

2021 Fiscal Plan for COSSEC

Building a Safe and Resilient Cooperative System

**As certified by the Financial Oversight and Management
Board for Puerto Rico**

May 27, 2021

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List of Acronyms and Key Terms

AA	Considered to be a high grade assigned to an issuer's bond by any of the major credit rating agencies (but not as high as AAA)
AAA	Highest possible rating that may be assigned to an issuer's bonds by any of the major credit rating agencies
AAFAF	The Puerto Rico Fiscal Agency and Financial Advisory Authority, by its Spanish acronym
ALLL	Allowance for loan and lease losses
BBB+	A BBB is a grade assigned to an issuer's bond by any of the major credit rating agencies; a BBB+ rating reflects an opinion that the issuer has the current capacity to meet its debt obligations but faces more solvency risk than an A-rated issue and less than a BB-rated issue if business, financial, or economic conditions change measurably
BCBS	Basel Committee on Banking Supervision
BOD	Board of Directors
CAEL	Capital adequacy, Asset quality, Earnings, liquidity and Sensitivity
CAGR	Compound Annual Growth Rate
CAMEL	Capital adequacy, Asset quality, Management, Earnings, liquidity and Sensitivity
CARES Act	The Coronavirus Aid, Relief, and Economic Security Act
CDC	Cooperative Development Commission
CD	Certificates of Deposit
CECL	Current Expected Credit Loss
CMOS	Collateral Mortgage Obligation
COSSEC	Public Corporation for Supervision and Insurance of Cooperatives, by its Spanish acronym
COSVI	Life insurance cooperative
COVID-19	2019 novel coronavirus
FDIC	Federal Deposit Insurance Corporation

FOMB	The Financial Oversight Management Board
FROB	Fund for Orderly Bank Restructuring, by its Spanish acronym
GAAP	Generally Acceptable Accounting Principles
GSEs	Government Sponsored Enterprises
MBS	Mortgage Backed Securities
MMDA	Money Market Deposit Accounts
NCUA	National Credit Union Administration
OE	Executive Order issued by The Government, by its Spanish acronym
OREO	Other Real Estate Owned
P&A	Purchase and Assumption
PMO	Project Management Office
PROMESA	Puerto Rico Oversight, Management, and Economic Stability Act
PROSAD- COOP	Savings and Credit Cooperative Shares and Deposits Insurance Corporation
RAP	Regulatory Accounting Principles
ROA	Return on Assets
RTC	Resolution Trust Corporation
S&L	Savings and Loans associations, also known as “thrifts”
TDR	Troubled Debt Restructured
TMO	Transformation Management Office

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Executive Summary

The cooperative system is an important part of the financial infrastructure of Puerto Rico. It provides residents in communities across Puerto Rico with access to financial services. The cooperative system and COSSEC, as its regulator and insurer, have fulfilled this role for many years. However, there are several risks that could undermine the full potential of the cooperative system if they are not promptly addressed. These risks are well known and have been publicly reported. The cooperative system must improve its long-term resilience by moving toward higher national standards for governance and transparent accounting. Near-term reforms can serve to maintain the safety and soundness of COSSEC's insurance fund and the cooperative system as a whole. These reforms will also serve to protect the approximately 1 million residents of Puerto Rico who depend on cooperatives for access to financial services.

The 2021 COSSEC Fiscal Plan outlines a comprehensive set of short, medium, and long-term measures that, when implemented by the Government in a timely manner, will pave the way towards a healthier, more sustainable cooperative system in the Commonwealth. The measures in this Fiscal Plan have been built around three main axes of reform for financial systems: implementing changes in governance, increasing transparency in accounting, and improving supervisory interventions. Short and mid-term measures include, but are not limited to, a new Board governance structure for COSSEC, a concrete timeline to transition from RAP to GAAP¹ accounting, and specific supervisory interventions needed to ensure timely interventions for failing cooperatives.

Moreover, this plan provides an overview of longer-term reforms that COSSEC must adopt to ensure the cooperative system can thrive into the future. The financial services industry is undergoing significant transformation as consumer expectations for the level of service provided have grown. For the cooperative system to thrive in the decades to come, there will need to be bold steps taken to modernize and adopt forward-leaning digital capabilities.

While this 2021 COSSEC Fiscal Plan outlines the key measures needed to improve COSSEC's ability to regulate the system, it will only be effective only if COSSEC substantially steps up the scale and pace of its own transformation. There has been little progress in the reforms outlined in certified Fiscal Plans of 2017 and 2020, and the situation continues to worsen. The Oversight Board continues to urge the Government to implement the milestones of the 2021 COSSEC Fiscal Plan to ensure the stability of the cooperative system. Further delays will only exacerbate the risks in the cooperative system. Accordingly, the 2021 COSSEC Fiscal Plan includes much more detail on the actions, timelines, and milestones required to intervene in and

¹ Regulatory accounting principles (RAP) and Generally Accepted Accounting Principles (GAAP). RAP is the applicable standard for cooperatives in Puerto Rico, while GAAP is the federal standard for financial institutions, including commercial banks and federal credit unions in Puerto Rico.

implement final resolution for any insolvent cooperatives. The Fiscal Plan also includes budget incentives to allow COSSEC to build its professional staff subject to completion of milestones.

A well-governed regulator and well-capitalized insurance fund are critical to maintaining depositor confidence, particularly in times of uncertainty and crisis. On the other hand, thoughtful actions now can set the stage for a more resilient and vibrant cooperative sector serving communities across Puerto Rico for years to come. COSSEC, as the insurer and regulator of the cooperative system, must comply with the Fiscal Plan pursuant to the Puerto Rico Oversight, Management, and Economic Stability Act of 2016.

Part I: Context for COSSEC and current challenges for the cooperative system

Chapter 1. Introduction and background

History and Context

The first manifestation of the cooperative system in Puerto Rico began in the late 1800s with “Los Amigos del Bien Público” (Friends of the Public Good), an organization that provided health services with fees that varied according to the beneficiary’s age. After the Spanish-American war, cooperatives started to gain traction, ultimately resulting in the first cooperative law being passed in 1920. In the 1940s, the “Liga de Cooperativas” (Cooperatives League) was formed to promote the cooperative movement in Puerto Rico. Years later, in the 1970s and 1980s, savings and credit, insurance and housing cooperatives on the Island boomed. It was during this time that the government started the Savings and Credit Cooperative Shares and Deposits Insurance Corporation (PROSAD-COOP, by its Spanish acronym) Program under Law 99-1980. This program insured the shares and deposits of the members of the savings and credit cooperatives up to \$40,000 per member. PROSAD-COOP’s objective was to place cooperatives on an equal competitive footing with commercial banks that were able to offer deposit accounts covered by the Federal Deposit Insurance Corporation (FDIC). In the 1990s, the insured cooperative system weakened financially. As PROSAD-CO-OP looked to raise insurance coverage given to cooperatives, cooperatives incurred losses. After several failed attempts to restructure the program, the Public Corporation for Supervision and Insurance of Cooperatives (COSSEC, by its Spanish acronym) was established in 2001, as a means to improve operations and return cooperatives to stronger financial conditions, provide stronger regulatory oversight, and unify the cooperative system as a whole.

