funds- which are marketed in Puerto Rico, but not abroad- suffered a sharp and sudden depreciation as a result of a run against Puerto Rican official bonds in the municipal bond marketplace in the U.S. Hence, this industry which had fared well during most of the crisis, is now suffering its own crisis within the current crisis.

This phenomenon, particular to investment companies, can also be seen in the behavior of net income before taxes, which remained positive between 2004 and 2012- with the exception of 2008, when the worldwide financial crisis exploded- but suffered a dramatic fall in 2013.

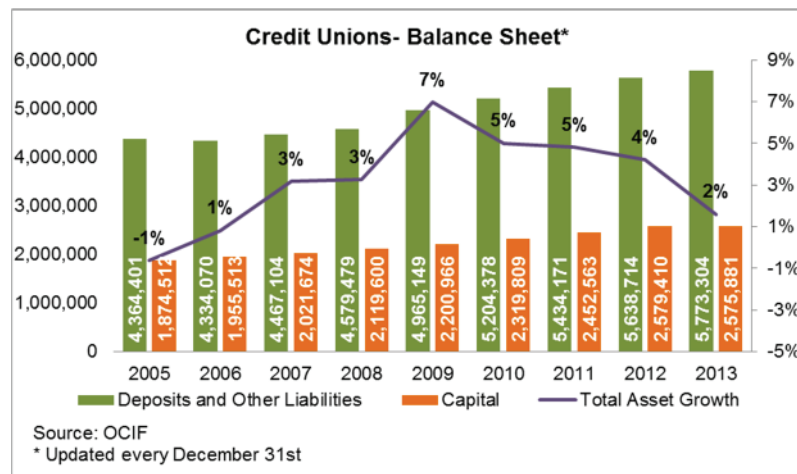




## 5. CURRENT TRENDS: CREDIT UNIONS

Credit unions are the financial industry which has weathered the financial crisis the best. This is not to say that the industry has been immune to the effects of the recession nor avoided a decrease in value of Puerto Rican official bonds, however, it has shown sustained growth in all the main areas during the economic crisis.

Although the growth has not been marked, the credit unions' assets have grown in all years between 2006 and 2013, with 2009 boasting a 7% increase, just when the global economy was going through a recession caused by the financial crisis which exploded in 2008. Furthermore, credit unions have registered sustained growth in their capital base during this difficult period.



The most interesting characteristic of credit unions, is that they have been able to maintain, and even increase, their deposit base during the crisis. This is due to the nature of the relationship between credit unions and their depositors- credit unions work closely with their partners in order to create a stable base and loyal depositors in the communities in which they operate. This type of relationship could be emulated by other depository industries so that they may, too, strengthen their local deposits in the financial sector.

## 6. CURRENT TRENDS: MORTGAGE INSTITUTIONS

Puerto Rico has a high number of mortgage institutions, due to the fact that most are small institutions and are grouped by regional areas. However, there are some that are affiliated to the major commercial banks and, hence, are very large in size.

As can be expected, the mortgage industry has been one of the most afflicted during the crisis, since it is directly tied to one of the areas most affected by the economy's downturn. The construction and sale of new homes on the Island were practically paralyzed some six years ago, which, in turn, caused the industry to focus on refinancing and reselling of existing housing units. The size of the industry has decreased to merely 16% of what it was back in 2004, in terms of assets.

In addition to the challenges mentioned, this industry also faces structural challenges related to the legal and regulatory arena as well as with the demographic transition that Puerto Rico is currently undergoing. These issues will be examined in detail at the moment of formulating strategies for the industry as part of the economic development plan.

Total Asset Balance Sheet for Mortgage Institutions in Percentages*					
	2004	2007	2010	2013	Accumulated Growth
Total Assets	100	100	100	100	-84.2
Cash	7.4	5.8	3.2	7.0	-85.0
Net Loans and Leases	53.2	47.5	59.0	31.8	-90.6
Other Current Assets	11.5	18.0	11.9	2.1	-97.1
Securities	11.7	6.9	4.7	2.7	-96.4
Other Assets	16.2	21.8	21.2	56.5	-45.0
Total Assets (billions)	\$10,976,081	\$5,916,728	\$4,744,065	\$1,735,590	-84.2

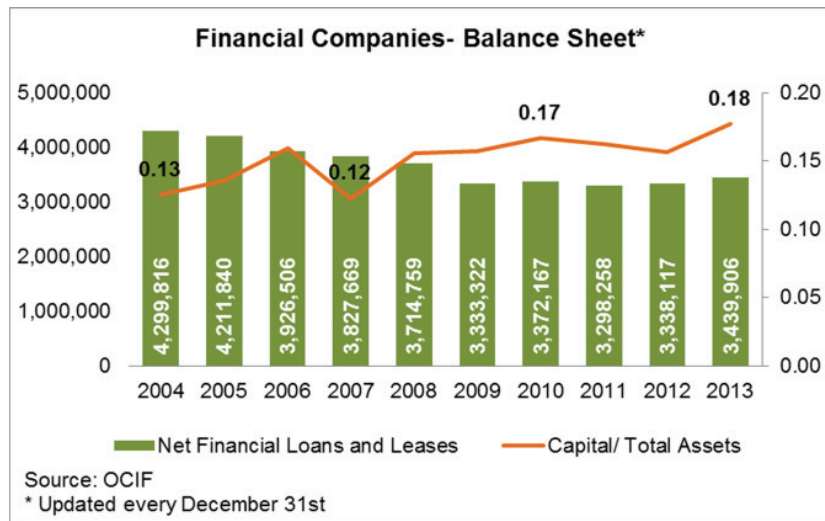
Source: OCIF

\* Updated every December 31st

## 7. CURRENT TRENDS: OTHER INDUSTRIES

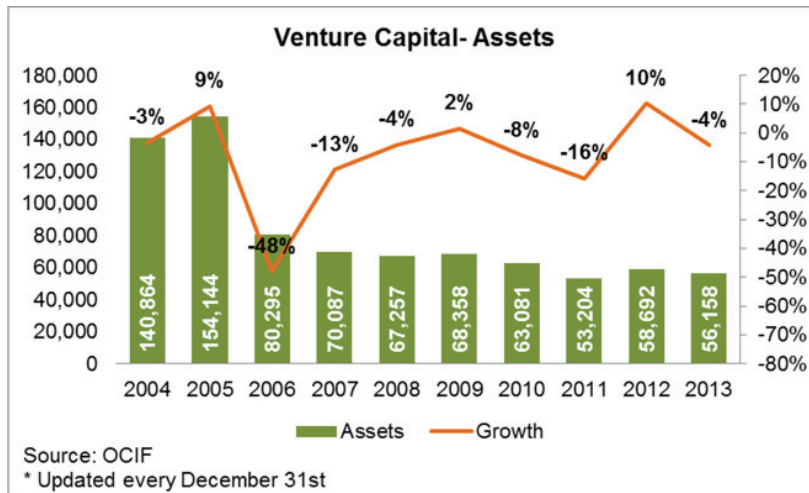
There are other industries in the financial sector aside from the ones examined up to now, which, although smaller in size, also play an important role in the economy and should grow in size in the medium and long run. Among these are financial companies and capital risk funds.

As with other industries, these also registered important decreases in their operational volume, which impacted their total assets as well as their profitability. For financial companies the decrease has not been as steep as in other financial activities, but in the case of capital risk funds, the decrease was dramatic.



Financial companies specialize in the financing of high value sales, such as, for example, the purchasing of automobiles. In general, they compete with commercial for the placement of loans to consumers and businesses, but they limit themselves to certain types of financing. The fact that car sales have increased significantly in the past four (4) years has been an important factor in the relatively favorable performance of this industry.

In terms of the capital risk funds, it is perfectly understandable that economic activity has slowed down as a result of the crisis, since one of the areas most affected by a recession- especially if it is prolonged and severe- is the launching of new business initiatives. Nevertheless, this industry should be focused on in the drafting of a development plan for the financial sector, since it is a key financial activity for the economy of entrepreneurship and knowledge. Currently, this is an underdeveloped industry in Puerto Rico, and it is necessary for it to become a bigger piece in the local economy in the medium and long run.