Significance of the Cooperative system in Puerto Rico

Today, COSSEC acts as the regulatory body for the cooperative system, which serves one-third of the Island’s population and is a critical component of the Island’s economy with ~1 million cooperative members. Furthermore, cooperatives mostly serve low-to middle-income populations.

Apart from the financial benefits that cooperatives bring to municipalities throughout the Island, the cooperative system also plays an important role in serving local communities, particularly outside of San Juan and other population centers. This has become particularly evident given recent events like Hurricanes María and Irma the earthquakes in the municipalities of the south of Puerto Rico, and, the more recent COVID-19 crisis, as cooperatives serve as an economic anchor for families and communities' critical food and relief supplies, and cash assistance. Financial inclusion is one of the principal conditions required for economic and social participation of members in a society. The United Nations has identified financial inclusion as an enabler for seven of the 17 Sustainable Development Goals, and it is considered by the World Bank as a key lever in mitigating extreme poverty and boosting shared prosperity. Similarly, research reveals that hunger, poverty, and gender inequality, among others, are reduced when countries strategically advance financial inclusion through the collaboration of actors in the public, private and social spheres².

Lack of universal access to basic financial products and services (such as credit, savings accounts, insurance, or electronic transfers) is a problem in the US and around the world. According to the FDIC, 6.5% of US households are unbanked (8.4 million households, with 14.1 million adults) and 18.7% of households are underbanked (24.2 million households, with 48.9 million adults). Without the means to save, invest, or start a business, individuals lose significant economic potential and communities are impoverished.

Consequently, public, and private organizations and structures exist to promote equality, productivity, and development in areas of economic exclusion. Credit and savings cooperatives, which are owned and operated by and for their members, embody this idea as entities of social character that grant access to financial services for otherwise unserved populations. Puerto Rico is no exception, as its cooperative system is an important network that has allowed disadvantaged groups, such as the elderly or low-income families, to access the formal financial system. An example of this is the fact that only 15 days after Hurricane María, 90% of cooperatives were servicing members of their communities and 30 days after it, there were 17 municipalities in which cooperatives were the only functioning financial institution.

Cooperative system overview

Similar to credit unions on the U.S. mainland, the cooperative system's members are also its owners, with a maximum share insurance limit of \$250,000 per person. COSSEC's system is composed of 111 locally chartered, regulated, and insured credit unions, holding ~\$8.3 billion in shares and deposits. Although the total number of cooperatives has decreased in the past 20 years, insured deposits and shares have increased.

Asset base & funding sources

The cooperative system continues to attract a large number of people into the financial services market, and it continues to stimulate local initiative and local economic strength. This suggests the relevance it has in driving economic development in Puerto Rico and in advancing financial

² The World Bank (2019) The Global Database 2017.

inclusion for its population. In recent years, cooperatives’ customer base has continued to increase, and collective system assets have grown 28% between 2012 and 2020 (1.05% Compound Annual Growth Rate, “CAGR”) because of an ~\$800 million increase in loan balances. Growth in loan balances derives from increased shares and deposits (which account for ~\$600 million of the ~\$800 million increase between 2012 and 2020). The surge in deposits in cooperatives is associated with the three rounds of payments of the Federal Government stimulus programs including CARES Act (\$1,200 per adult), Consolidated Appropriations Act (\$600 per adult) and American Rescue Plan (\$1,400 per adult), as well as federal unemployment transfers, in response to the Covid-19 pandemic. This increase in deposits provide cooperatives with the opportunity of increasing funds that could be loaned or invested taking in consideration their risk tolerance, reserve requirements and future funding needs³.

EXHIBIT 1: ASSET BASE GROWTH - TOTAL ASSETS (\$ BILLION) AS OF DECEMBER 2020
(Calendar Year)



Total assets in the system as of December 2020 saw their most significant increase in over a decade. As the graph illustrates, since 2012 total assets have increased over \$2.3 billion or 28%.

Most of the cooperative’s assets are in north (29%), followed by the east (18%) and center (17%) region of Puerto Rico. Data suggests that the role of cooperatives has been growing in the metropolitan area of San Juan which is associated with traditional banking. In terms of assets, the metropolitan area of San Juan (12%) has overcome other traditional cooperative regions such as the South (9%) and is almost at the level of the West (15%) portion of Puerto Rico.

³ The Peter G. Peterson Foundation (2021) What to know about all three rounds of Coronavirus stimulus checks.

EXHIBIT 2: COOPERATIVE ASSETS BY GEOGRAPHIC LOCATION

Geographic Location	Cooperatives Assets	Percent
North	\$3,000,120,776	29%
East	\$1,848,094,014	18%
Center	\$1,728,676,398	17%
West	\$1,591,632,010	15%
Metro	\$1,220,997,918	12%
South	\$984,632,281	9%
Total	\$10,374,153,398	100%

Notes:
 1. Data submitted by COSSEC as December 2020.
 2. Cooperative assets distribution based on the location of the main office.

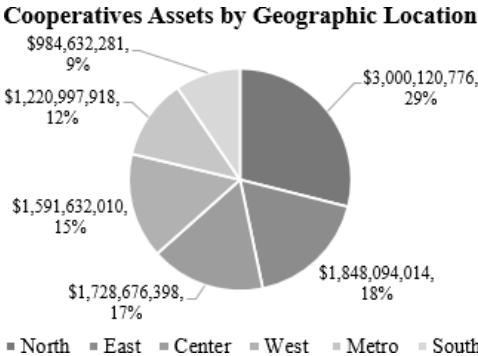
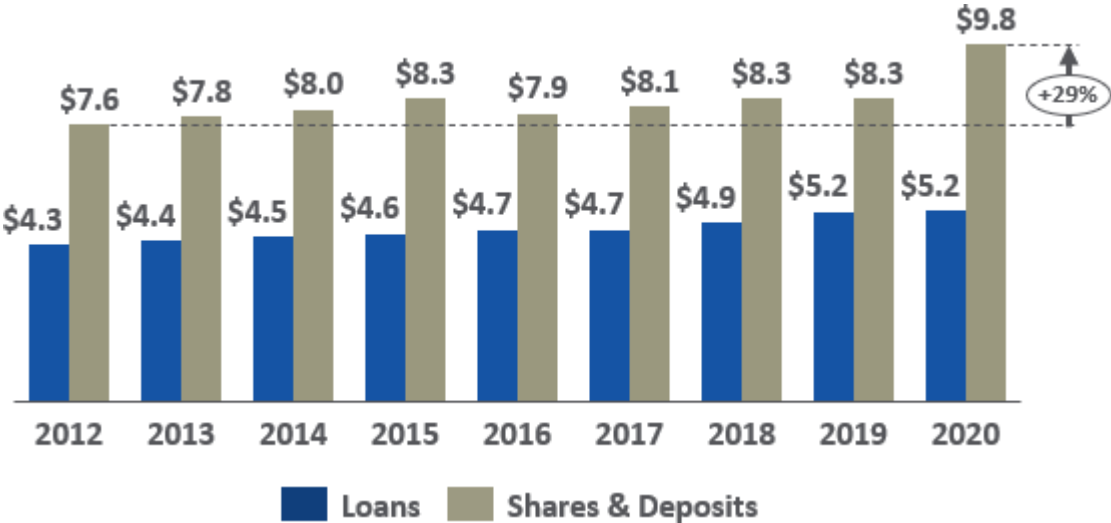


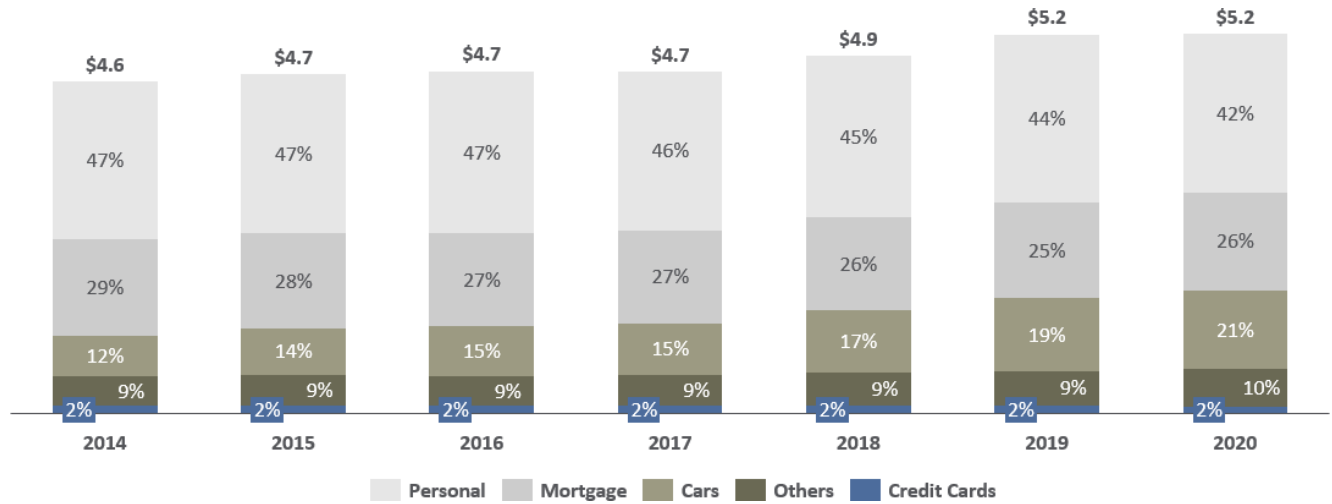
EXHIBIT 3: STABILITY IN FUNDING SOURCES- LOANS AND SHARES & DEPOSITS (\$ BILLION) OF DECEMBER 2020



Loan portfolio composition

In line with the socially driven mission of cooperatives, oftentimes members’ deposits and shares are pledged as the guarantee for loans. When it comes to the cooperative loan portfolios, 42% are personal & consumer loans, 26% are mortgages, 21% cars, and the rest are credit card loans (as of December 2020). Of these, 44% have physical collateral, which reduce the chance of loss in a default scenario. It is worth noting car loans grew from 12% in 2014 to 21% in 2020, which exceeds growth of other loan types.

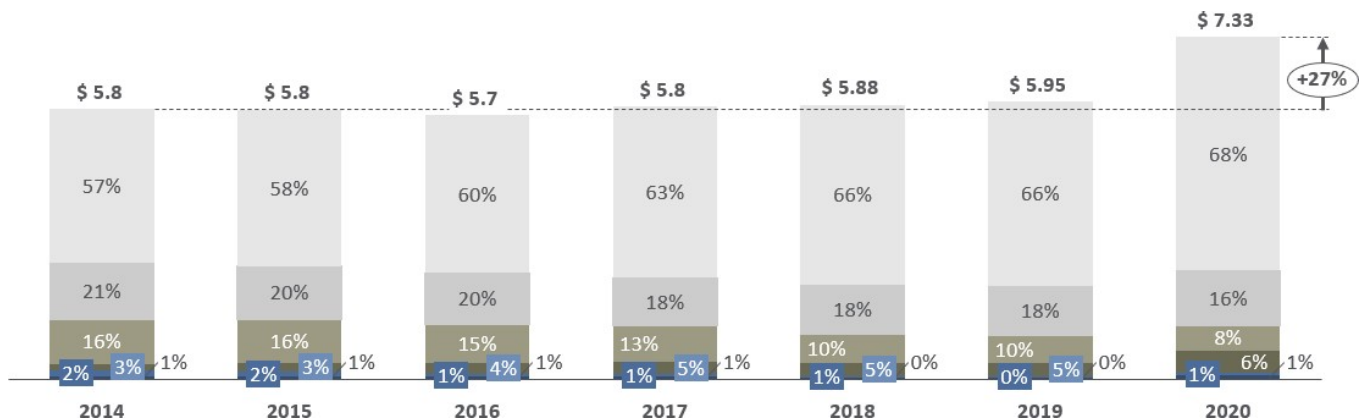
EXHIBIT 4: LOAN PORTFOLIO COMPOSITION - LOANS BY TYPE (\$ BILLION) AS OF DECEMBER 2020



Deposit composition

The cooperative system holds ~\$7.3 billion in deposits. These deposits are mainly made up of Money Market Deposit Accounts (“MMDA”) and savings accounts (68% of total deposits as of December 2020). The remainder consists of Certificates of Deposit (“CD’s”), which represent 68% of total deposits. CD’s consist of a lump-sum that is “locked-up” for a longer period of time in exchange for an interest premium, and early withdrawal usually results in a penalty for the depositor.

EXHIBIT 5: COOPERATIVES’ DEPOSIT COMPOSITION - DEPOSITS BY TYPE (\$ BILLION) AS OF DECEMBER 2020



Assets & Liabilities

As of March 2020, the cooperative system had the following assets and liabilities composition:

EXHIBIT 6: COOPERATIVES' ASSETS, LIABILITIES AND CAPITAL AS OF DECEMBER 2020

Assets (\$ million)		Liabilities (\$ million)	
Cash	898	Total Deposits	7,331
Total Loans	5,225	Accounts Payable	131
Loan Loss Provision	(125)	Total Liabilities	7,462
Saving Accounts	1,768	Equity (\$ million)	
Total Investments in Securities	1,565	Shares	2,382
Total Investments in Cooperatives	306	Indivisible Capital Reserves	360
Land & Property	336	Investment Valuation Reserves	228
Other Assets	401	Other Reserves	8
Total Assets	10,374	Others	(66)
		Total Equity	2,912
		Total Investments	10,374

Overview of COSSEC

Under Act 114-2001, COSSEC serves as the regulatory body for the Island's cooperatives, and its main function is oversight of both credit and savings and non-financial cooperatives. Its jurisdiction also includes the consolidation of financially distressed cooperatives, technical assistance and personnel training. COSSEC also insures shares up to \$250,000 per person to protect members from losses caused by a cooperative's inability to pay its debts when due.