## REGIONAL TRENDS

### 1. LOCATION QUOTIENT (PUERTO RICO/US) OF WAGES, EMPLOYMENT AND ENTERPRISES.

The Location Quotient (LQ) is a way of quantifying how concentrated an industry is in a region compared to a larger region, in this case Puerto Rico to the United States of America. LQ were calculated for the Number of Employees, Annual Payroll per Employee, and Number of Establishments based on P.R. and U.S. data from the U.S. Census Bureau, County Business Pattern for the year 2011. Tables 1 through 4 show the Industry Location Quotient (LQ) analysis performed for the Finance & Insurance Sector and Sub-sectors (NAICS 52), including the Number of Employees, Number of Establishments, and Total Annual Payroll sorted from largest to smallest values, and Annual Payroll per Employee sorted from smallest to largest value. Those tables show the sub-sectors according to the concentration value of Puerto Rico compared with the United States of America. The data for this analysis was obtained from the U.S Census Bureau. County Business Patterns for 2011.

**Table 1: Location Quotient of Number of Employees  
Finance and Insurance (NAICS - 52)**

Sector by NAICS	Location Quotient
5222- Nondepository credit intermediation	3.22
5259- Other investment pools and funds	2.68
5223- Activities related to credit intermediation	1.17
5241- Insurance carriers	1.03

**Table 2: Location Quotient of Annual Payroll Per Employee  
Finance and Insurance (NAICS - 52)**

Sector by NAICS	Location Quotient
5239 - Other financial investment activities	0.36
5259 - Other investment pools and funds	0.60

**Table 3: Location Quotient of Number of Establishments  
Finance and Insurance (NAICS - 52)**

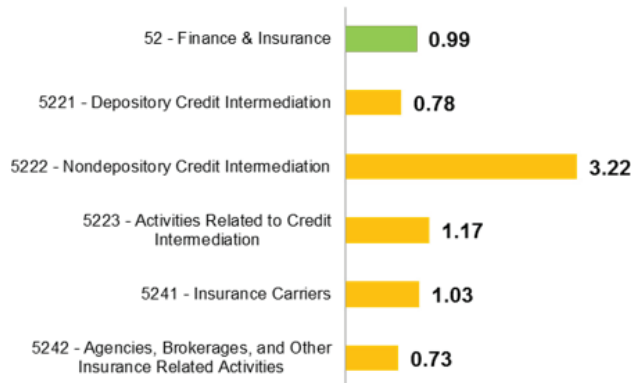
Sector by NAICS	Location Quotient
5232 - Securities and commodity exchanges	11.13
5222 - Nondepository credit intermediation	1.97
5259 - Other investment pools and funds	1.26
5241 - Insurance carriers	1.01

**Table 4: Location Quotient of Total Annual Payroll  
Finance and Insurance (NAICS - 52)**

Sector by NAICS	Location Quotient
5222 - Nondepository credit intermediation	3.30
5259 - Other investment pools and funds	1.60
5223 - Activities related to credit intermediation	1.27
5232 - Securities and commodity exchanges	1.15
5242 - Agencies, brokerages, and other insurance related activities	1.07
5241 - Insurance carriers	1.06

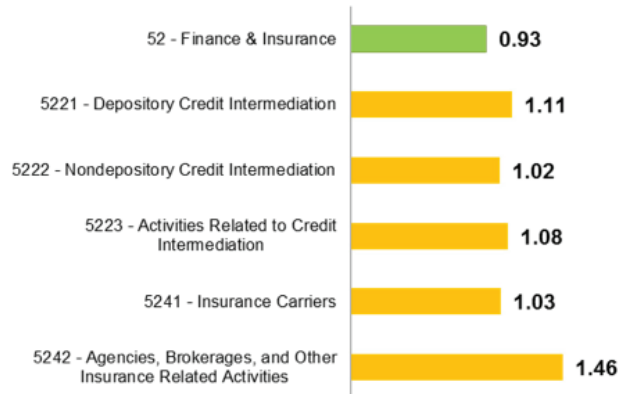
The following graphs show the Finance & Insurance Sector (NAICS 52) LQ with respect to the Number of Paid Employees for this sector in 2011 was 0.99 meaning that P.R. has 0.99 paid employees for every 1 paid employee in the U.S. LQ with respect to the Annual Payroll per Employee for this sector in 2011 was 0.93 meaning that P.R. pays \$0.93 per employee for every \$1 paid per employee in the U.S.

**Location Quotient for Number of Employees  
NAICS 52 - Finance and Insurance Sector and Sub-Sectors  
P.R. and U.S. 2011**



Calculated by PR Planning Board with data from the U.S. Census Bureau, County Business Patterns

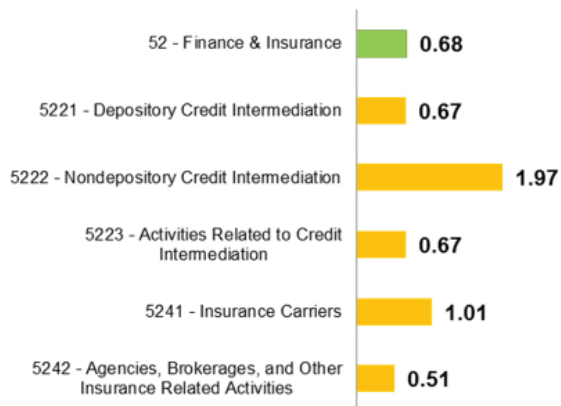
**Location Quotient for Annual Payroll per Employees  
NAICS 52 - Finance and Insurance Sector and Sub-Sectors  
P.R. and U.S. 2011**



Calculated by PR Planning Board with data from the U.S. Census Bureau, County Business Patterns

The following graphs show LQ with respect to the Number of Establishments for this sector in 2011 was 0.68 meaning that P.R. has 0.68 establishments for every 1 establishment in the U.S. For the year 2011 the Annual Payroll per Employee in P.R. was \$42,093 and in the U.S. \$83,849. This means that, on average, the Annual Payroll per Employee in P.R. is 50.20 percent of what it is in the U.S. which represents a difference of -\$41,755.

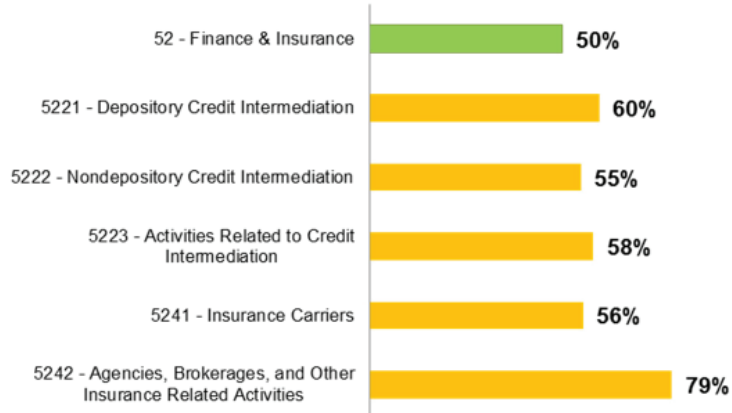
**Location Quotient for Number of Establishments  
NAICS 52 - Finance and Insurance Sector and Sub-Sectors  
P.R. and U.S. 2011**



Calculated by PR Planning Board with data from the U.S. Census Bureau, County Business Patterns



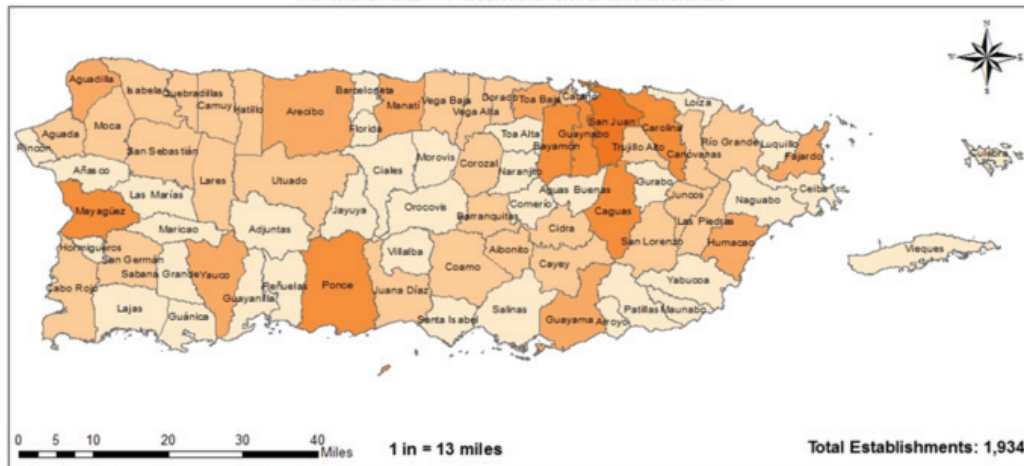
**P.R. Annual Payroll per Employee as a Percentage of U.S.  
Annual Payroll per Employee  
NAICS 52 - Finance and Insurance Sector and Sub-Sectors  
P.R. and U.S. 2011**