COSSEC's main powers and responsibilities

Under Act 114-2001, COSSEC is the system regulator and insurer of deposits for the cooperative system. Its main powers and responsibilities include:

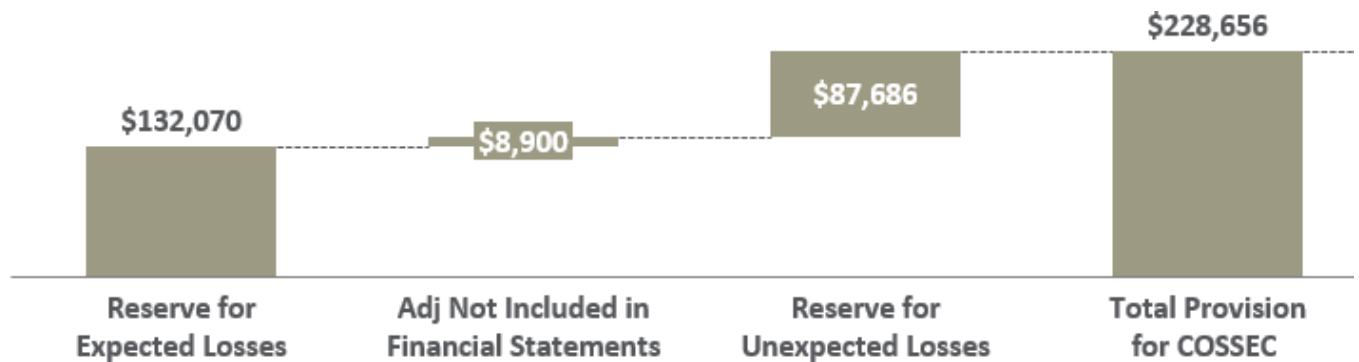
- Comprehensive oversight and supervision of cooperatives to ensure compliance with regulations regarding their operations, businesses, products, and/or services.
- Providing shares and deposit insurance for savings and loans cooperatives.
- Ensuring economic solvency of cooperatives, particularly credit and savings cooperatives.
- Ensuring rights and prerogatives of cooperatives' partners, protecting their financial interests, their right to be informed and preventing deceitful and fraudulent practices in the offer, sale, purchase, and any other transaction of cooperatives.

Under these guiding principles, it is part of COSSEC's mandate to guarantee the economic stability and soundness of the Puerto Rico cooperatives and, consequently, to protect members and their deposits.

COSSEC's financial standing

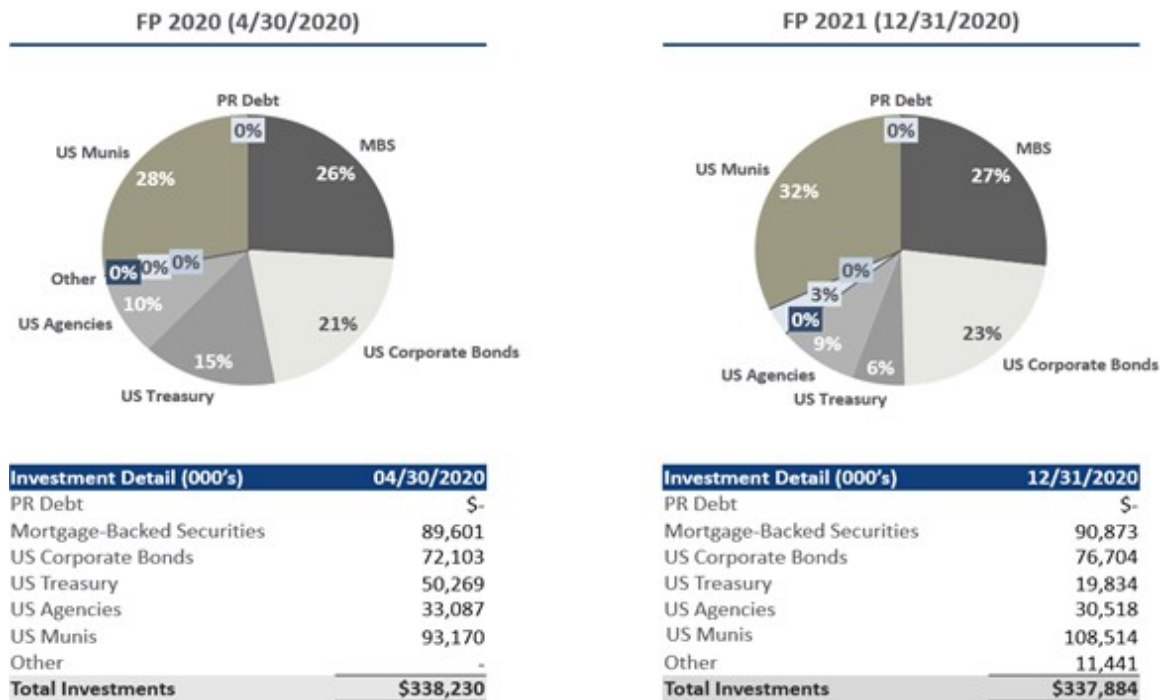
As of September 2020, COSSEC's actuary estimated a total provision of \$229 million to fulfill its role as the insurer of the cooperative system and its members. This provision is composed of \$141 million of expected losses reserves and \$88 million of unexpected losses.

EXHIBIT 7: COSSEC'S PROVISION FOR LOSSES



In terms of investment portfolio composition, COSSEC has \$337 million in total investments (market value), including mostly US corporate bonds (23%), mortgage-backed securities (27%), US municipal bonds (32%), and US Treasury bonds (6%), among others.

Exhibit 8: COSSEC Investments Composition



COSSEC must include metrics to measure the risk management of the COSSEC Insurance Fund to control sudden fluctuations in the market value of COSSECs investments by matching effective duration (sensitivity of the present value of cash flows) to COSSEC's assets and liabilities. A measure of risk management should include amending the COSSEC Investment Policy and adjusting the COSSEC Insurance Fund effective duration to the effective duration of the reserve for expected losses as determined by the actuary based on the weighted expected life of financial cooperatives. COSSEC must submit a risk management report of the COSSEC Insurance Fund within 90 days of the certification of this 2021 Fiscal Plan.

Key stakeholders in the Cooperative System

The Oversight Board has consulted a broad range of stakeholders in order to inform its efforts to develop this fiscal plan and improve the conditions of the cooperative system. This includes government and private sector stakeholders, as well as representatives of the cooperative movement itself such as Liga de Cooperativas (“Cooperatives League”), the G-25, and the Alianza de Cooperativas (“Cooperatives Alliance”).