Calculated by PR Planning Board with data from the U.S. Census Bureau, County Business Patterns

A number of maps have been included, which illustrate the changes in the Number of Establishments in the Finance and Insurance sector for Puerto Rico (NAICS 52) for the years 2006 and 2011, and for various other sub-sectors for the year 2011: Credit Intermediation and Other Related Activities (NAICS 522), Securities, Commodity Contracts, and Other Financial Investments and Related Activities (NAICS 523), Insurance Carriers and Related Activities (NAICS 524) and, Funds, Trusts, and Other Financial Vehicles (NAICS 525). The largest concentration of establishments can be observed in the metropolitan area, as well as the cities of Ponce and Mayaguez, as can be seen throughout the maps.

**Number of Establishments in Puerto Rico, 2006  
NAICS 52 - Finance and Insurance**



U.S. Department of Commerce, Census Bureau  
County Business Patterns  
Puerto Rico Planning Board  
Economic and Social Planning Program

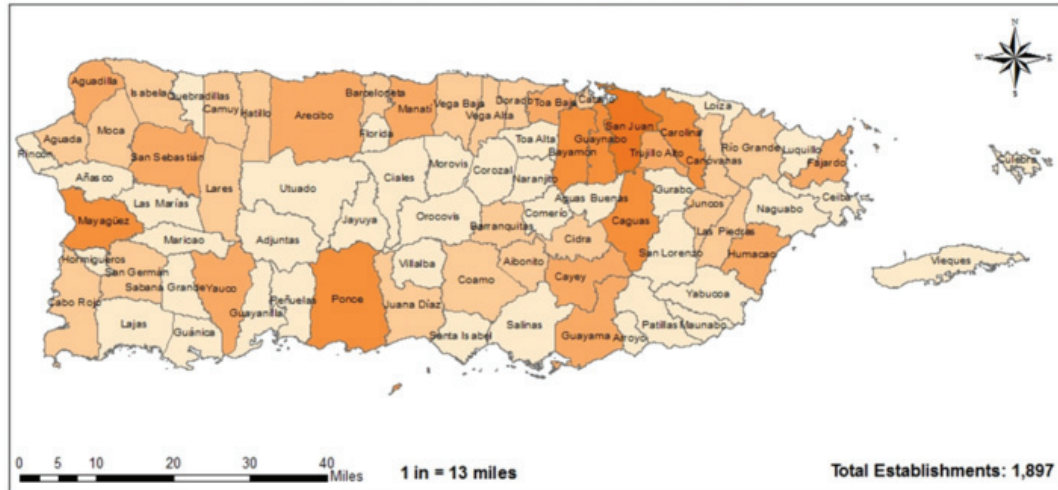
Establishments	Frequency
0 - 7	39
8 - 19	26
20 - 47	8
48 - 103	4
104 - 729	1



The following map shows a 2% decrease in the number of establishments in NAICS sector 52 between 2006 and 2011, particularly in the center and northeast of the Island.



Number of Establishments in Puerto Rico, 2011  
NAICS 52 - Finance and Insurance



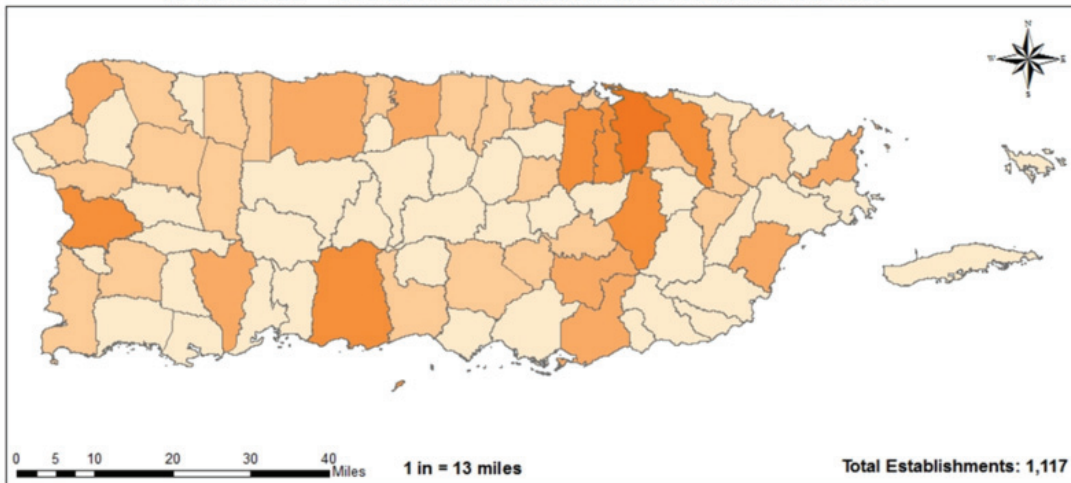
U.S. Department of Commerce, Census Bureau  
County Business Patterns  
Puerto Rico Planning Board  
Economic and Social Planning Program

Establishments	Frequency
0 - 7	39
8 - 16	22
17 - 48	11
49 - 112	5
113 - 671	1



The following map shows the number of establishments in Puerto Rico for the Credit Intermediation and Related Activities sub-sector (NAICS 522). The frequency and distribution of NAICS sub-sector 522 are similar to those of NAICS Finance and Insurance sector 52, as can be seen in the following map.

Number of Establishments in Puerto Rico, 2011  
NAICS 522 - Credit Intermediation and Related Activities



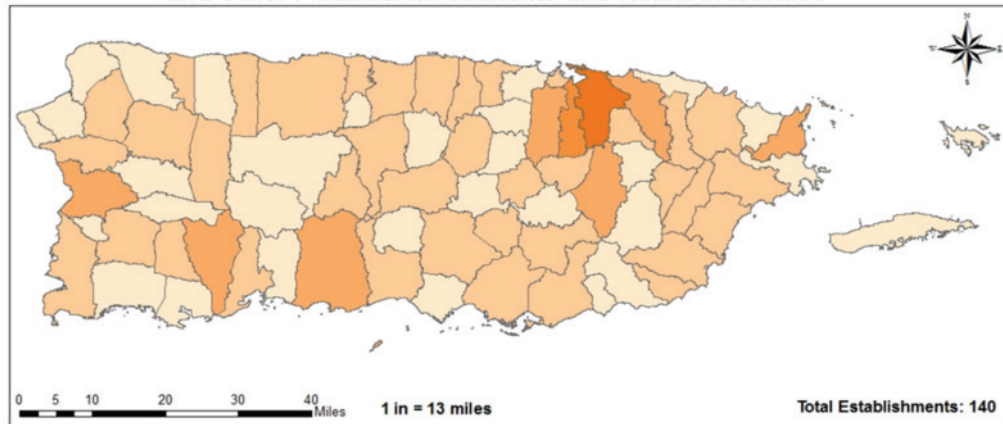
U.S. Department of Commerce, Census Bureau  
County Business Patterns  
Puerto Rico Planning Board  
Economic and Social Planning Program

Establishments	Frequency
0 - 5	39
6 - 12	23
13 - 27	9
28 - 77	6
78 - 331	1



As can be seen in the following maps, the Securities, Commodity Contracts, and Other Financial Investments and Related Activities sub-sector (NAICS 523), has a lesser number of establishments than other sub-sectors and are concentrated in the metropolitan area.