Topics of discussion with these groups included (but were not limited to): financial inclusion and service to communities across Puerto Rico, governance reforms for COSSEC, measures to address or reduce systemic risks, resolution of cooperatives with financial concerns, RAP accounting to GAAP accounting transition, COSSEC insurance funding, and approaches to allow institutions other than cooperatives to participate in transactions to resolve cooperatives with financial concerns (Article 7.02 of Act 255 of 2002).

Chapter 2. Financial challenges facing the cooperative system

Despite the significance of the cooperative system to the economy of Puerto Rico, in recent years it has been threatened by internal and external factors that have resulted in under-capitalization that, if not promptly addressed, could jeopardize the cooperatives' ability to maintain their financial safety and soundness.

There are several key drivers behind the current weaknesses in the system and second-order effects to COSSEC. These include investments that cooperatives hold in bonds of the Government of Puerto Rico and its instrumentalities, cross-deposits and deposits in second-degree cooperatives, as well as shortcomings in the governance and administration of cooperatives and COSSEC.

Investments in government bonds and its instrumentalities

In 2002, under Act 255 of 2002 or the Cooperative Savings and Credit Companies Law (Act 255-2002), all cooperatives could buy (1) Treasury securities (bills, notes and bonds), (2) US Agency bonds (GSE's) and (3) US Municipal Bonds (AAA & AA). Following Act 255-2002, Regulation 7051 of 2005, allowed “adequate condition Coop's” to also invest in additional investments, specifically (4) US Corporate Bonds (AAA & AA), (5) US Asset Backed Securities, (6) US

Mortgage-Backed Securities (“MBS”) and (7) US Collateral Mortgage Obligation (“CMOS”). Regulation 7051 of 2005 leverages the CAMEL⁴ international rating system to differentiate between adequate condition cooperatives and other cooperatives (with only adequate condition cooperatives being able to invest in those additional security types).⁵ CAMEL is used to score institutions between one (best) and five (worst), with any score higher than a three being considered less-than- satisfactory⁶. In the case of Regulation 7051, cooperatives ranked between one and three were determined to be adequate and hence could diversify the bond types in which they invested, while the remainder are limited to the three initial bond types.

Cross-deposits and deposits in second-degree cooperatives

The cooperative system relies on certain secondary cooperatives to provide insurance and supporting banking services, including COSVI, Cooperativa de Seguros Múltiples, and Banco Cooperativo.

By regulation, cooperative members invest in these entities and serve on their management boards. Because of this structure, cooperatives have financial exposure via cross-deposits across cooperatives (approximately \$544 million) and Banco Cooperativo (approximately \$586 million). COSSEC has increasingly been challenged to understand and manage the risks from the interconnected web of financial relationships.

For example, to the extent that there are linkages with insurance providers, COSSEC must understand the underlying financial health of those providers in order to evaluate the risk that cooperatives’ investments could lose value. In the case of cross-deposits, COSSEC’s analysis of stress scenarios at the individual cooperative level may not fully capture the system wide risks involved when multiple cooperatives hold deposits with each other.

Between December 2015 and December 2020, cross-deposits between cooperatives has seen a significant decrease. By year end 2015, for example, cross deposits in the system were \$946 million compared to \$544 million in December 2020. This 42% decrease is a key indicator of the steady liquidity improvements within the cooperative system. The proportion of cross deposits within total deposit composition is another illustration of how the system is recovering. During 2015, the \$946 million in cross deposits made up approximately 16% of total deposits in the system (\$5.8 billion total).

In contrast, by December 2020 these deposits only made up roughly 7% of total deposits of \$7.33 billion within the system. Cooperatives exposure to other cooperatives and to Banco Cooperativo could be considered as a systemic risk based on the guidelines of the Basel Committee on Banking Supervision (Basel Committee). The Basel Committee guidelines identify the need to “strengthen

⁴ Capital, Asset, Management, Earnings and Liquidity based on Regulation 7790 of 2010

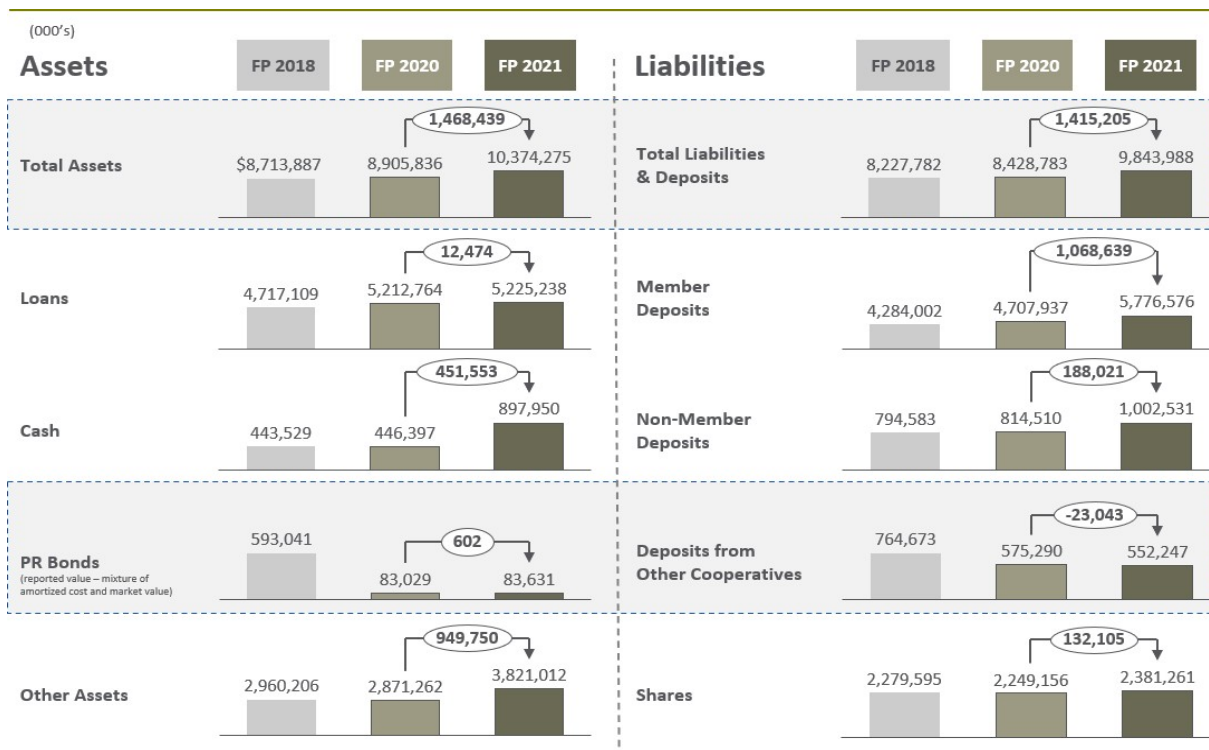
⁵ Reglamento de la Ley de Sociedades Cooperativas de Ahorro y Crédito de 2002, Act 255 of 2002

⁶ Federal Reserve Bank of San Francisco, 1999

the oversight and regulation” as a key element to mitigate the systemic risk arising from interactions with financial institutions that could be in distress. Another important element considered by the Basel Committee is the “liquidity support” necessary to face financial interconnection during potential crisis⁷.