Number of Establishments in Puerto Rico, 2011  
NAICS 523 - Securities, Commodity Contracts,  
and Other Financial Investments and Related Activities



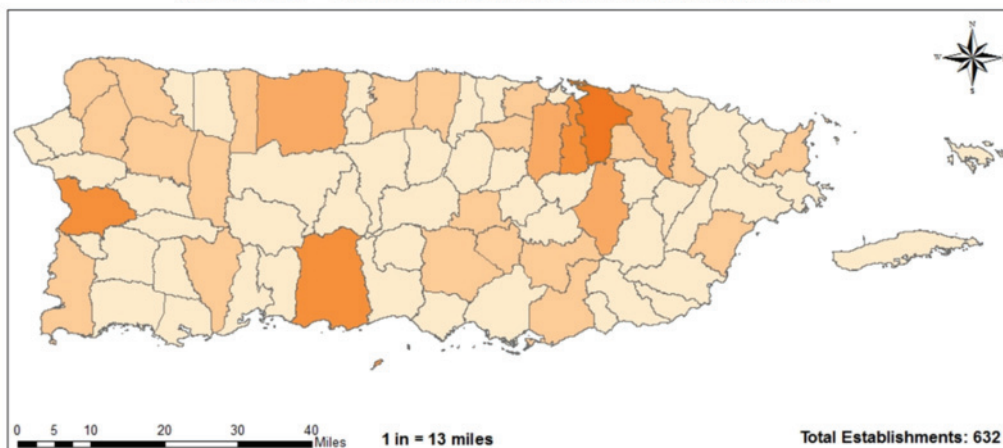
U.S. Department of Commerce, Census Bureau  
County Business Patterns  
Puerto Rico Planning Board  
Economic and Social Planning Program

Establishments	Frequency
0	31
1 - 2	38
3 - 6	7
7 - 14	1
15 - 55	1



San Juan, Mayagüez, and Ponce are the municipalities with the highest number of establishments in the Insurance Carriers and Related Activities sub-sector (NAICS 524). Similarly to the Credit Intermediation and Related Activities sub-sector (NAICS 522), the establishments are concentrated in the metro and an absence of these can be noted in the center of the Island as can be seen in the following map.

Number of Establishments in Puerto Rico, 2011  
NAICS 524 - Insurance Carriers and Related Activities



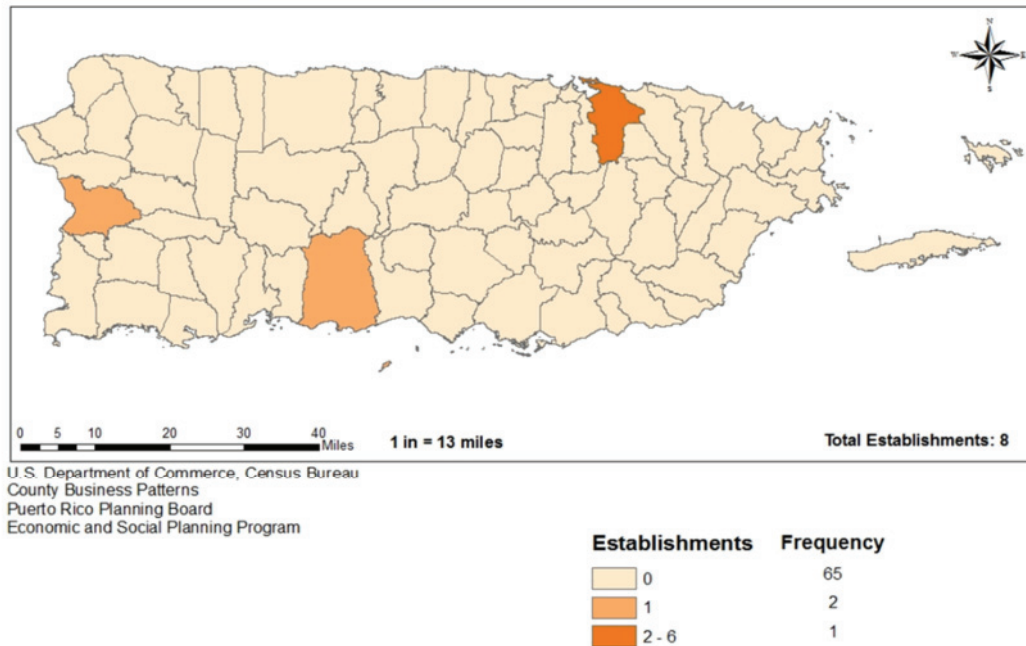
U.S. Department of Commerce, Census Bureau  
County Business Patterns  
Puerto Rico Planning Board  
Economic and Social Planning Program

Establishments	Frequency
0 - 2	49
3 - 9	21
10 - 30	4
31 - 46	3
47 - 279	1



A pattern similar to the one seen in the Insurance Carriers and Related Activities (NAICS 524) and Credit Intermediation and Related Activities (NAICS 522) sub-sector (where establishments are grouped and concentrated in the municipalities of San Juan, Ponce y Mayagüez) can be observed in the Funds, Trusts, and Other Financial Vehicles sub-sector (NAICS 525). However, the number of establishments in this sub-sector is less than in any other sub-sector, and all of them are located solely in the three municipalities mentioned.

Number of Establishments in Puerto Rico, 2011  
NAICS 525 - Funds, Trusts, and Other Financial Vehicles



## 2. COMPARISON OF THE CHARACTERISTICS OF THE SECTOR WITH SELECTED STATES (I.E., FLORIDA, HAWAII, SOUTH CAROLINA, MISSISSIPPI, MASSACHUSETTS, CONNECTICUT).

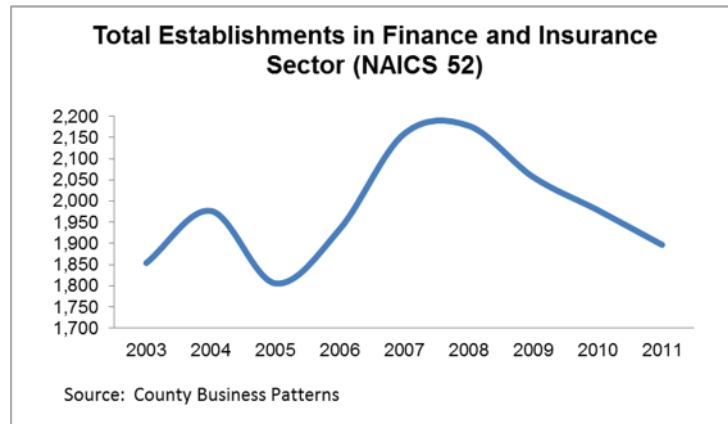
In this section, the Number of Establishments and the Annual Payroll per Employee sub-sectors, from the Finance and Insurance sector will be evaluated, for the 2003-2011 period. As shown in the following table, there is an increase in the number of establishments for the 2006-2008 period, with a 7.1 percentage change for 2006, 11.6 for 2007, and 0.9 for 2008, which is followed by a decrease to pre-2006 levels in establishments.

Finance and Insurance Sector (NAICS 52) Profile in Puerto Rico						
Year	Establishments	%Change	Employees <sup>1</sup>	%Change	Yearly Payroll <sup>2</sup>	%Change
2003	1,854		35,450		\$1,270,284	
2004	1,977	6.6%	37,924	7.0%	\$1,403,673	10.5%
2005	1,806	-8.6%	36,577	-3.6%	\$1,273,184	-9.3%
2006	1,934	7.1%	40,304	10.2%	\$1,406,578	10.5%
2007	2,159	11.6%	40,004	-0.7%	\$1,491,822	6.1%
2008	2,178	0.9%	40,710	1.8%	\$1,565,957	5.0%
2009	2,057	-5.6%	37,660	-7.5%	\$1,432,341	-8.5%
2010	1,979	-3.8%	34,906	-7.3%	\$1,430,413	-0.1%
2011	1,897	-4.1%	34,633	-0.8%	\$1,457,813	1.9%

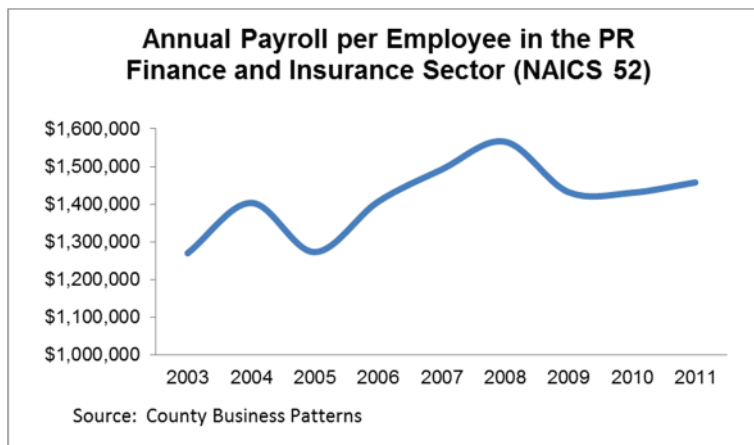
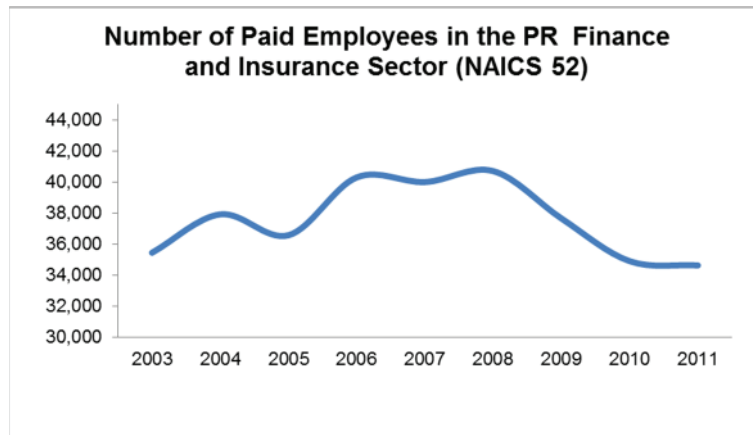
Source: County Business Patterns

<sup>1</sup> In payroll by March 12th

<sup>2</sup> In thousands



A similar trend to the one seen for the Number of Establishments sub-sector can be seen in the Number of Paid Employees and Annual Payroll per Employee sub-sectors: a percentage increase for the 2006-2008 period, followed by a reduction to pre-2006 levels, as the following graphs indicate.



When the Number of Establishments sub-sector in Puerto Rico is compared to those in the states of Connecticut, Florida, Hawaii, Massachusetts, Mississippi the same pattern previously identified can be observed- there is an increase in the number of establishments for the 2006-2008 period, followed by a decrease to pre-2006 levels. This is shown in the following graph.

## Total Establishments in Finance and Insurance Sector (NAICS 52)

Year	Connecticut	Florida	Hawaii	South Carolina	Massachusetts	Mississippi
2003	5,907	29,822	1,495	6,690	9,572	4,465
2004	6,212	31,626	1,519	6,854	9,688	4,601
2005	6,145	32,974	1,600	6,827	9,731	4,707
2006	6,351	34,734	1,640	7,162	9,836	4,617
2007	6,540	35,716	1,674	7,596	10,073	4,932
2008	6,629	33,957	1,602	7,731	10,018	4,936
2009	6,399	32,301	1,528	7,689	9,695	4,865
2010	6,339	31,305	1,450	7,332	9,437	4,716
2011	6,178	30,500	1,425	7,201	9,359	4,698

Source: County Business Patterns

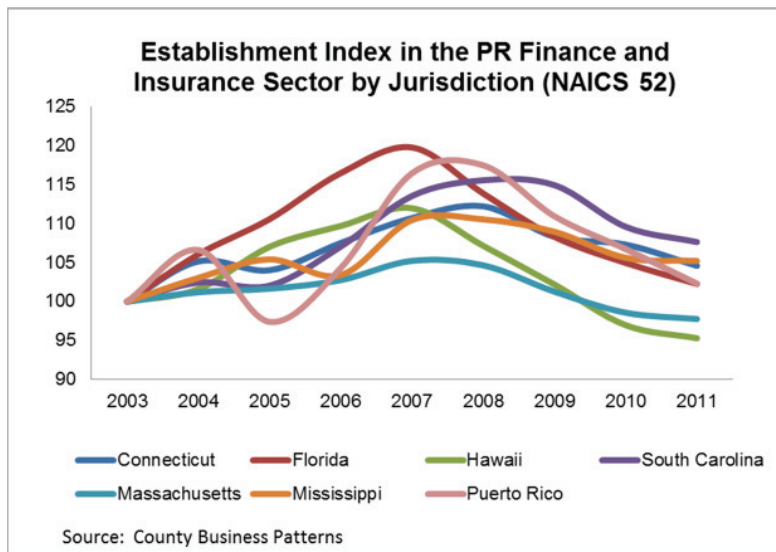
As can be observed, Florida boasts the greatest number of establishments with an average of 32,548 establishments, followed by Massachusetts (9,712), South Carolina (7,231), Connecticut (6,300), Mississippi (4,726) and lastly, Hawaii (1,548). Florida also has the greatest number of paid employees.

## Number of Paid Employees in the PR Finance and Insurance Sector (NAICS 52)

Year	Connecticut	Florida	Hawaii	South Carolina	Massachusetts	Mississippi
2003	145,393	357,834	19,218	70,662	209,576	34,581
2004	137,330	372,380	19,256	66,961	213,848	34,641
2005	133,285	370,990	19,707	65,591	206,327	35,616
2006	169,053	388,417	20,097	69,745	211,046	34,550
2007	128,497	370,797	20,608	67,432	214,822	35,251
2008	128,897	386,983	19,363	69,830	221,263	35,876
2009	124,950	338,098	19,220	67,278	209,550	35,142
2010	121,304	328,994	19,171	67,508	197,247	33,764
2011	115,490	331,921	18,783	65,516	196,755	33,593

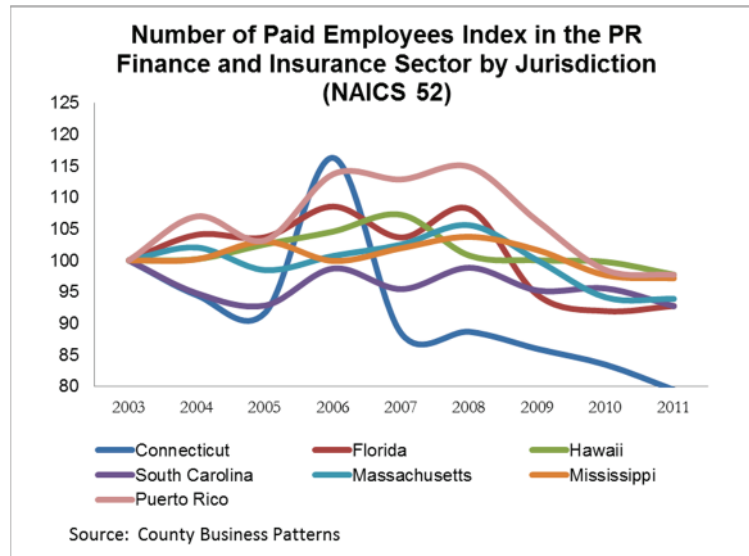
Source: County Business Patterns

The following graph shows the behavior for the number of establishments in the 2003-2011 period, using an index with 2003 as the base year. In 2005, Puerto Rico, South Carolina y Connecticut show a decrease in the number of establishments, for which Puerto Rico's is the most significant. Mississippi shows a marked decrease in the number of establishments for the year 2006. These trends become positive briefly in 2007, and negative once again in 2009.





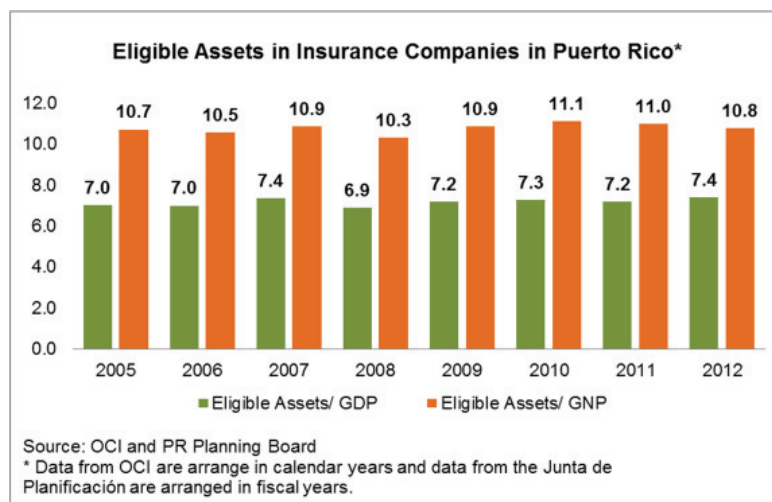
The following graph shows the index for the Number of Paid Employees by jurisdiction, in the Finance and Insurance sector (NAICS 52). As can be seen in the graph, all jurisdictions show varying patterns, however, they all show negative trends by 2011. Puerto Rico is the only jurisdiction which shows an increase with respect to 2003 (up until 2008, at which point the trend begins to show a decline).