The case of cooperatives’ exposure to other cooperatives could represent a higher cost to the COSSEC Insurance Fund when implementing a final resolution to insolvent cooperatives. An elevated exposure of cooperatives to Banco Cooperativo could increase the risk of cooperatives. The Oversight Board recommends that AAFAF and COSSEC develop an action plan to mitigate and control the systemic risk within 90 days of the certification of this Fiscal Plan. This could include actions such as phasing out of higher exposure and setting limits to cross deposits among cooperatives and to deposits in Banco Cooperativo.

EXHIBIT 9: ASSETS & LIABILITIES COMPARISON AS OF DECEMBER 2020



Assets and Liabilities within the cooperative system also reflect overall improvement and continued growth within cooperatives. Between the 2018 Fiscal Plan submitted by the Government but not certified by the Oversight Board and this 2021 Fiscal Plan, total system assets have increased except for Puerto Rico bond holdings. It is worth mentioning that cooperatives’ own investments are included within other assets. These investments amount to only \$205 million, which represent only 1.95% of total assets in the system. Total liabilities, which include shares and

⁷ Basel Committee on Banking Supervision (2017). Identification and Management of Step-in Risk.

deposits, have increased except for cross deposits, as indicated earlier. Across the board, these positive trends speak for the overall health of the cooperative system.

Impact of Natural Disasters and COVID-19

In recent years, Puerto Rico has suffered several events that have deeply impacted residents and communities. Hurricanes María and Irma in September 2017, and the series of earthquakes that hit the Commonwealth for months, beginning December 2019, have caused catastrophic damage to Puerto Rico's people and businesses, and left billions in damages. The cooperative system proved to be resilient through these disasters and played an important role in enabling the recovery process to start. Just 15 days after Hurricane María, 90% of cooperatives were serving their communities and \$1.43 billion was granted in loan moratoria.

As in all jurisdictions around the world, the COVID-19 pandemic has taken an enormous toll on communities across Puerto Rico. On March 12th, 2020 Puerto Rico entered a state of emergency and later, on March 15th, a strict lock-down was imposed to curb the spread of the virus. In FY2020 there was sharp economic contraction, followed by recovery in FY2021 as the combined effect of federal economic relief funds and rollout of highly effective vaccines has taken hold. While the outcome is not yet clear and the situation is evolving rapidly, it is reasonable to conclude that the COVID- 19 pandemic has affected and will continue to affect the cooperative system and its members.

Chapter 3. COSSEC efforts to date

Analysis of capital adequacy

Many cooperatives have accumulated losses that threaten their long-term viability and solvency. Those includes a number of insolvent and undercapitalized cooperatives that have accumulated millions in losses, including those losses related to investments in Puerto Rico bonds.

Given the use of actuarial methodology (RAP), which allows the masking of losses and creates the appearance of stronger financial health in cooperative financial statements.

COSSEC has provided a stress test scenario which adjusts cooperatives' current financial reporting in the following ways:

- **Market Value adjustment:** value assets including Puerto Rico Government Bonds at market value
- **ALLL adjustment:** add 50% of TDRs and 6+mo. delinquent loans where greater than ALLL.
- **OREO adjustment:** write-down of 50%.
- **COSVI adjustment:** 100% write-down of investment in COSVI.
- Estimated loss to COSSEC based on 20% of assets historical average loss given failure for FDIC and NCUA.

COSSEC also has undertaken an analysis to understand what level of capitalization would be required for cooperatives to reach a 6% target capitalization. The need for this level of resources, and the time frame upon which it is required, will depend on a variety of factors. However, it provides an overview of the extent to which cooperatives in the system need to build resources in the interests of long-term resilience. It also informs COSSEC's forecast of what reserves it will need to ensure that it can effectively operate as a provider of deposit insurance.

Actuarial Risk Level Priorities

Within COSSEC's actuarial report, four categories have been defined for cooperatives based on the extent of capital requirements they are facing. Specifically:

- *Priority 1:* Currently unable to cover accumulated losses (negative capital before running analysis).
- *Priority 2:* ROA is negative, meaning that even after the 15-year loss amortization, the cooperative would still be unable to generate positive earnings.
- *Priority 3:* Projected ROA is positive but may not be sufficient to cover amortized losses on investments (negative net ROA) and could amortize with or without assistance.
- *Priority 4:* Positive projected ROA enough to cover losses on investments without assistance.

The 2021 COSSEC Fiscal Plan requires COSSEC to develop and commit to a plan to identify and address any cooperatives that are currently insolvent and undercapitalized (priority 1 and 2), and that create risks and higher insurance premium payments for the healthier cooperatives.

An updated analysis of capitalization in the cooperative system from December 2020 shows an overall improvement in capitalization of the cooperative system. In comparison with prior reports, December 2020 data shows a general shift towards greater capitalization, higher asset base, and lower risk loss to COSSEC. As an example, the 2020 Fiscal Plan submitted to the FOMB showed \$442 million needed to achieve optimal 6% capitalization. December 2020 data presents a need of \$401 million, or a 9% decrease. This lower threshold coupled with COSSEC's larger Reserve Fund for 2021 shows COSSEC has continued taking the correct actions towards a sound cooperative system.

Liquidity stress scenarios

COSSEC also conducted liquidity stress scenarios. The analysis – which is typical for banking regulators to require - considers what would happen in the case of a sudden withdrawal of funds from the cooperative system. For example, during a time of media reporting about the vulnerability of the cooperative system in 2016, there was a system-wide run of approximately 4%. Using deeper stress scenarios, COSSEC must ensure that it has a plan and financial resources available to maintain high levels of depositor confidence.

Available COSSEC financial resources

Regarding investment yields, the expected yield on COSSEC’s investment portfolio has been reduced from 3.5% to 3.25%. This decrease is related to reduced interest rates, maturity principal repayment and is further affected by the COVID-19 crisis.

EXHIBIT 10: COSSEC BALANCE SHEET

(000’s)	12/31/17	12/31/19	12/31/20	UNAUDITED Financial Statement
Cash	\$4,200	\$2,312	\$27,071	
Investments	285,000	344,576	347,704	
Account Receivable	2,100	2,500	2,694	
Note Receivable	-	3,700	-	
Capital Assets	2,400	1,309	1,061	
Pension Deferrals	-	9,100	4,871	
Total Assets	293,700	363,497	383,403	

Accounts Payable & Accrued Expenses	15,600	23,699	14,660	
Pension Obligations	-	39,713	44,391	
Coop Investigation Reserve Fund	1,000	640	670	
Reserve for Expected Losses	200,000	200,200	225,404	