## INSURANCE INDUSTRY

As mentioned earlier, even though the insurance industry is part of the finance sector, it possesses very unique characteristics which sets it apart from the rest of the industries in the sector. For this reason, its behavior is not similar to commercial banking or other industries which have been severely affected in the economic crisis.

Industry indicators show that, as a response to the crisis, insurance operations have limited their growth. Assets have remained stable, for the most part, sustaining slight growth and remaining stable by avoiding sharp declines which seemed unavoidable in the rest of the financial sector.



Also noteworthy, is the fact that insurance companies have been able to maintain positive profitability throughout the duration of the crisis. Between 2005 and 2012, the industry's income was negative only in one year (2006), and this was before the beginning of the crisis. In addition to this, there is a clear growth trend for the number of people paying insurance premiums for the 2005-2012 period, even though 2012 saw a regress in this indicator.

Insurance Company Premiums*									
	2005	2006	2007	2008	2009	2010	2011	2012	Accumulated Growth
<u>Local Insurance Carriers</u>									
Health	\$2,128	\$3,052	\$4,150	\$4,158	\$4,737	\$5,366	\$6,123	\$5,477	157.3
Property and Casualty	\$1,769	\$1,794	\$1,788	\$1,742	\$1,660	\$1,620	\$1,605	\$1,636	-7.5
Life and Disability	\$2,241	\$2,671	\$2,297	\$2,586	\$2,662	\$2,636	\$2,508	\$2,586	15.4
<u>Foreign Insurance Carriers</u>									
Property and Casualty	\$337	\$245	\$404	\$251	\$212	\$208	\$205	\$214	-36.4
Life and Disability	\$487	\$560	\$615	\$560	\$535	\$598	\$618	\$664	36.4
Total Premiums and Losses	\$6,962	\$8,322	\$9,254	\$9,297	\$9,805	\$10,427	\$11,059	\$10,577	51.9

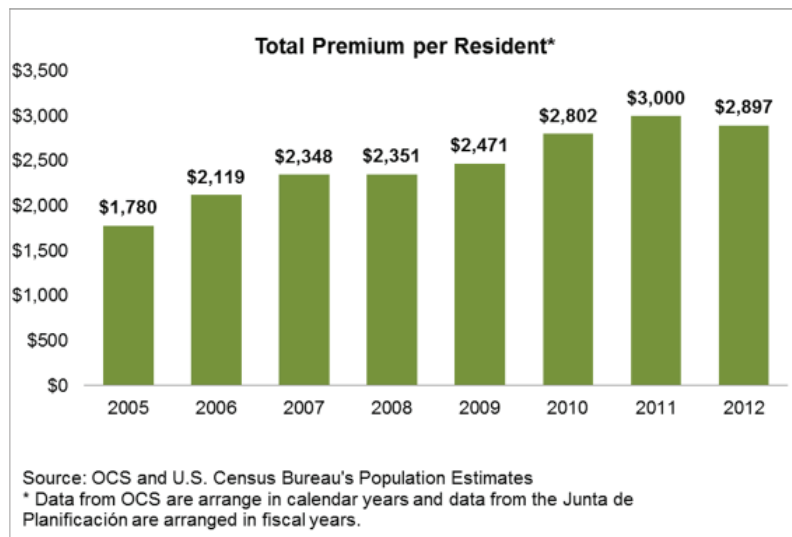
Source: Office of the Puerto Rico Commissioner of Insurance

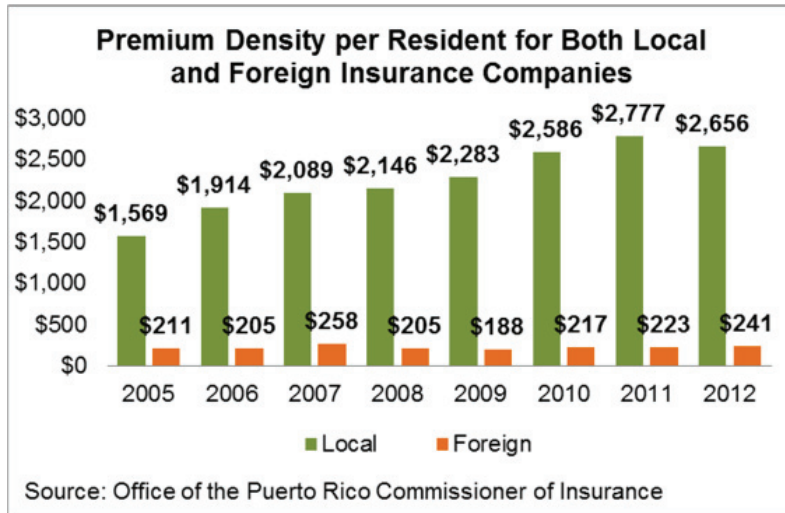
\*Updated every December 31, in millions of dollars

Local Insurance Company Revenues*								
	2005	2006	2007	2008	2009	2010	2011	2012
Net Revenue	\$161	-\$587	\$320	\$295	\$394	\$391	\$367	\$338
Local Premiums	\$6,138	\$7,517	\$8,235	\$8,486	\$9,058	\$9,622	\$10,237	\$9,699
Net Revenue/ Local Premiums	2.6%	-7.8%	3.9%	3.5%	4.3%	4.1%	3.6%	3.5%

Source: Office of the Puerto Rico Commissioner of Insurance

\*Updated every December 31, in millions of dollars





## II. SWOT ANALYSIS

### INTRODUCTION OBJECTIVES

The objective of this chapter is to identify strengths, weaknesses, opportunities, and threats to the financial sector in Puerto Rico and its sub-sectors.

### SOURCE OF INFORMATION

The sources that were used for the analysis include the Report on the Competitiveness of Puerto Rico's Economy, published by the Federal Reserve Bank of New (FED); the book titled The Economics of Puerto Rico: Restoring Growth edited by Collins, Bosworth and Soto-Class; interviews with people of interest within the industry, and previous analyses on the topic performed by Advantage Business Consulting.

### ORGANIZATION

This chapter presents the analysis of the Strengths, Weaknesses, Opportunities, and Threats (SWOT) to the financial sector and sub-sectors in Puerto Rico. The chapter begins with a broad financial analysis of the whole sector, and then each sub-sector or industry is analyzed separately.



## TABLE AND DISCUSSION

**S****FINANCIAL SECTOR– Strengths**

- Long history of institutional growth (over a century).
- Integration to the biggest financial system in the world (U.S.)
- Access to U.S. financial markets.
- Openings to global financial markets, especially European.
- Experience in U.S. financial system's procedures and practices.
- Participation in U.S. financial system's legal and regulatory framework.
- Highly qualified human resources at different levels (management, profesional, and support personnel).
- Local market with fairly sophisticated and demanding clients.
- Relatively balanced development of main industries in the sector.
- Relatively high level of financial deepening in the Puerto Rican economy.
- High level of technological sophistication.

**W****FINANCIAL SECTOR-Weaknesses**

- Lack of development in some financial industries.
- Lack of development in some financial markets.
- Insufficient diversification and integration of the “pieces” of the local financial system.
- Insufficient base of core local deposits.
- Lack of congruency between incentives promoting savings and investment.
- Lack of “even playing field” for different industries.
- Not enough internationalization of main industries.
- Vulnerability to outside shocks, specially from the U.S.
- Limited capacity for innovation (followers, rather than leaders).

O

## FINANCIAL SECTOR- Opportunities

- Regulatory and institutional support from the U.S. (e.g. Federal Reserve).
- Possible strengthening of internal savings as well as core local deposits.
- Possible legislative support for the development of industries and lesser developed markets.
- Emerging demand for financial intermediation services due to growth in local entrepreneurship.
- Potential client internationalization and exportation of intermediation services.
- Potential participation in the financing of public-private partnerships.
- Potential for the innovation of financial services to sectors of interest (the elderly, social interest housing).