Total Liabilities	216,100	264,252	285,127	

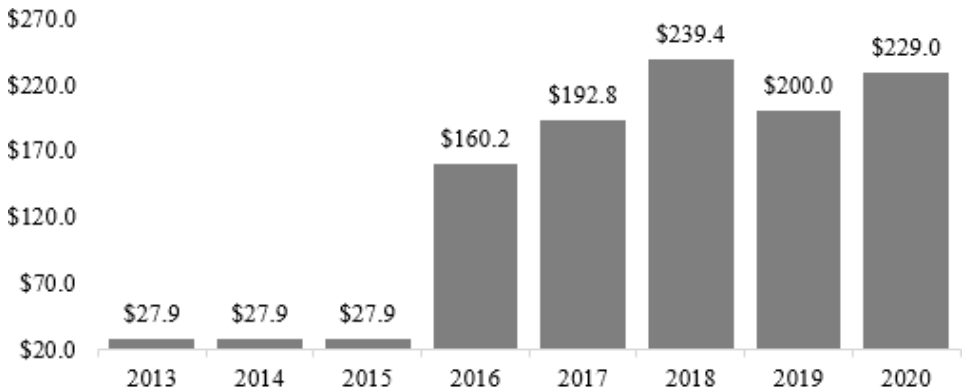
Net Position	77,600	99,245	98,276	

Total Liabilities & Net Position	\$293,700	\$363,497	\$383,403	

Ex-ante funding:
 COSSEC maintains ex-ante funding to cover possible losses from resolving trouble Cooperatives, represented by the aggregate of the Corporation’s net position an its reserve for expected losses

During the fiscal years 2013 through 2015, the COSSEC reserve for expected losses maintained a stable pattern around \$28 million. After 2015, the reserve increased steadily up to \$229 million in 2020. This historical trend of the COSSEC reserve for expected losses reflects the situation of increasing risk that could undermine the full potential of the cooperatives system and the COSSEC Insurance Fund if they are not promptly addressed. This is also evidence that there has been little progress in the reforms outlined in Fiscal Plans of 2017 and 2020, and the situation continues to worsen. The Oversight Board continues to urge the Government to take actions to ensure the stability of the cooperative system. Further delays will only exacerbate the risks in the cooperative system.

EXHIBIT 11: COSSEC RESERVE FOR EXPECTED LOSSES (FISCAL YEAR)



Source: COSSEC (<https://www.cossec.com>)

Part II: Reform measures to the cooperative system

Chapter 4. Measures required to improve governance, oversight and supervision

COSSEC, individual cooperatives, and all stakeholders must work together to ensure the strength and reliability of the cooperative system via effective regulation and strong insurance. This will require a much more assertive posture, as COSSEC must improve the resiliency of the system. These include reforms that have been discussed for years, but consistently deferred. COSSEC governance must be strengthened to allow COSSEC to act quickly, decisively, and in the best interests of the safety and soundness of the cooperative system and to ensure depositor protection. The 2021 COSSEC Fiscal Plan also recommends improving **transparency in accounting and implementing improved supervisory interventions** to protect the integrity of the system. Along these lines, the 2021 COSSEC Fiscal Plan recommends **that cooperatives with major financial concerns be addressed and resolved within 24 months** (i.e., by the end of FY 2023) through a 3-phase intervention process. Taken together, these actions will maintain confidence in the cooperative system, and build its long-term resilience.

Reforms to COSSEC governance

The management processes for the transformation of COSSEC and the cooperative system will require a robust governance model and proper monitoring of cooperative operations. To achieve key reforms to the existing governance structure, protocols, and consequences for mismanagement, COSSEC must have a strong Board of Directors that is able to make decisions independently.

Re-designing governance and establishing protocols

Re-designing governance and establishing protocols is a fundamental process in restoring the cooperative movement. The COSSEC Board should be reformed to ensure that it is an independent

body able to take necessary actions to protect the insurance fund and the depositors who rely upon it. Currently, as per Section 5 of Act 114-2001, COSSEC's board is comprised of 9 members, 5 of which are cooperative members and the remaining 4 are government officials. The existing structure often hinders collaborative oversight and interventions when conflicts of interest arise within the BOD. To remove unnecessary restrictions that hinder successful execution of this Fiscal Plan, the following amendments to the Board structure should be undertaken:

- The Board of Directors should be composed of 5 members (to ensure continuity).
- Members should not have any affiliation or financial ties to a cooperative regulated by COSSEC or the cooperative movement
- The Board of Directors should have the following member composition
 - AAFAF Executive Director
 - Commissioner of Financial Institutions
 - Academic who studies financial regulation and/or accounting
 - 2 members with extensive background in private sector financial services (but not currently affiliated with cooperatives, banks, or credit unions)
- All members of the Board of Directors should have appropriate academic credentials, such as a bachelor's degree in finance and/or accounting as minimum academic preparation and, preferably, must have completed a postgraduate degree in finance, business administration and/or law in an entity recognized and accredited by the Middle States Association.

The Government should submit legislation that addresses this change in governance structure for COSSEC's Board of Directors.

Transparency in accounting

It is a challenge to get an accurate understanding of the state of the cooperative system because the legal system allows cooperatives to use RAP, and RAP does not require disclosure of the current market value of assets under distress. Specifically, losses incurred by cooperatives are not required to be marked to market, which masks losses and creates the appearance of stronger financial health. This is a major reason why mainland U.S. savings & loan institutions were forced to transition from RAP to GAAP in the aftermath of the savings & loan crisis.

Additionally, RAP treats shares differently than GAAP: under RAP, members' shares are considered as part of the capital, while under GAAP shares are considered a liability. This results in an overestimation of solvency and capital base.

Additionally, special accounting treatment allowed by Act 220-2015 permits cooperatives to amortize over a 15-year period any losses resulting from the default of Puerto Rico government bonds.

To drive real efficiencies and reforms for the long-term benefit of COSSEC and the cooperative system, COSSEC should implement improved accounting practices aligned with global best practices for transparency.

The Government must submit legislation that addresses this critical gap by requiring all cooperatives to convert their accounting books and adhere to GAAP within 4 years. For the avoidance of doubt, by requiring adherence to GAAP, the proposed legislation must also eliminate any special accounting treatment for holdings of Puerto Rico government bonds. By transitioning from RAP to GAAP, stakeholders will have improved transparency into the true financial condition of the cooperative system, closing the gap between local and federal accounting standards.

COSSEC’s head accountant and experienced examiners should follow-up with individual cooperatives to ensure the transition of accounting methodologies is done in a timely and precise manner.