T

## FINANCIAL SECTOR - Threats

- Potential difficulties in meeting new regulation requirements.
- Possible increase in the cost of funds due to the increase in U.S. interest rates and negative twist in perception of Puerto Rico's country-risk.
- Risk of excessive consolidation and limiting of competition in the banking industry due to the local market contraction.
- Competition from international banking centers and insurance carriers in the Caribbean.
- Loss of business opportunities in the public sector due to the fiscal emergency.

## Commercial Banks

<b>S</b> <b>Strengths</b> <ul style="list-style-type: none"> <li>• Longstanding experience regarding growth and institutional development.</li> <li>• Adjustment to the legal and regulatory framework of the U.S.</li> <li>• Assimilation of U.S. banking best practices and processes.</li> <li>• Access to U.S. financial markets.</li> <li>• High technological sophistication.</li> <li>• High level human resources.</li> </ul>	<b>W</b> <b>Weaknesses</b> <ul style="list-style-type: none"> <li>• Weak local deposit base.</li> <li>• Dependence on brokered deposits.</li> <li>• Vulnerability to external shocks, especially from the U.S.</li> <li>• High exposure to economically-depressed sectors (construction and housing).</li> <li>• Clientele with dependency on real estate as credit collateral.</li> <li>• Excessive asset concentration in real estate vis a vis commercial loans.</li> </ul>
<b>O</b> <b>Opportunities</b> <ul style="list-style-type: none"> <li>• Internationalization potential.</li> <li>• Institutional strengthening due to new focus of U.S. regulations.</li> <li>• Possible institutional support from the Federal Reserve.</li> <li>• Potential growth of demand for products and services by local entrepreneurship.</li> <li>• Potential participation in the financing of public-private partnerships.</li> </ul>	<b>T</b> <b>Threats</b> <ul style="list-style-type: none"> <li>• Potential difficulties in meeting new regulatory requirements.</li> <li>• Brokered deposits' regulatory restrictions.</li> <li>• Possible increase in the cost of funds in the U.S. market.</li> <li>• Potential loss of business opportunities in the public sector.</li> <li>• Possible credit downgrading due to heightened country risk.</li> </ul>

## International Banking Entities (IBE's)

<b>S</b> <b>Strengths</b> <ul style="list-style-type: none"> <li>• Experience arising from several decades of growth and consolidation.</li> <li>• High asset volume = critical mass for international growth.</li> <li>• Fiscal and regulatory environment favorable for its development.</li> <li>• Access to high quality human resources.</li> <li>• Technological sophistication.</li> </ul>	<b>W</b> <b>Weaknesses</b> <ul style="list-style-type: none"> <li>• Limited impact in local economy.</li> <li>• Dependency on preferential tax treatment.</li> <li>• Vulnerable to competing with jurisdictions with special fiscal advantages for global financial capital.</li> </ul>
<b>O</b> <b>Opportunities</b> <ul style="list-style-type: none"> <li>• Potential for greater effects in local economy (employment, sourcing).</li> <li>• Act as a vehicle for the internationalization of the local financial system.</li> <li>• Opportunity to finance public-private partnerships.</li> <li>• Potential for linking with emerging local exports sector.</li> <li>• Opportunity for shelter under international tax agreements of the U.S.</li> </ul>	<b>T</b> <b>Threats</b> <ul style="list-style-type: none"> <li>• Possible negative effects arising from the weakening of local commercial banks.</li> <li>• Possible negative effects from the weakening of manufacturing.</li> <li>• Possible challenges to the preferential tax treatment which shelters the industry.</li> </ul>

## Credit Unions

<b>S</b> <b>Strengths</b> <ul style="list-style-type: none"> <li>• Solid and stable base of core deposits.</li> <li>• Solid and stable base of partners in the local communities.</li> <li>• Positive public image.</li> <li>• Legislation favorable to its development.</li> <li>• Modern and effective system of prudential supervision and regulation.</li> <li>• Long history of development and achievements.</li> <li>• Financial stability throughout the crisis.</li> </ul>	<b>W</b> <b>Weaknesses</b> <ul style="list-style-type: none"> <li>• Low penetration in commercial financing.</li> <li>• Ageing of the traditional partner base.</li> <li>• Limited professional formation of executive team and management vis a vis commercial banking and other financial industries.</li> <li>• Technological lag of many institutions vis a vis other financial industries.</li> </ul>
<b>O</b> <b>Opportunities</b> <ul style="list-style-type: none"> <li>• Focus on recruiting young partners.</li> <li>• Growth towards the commercial loans market</li> <li>• Increased effectiveness and revenue as a consequence of technological updates.</li> <li>• Increased effectiveness and revenue as a result of training management and executives (e.g. generation of assets and liabilities).</li> </ul>	<b>T</b> <b>Threats</b> <ul style="list-style-type: none"> <li>• Risk due to exposure to government debt in investment portfolios.</li> <li>• Demographic risk due to low presence of young people in the partner base.</li> <li>• Risk of weakness in local economy, especially for smaller credit unions.</li> <li>• Risk of increase in interest rates due to changes in monetary policy.</li> </ul>

## Investment Companies

<b>S</b> <b>Strengths</b> <ul style="list-style-type: none"> <li>• Legislation favorable for its development.</li> <li>• Appeal of mutual funds to local investors.</li> <li>• Generous tax considerations for industry products.</li> <li>• History of positive yields for clients.</li> <li>• Industry links the U.S. and other parts of the world.</li> <li>• High quality human resources.</li> </ul>	<b>W</b> <b>Weaknesses</b> <ul style="list-style-type: none"> <li>• Small size of local financial system.</li> <li>• Extreme exposure to government credit.</li> <li>• Dependency on local tax considerations not comparable to other jurisdictions.</li> <li>• Vulnerable to negative effects of remarks made by regulators and/or investors.</li> </ul>
<b>O</b> <b>Opportunities</b> <ul style="list-style-type: none"> <li>• High growth potential.</li> <li>• Diversification and internationalization potential.</li> <li>• Investment potential in public-private partnerships.</li> </ul>	<b>T</b> <b>Threats</b> <ul style="list-style-type: none"> <li>• Possible negative effects in public trust due to recent remarks regarding the industry.</li> <li>• Risk of loss due to downgrading or contest of government securities/bonds.</li> <li>• Possible negative effects of more rigorous regulation.</li> </ul>



## Mortgage Institutions

<b>S</b> <b>Strengths</b> <ul style="list-style-type: none"> <li>• Integration to the U.S. mortgage market and system.</li> <li>• Access to funding sources in the U.S.</li> <li>• Participation in the U.S. legal and regulatory framework.</li> <li>• Federal and local public policy of stimulating the purchase of housing.</li> <li>• High quality human resources.</li> <li>• Technological sophistication.</li> </ul>	<b>W</b> <b>Weaknesses</b> <ul style="list-style-type: none"> <li>• Struggle of the local housing market: extreme contraction of the industry (16% of its pre-crisis size).</li> <li>• Dependency on funding from outside sources.</li> <li>• Vulnerability to interest rate risk.</li> <li>• Exposure to the volatility of the secondary mortgage market .</li> <li>• Exposure to demographic risk: decrease in new homes, migration, and population aging.</li> </ul>
<b>O</b> <b>Opportunities</b> <ul style="list-style-type: none"> <li>• Refocusing in social interest housing market.</li> <li>• Product innovation for ageing population.</li> <li>• Emphasis in collection services for the secondary market.</li> </ul>	<b>T</b> <b>Threats</b> <ul style="list-style-type: none"> <li>• Possible difficulties in complying with new, more demanding, regulation.</li> <li>• Possible difficulties in raising external funds due to increase in interest rates.</li> <li>• Danger of market stagnation due to migration and weaknesses in the economy.</li> <li>• Possible elimination of tax incentives for the purchasing of housing due to fiscal crisis.</li> </ul>

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## Financial Companies

<b>S</b> <b>Strengths</b> <ul style="list-style-type: none"> <li>• Access to banking credit and headquarters in the U.S.</li> <li>• High quality human resources.</li> <li>• Concentration in specialized segments of the market.</li> <li>• Technological sophistication.</li> </ul>	<b>W</b> <b>Weaknesses</b> <ul style="list-style-type: none"> <li>• Dependence of commercial and durable goods sector on economic dynamism; both, areas strongly affected in local crisis.</li> <li>• Vulnerability to increases in cost of funds.</li> </ul>
<b>O</b> <b>Opportunities</b> <ul style="list-style-type: none"> <li>• Increase in penetration in vehicle financing.</li> <li>• Possible growth based on development of local entrepreneurship.</li> </ul>	<b>T</b> <b>Threats</b> <ul style="list-style-type: none"> <li>• Risk due to weakening of motor vehicle sales.</li> <li>• Risk due to credit deterioration of small and medium-sized businesses.</li> <li>• Risk of changes in interest rates due to public policy.</li> </ul>

## Brokers

<b>S</b> <b>Strengths</b> <ul style="list-style-type: none"> <li>• Ties to the U.S. industry.</li> <li>• Assimilation of the global industry's best practices and procedures.</li> <li>• Participation of the U.S. regulatory system.</li> <li>• Ties to independent investors and local institutions.</li> <li>• High quality human resources.</li> <li>• Technological Sophistication</li> </ul>	<b>W</b> <b>Weaknesses</b> <ul style="list-style-type: none"> <li>• Local stock market is non existent.</li> <li>• Limited size of local individual and institutional market.</li> <li>• Intense competition with foreign brokers.</li> </ul>
<b>O</b> <b>Opportunities</b> <ul style="list-style-type: none"> <li>• Growth through import substitution (services provided by external brokers to local clients).</li> <li>• Benefit from the development of a local stock market.</li> <li>• Benefit from the development of class of sophisticated local investors.</li> </ul>	<b>T</b> <b>Threats</b> <ul style="list-style-type: none"> <li>• Intensification of external competition.</li> <li>• Damage to credibility and public image due to recent losses suffered by investors.</li> <li>• Losses in businesses related to local government securities.</li> </ul>

## Leasing Companies

<b>S</b> <b>Strengths</b> <ul style="list-style-type: none"> <li>• Access to U.S. banking credit and headquarters.</li> <li>• High quality human resources.</li> <li>• Concentration of specialized segments in the market.</li> <li>• Technological sophistication</li> </ul>	<b>W</b> <b>Weaknesses</b> <ul style="list-style-type: none"> <li>• Dependence of commercial and durable goods sector on economic dynamism; both, areas strongly affected in local crisis.</li> <li>• Vulnerability to increases in cost of funds.</li> </ul>
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## Small Loan Companies

<b>S</b> <b>Strengths</b> <ul style="list-style-type: none"> <li>• Control over a “niche” in the market.</li> <li>• Access to local and foreign banking funds.</li> <li>• Absence of foreign competition.</li> <li>• Favorable regulatory environment.</li> <li>• Strong record of operations and achievements.</li> </ul>	<b>W</b> <b>Weaknesses</b> <ul style="list-style-type: none"> <li>• Dependence on a low income sector heavily affected by the economic crisis and unemployment.</li> <li>• Vulnerable to increases in the costs of funds.</li> <li>• Vulnerable to demographic risk due to migration and ageing of population.</li> </ul>
<b>O</b> <b>Opportunities</b> <ul style="list-style-type: none"> <li>• Refocusing on immigrant, low-income population.</li> <li>• Financing of micro-entrepreneurs.</li> </ul>	<b>T</b> <b>Threats</b> <ul style="list-style-type: none"> <li>• Loss of clients due to economic crisis.</li> <li>• Loss of profitability due to increase in late payments (unemployment).</li> <li>• Risk of increase in interest rates due to changes in monetary policy.</li> </ul>

### Government Banks: Government Development Bank

<b>S</b> <b>Strengths</b> <ul style="list-style-type: none"> <li>• Public sector deposit base.</li> <li>• Access to U.S. bond market.</li> <li>• Long operational record as fiscal agent for the local government.</li> <li>• High quality human resources.</li> <li>• Technological sophistication.</li> </ul>	<b>W</b> <b>Weaknesses</b> <ul style="list-style-type: none"> <li>• Exposure to central government and public corporations' credit shortcomings.</li> <li>• Deterioration of financial condition due to the intermediation of "extra-constitutional debt".</li> <li>• Downgrading of credit ratings.</li> </ul>
<b>O</b> <b>Opportunities</b> <ul style="list-style-type: none"> <li>• Strengthening its influence in the government and public sector.</li> <li>• Growing role in the financing of strategic economic projects.</li> <li>• Participation in financing of public-private partnerships.</li> </ul>	<b>T</b> <b>Threats</b> <ul style="list-style-type: none"> <li>• Possible negative effects due to any additional downgrading of government credit.</li> <li>• Possibility of limited access to financing.</li> <li>• Risks due to the increase in interest rates as a result of changes in monetary policy.</li> </ul>

### Government Banks: Economic Development Bank

<b>S</b> <b>Strengths</b> <ul style="list-style-type: none"> <li>• Long record of operation and success</li> <li>• Solid private client base.</li> <li>• Positive corporate image.</li> <li>• High quality human resources.</li> <li>• Technological sophistication.</li> </ul>	<b>W</b> <b>Weaknesses</b> <ul style="list-style-type: none"> <li>• Dependency on outside sources of funding.</li> <li>• Exposure to credit risk due to the economic crisis suffered by their clients.</li> </ul>
<b>O</b> <b>Opportunities</b> <ul style="list-style-type: none"> <li>• Growth of agricultural development.</li> <li>• Growth due to development of local entrepreneurship.</li> <li>• Growth in tourism sectors.</li> <li>• Growing role in the financing of strategic economic projects.</li> </ul>	<b>T</b> <b>Threats</b> <ul style="list-style-type: none"> <li>• Possible losses due to deterioration of commercial and agricultural loan portfolio.</li> <li>• Risks due to the increase in interest rates as a result of changes in monetary policy.</li> </ul>



## Insurance Companies

<b>S</b> <b>Strengths</b> <ul style="list-style-type: none"> <li>• Solid roots in local economy.</li> <li>• Wide and diverse client base.</li> <li>• Advanced development of main insurance products.</li> <li>• Ties with U.S. and international industry.</li> <li>• Effective regulatory framework.</li> <li>• High quality human resources.</li> <li>• Technological sophistication.</li> </ul>	<b>W</b> <b>Weaknesses</b> <ul style="list-style-type: none"> <li>• Exposure to weaknesses in local economy.</li> <li>• Limited presence in international economy.</li> <li>• Vulnerable to demographic risk.</li> </ul>
<b>O</b> <b>Opportunities</b> <ul style="list-style-type: none"> <li>• Internationalization of the industry.</li> <li>• Access to under-insured segments of local population.</li> <li>• Innovative products for growing segments of population (e.g. the elderly).</li> </ul>	<b>T</b> <b>Threats</b> <ul style="list-style-type: none"> <li>• Potential losses due to the contraction in construction and automotive sales.</li> <li>• Possible growth limit due to the stagnancy of industries such as housing and car sales.</li> <li>• Possible challenges due to increase in costs in industries such as the health industry.</li> </ul>

## Insurance Companies

<b>S</b> <b>Strengths</b> <ul style="list-style-type: none"> <li>• Solid roots in local economy.</li> <li>• Wide and diverse client base.</li> <li>• Advanced development of main insurance products.</li> <li>• Ties with U.S. and international industry.</li> <li>• Effective regulatory framework.</li> <li>• High quality human resources.</li> <li>• Technological sophistication.</li> </ul>	<b>W</b> <b>Weaknesses</b> <ul style="list-style-type: none"> <li>• Exposure to weaknesses in local economy.</li> <li>• Limited presence in international economy.</li> <li>• Vulnerable to demographic risk.</li> </ul>
<b>O</b> <b>Opportunities</b> <ul style="list-style-type: none"> <li>• Internationalization of the industry.</li> <li>• Access to under-insured segments of local population.</li> <li>• Innovative products for growing segments of population (e.g. the elderly).</li> </ul>	<b>T</b> <b>Threats</b> <ul style="list-style-type: none"> <li>• Potential losses due to the contraction in construction and automotive sales.</li> <li>• Possible growth limit due to the stagnancy of industries such as housing and car sales.</li> <li>• Possible challenges due to increase in costs in industries such as the health industry.</li> </ul>