Implementation measures to transition from RAP to GAAP must include:

EXHIBIT 12: RAP TO GAAP TRANSITION TIMELINE

Implementation action	Target Date
<ul style="list-style-type: none"> Present legislation through AAFAP for RAP to GAAP accounting to amend Law 114, Law 220, and Law 255 	<ul style="list-style-type: none"> Jan-22
<ul style="list-style-type: none"> Implement amendments to Act 220 of 2015 to allow for GAAP accounting to substitute RAP accounting 	<ul style="list-style-type: none"> Widespread implementation by June 2025
<ul style="list-style-type: none"> Implement amendments to RAP accounting regulation for cooperatives of Regulation 8665 of 2015 under Art 4 of Law 114 of 2001 (Law of COSSEC) - for shares to be considered a liability instead of capital 	<ul style="list-style-type: none"> Widespread implementation by June 2025
<ul style="list-style-type: none"> Implement accounting standard codification ("ASC") 320-10-35 ("Debt securities") from GAAP 	<ul style="list-style-type: none"> All cooperatives by June of 2025
<ul style="list-style-type: none"> Implement ASC 320-10-35-20 ("CUSIP" or Committee of Uniform Security Identification Procedures") from GAAP 	<ul style="list-style-type: none"> All cooperatives by June of 2025
<ul style="list-style-type: none"> Implement ASC 320-10-35-30 (Evaluate Whether an Impairment Is Other Than Temporary) from GAAP 	<ul style="list-style-type: none"> June of 2025

Improved supervisory interventions

To prevent the accumulated loss of cooperatives with financial concerns, improved supervisory interventions should be adopted in a timely manner to identify risks earlier, and to resolve issues sooner and at potentially lower costs. This is particularly relevant if the economic conditions of Puerto Rico worsen, given COVID-19 or other external shocks that might affect the economic climate.

This process must consist of identifying cooperatives at risk (which has already been done by the COSSEC team), examining capital, liquidity and operations performance, and implementing corrective actions. COSSEC must aim to shorten the time it takes to complete interventions, which will be essential to completing the actions needed over the next 24 months. The detailed steps and actions required are specified below.

1. *Identification of cooperatives at risk*

In the first phase of resolving the cooperative system in Puerto Rico, COSSEC should classify cooperatives by their level of capitalization and risk. As part of COSSEC's actuarial activities, cooperatives have been categorized under RAP accounting within 4 priority levels. Under current law, COSSEC and cooperatives will have the option of using RAP accounting from actuarial reports that classify at-risk cooperatives. When legislative changes are approved, COSSEC must transition to classifying cooperatives under federal accounting standards. COSSEC must submit an updated roster of all cooperatives and their risk classification within 30 days after certification of the 2021 COSSEC Fiscal Plan. Additionally, the 2021 Fiscal Plan urges COSSEC to address all cooperatives with major financial concerns (Priority 1 and 2) within 24 months.

The next two phases should be iteratively conducted based on the conclusions of the risk classification, starting with Priority 1 cooperatives, according to the schedule in Exhibit 15.

2. *Risk examination*

COSSEC examiners should conduct the second phase of intervention. The second phase must be supervised by COSSEC supervisors and the vice-president assistant, with an approximate duration of 20 to 30 days (depending on each cooperative's assets). In this phase, COSSEC should examine priority 1 cooperatives' risk levels through CAEL (unlike CAMEL, CAEL does not evaluate cooperative management). The criteria used are valid both under GAAP accounting and RAP accounting methodologies.

Next, a report consisting of capital, liquidity and continuity of operations analyses should be generated by COSSEC's examiners to determine the probability that a cooperative will be able to continue with its operations. Based on the outcome of this risk examination report, COSSEC should determine which formal and informal corrective actions should be taken to ensure the sustainability and soundness of each at-risk cooperative.

3. *Corrective actions*

In the third phase of intervention, formal and informal measures should be taken to reform cooperatives based on the outcome of the report generated by COSSEC examiners as part of the second phase. The third phase should take no more than 60 days per cooperative, depending on how COSSEC's senior management organizes the work among the legal areas and the technical assistance and supervision areas.

Four potential informal measures should be taken to address *Priority 1* cooperatives, depending on the outcome of the COSSEC examiners' report. These measures fall under

operational and shared administration agreements between COSSEC and cooperatives. These measures are not mutually exclusive.

- *Solicitation for action plan*
- *Follow-up on action plans*
- *Written warnings*
- *Supervisory visits*

There also are formal measures to be taken by COSSEC. Based upon the examiner's determination, when COSSEC intervenes upon *Priority 1* cooperatives, COSSEC should either send the cooperative a cease-and-desist order to stop suspicious or illegal activities or place the cooperative into receivership. Cooperatives with financial concerns that are subject to intervention must be provided with an administrative hearing within 10 days after the intervention. The COSSEC official examiner, the COSSEC lawyer and/or management, and the lawyer and/or management for the cooperative with financial concerns should participate in the hearing. After the administrative hearing, COSSEC's legal examiner should submit a final report, in which he or she must determine if receivership is justified or not (according to COSSEC's evidence). COSSEC should base the length of this process on the cooperative's asset level, but it typically must not exceed 15 business days.

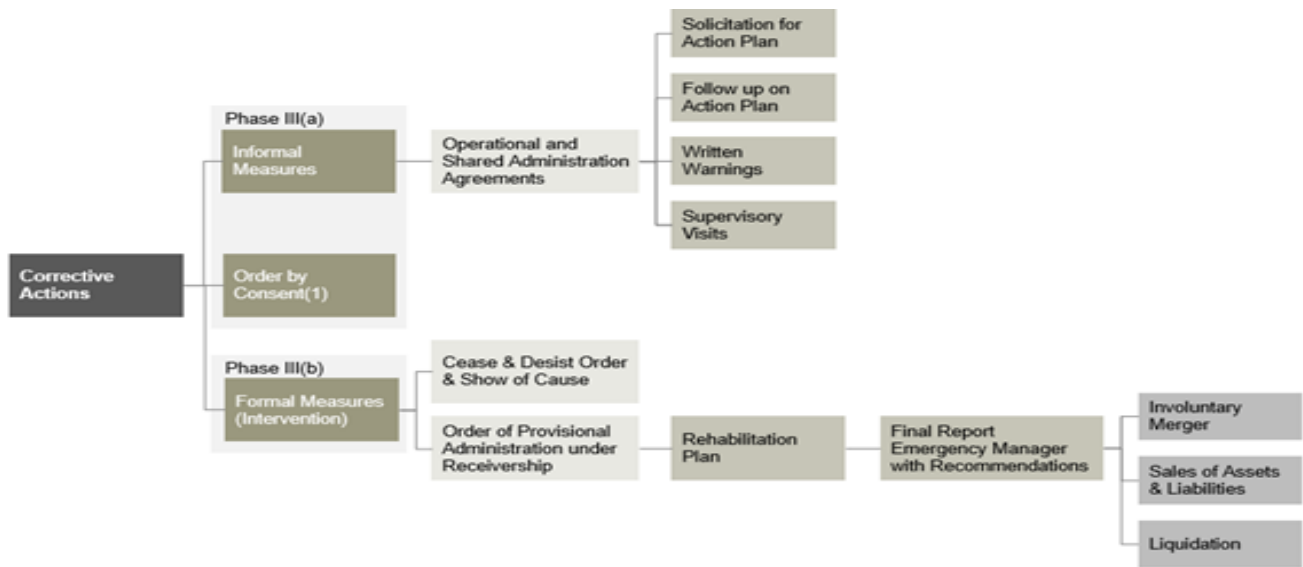
When COSSEC determines that the financial standing of a cooperative is no longer sustainable and therefore needs to intervene, COSSEC must place the cooperative into receivership.

COSSEC managers must next generate a rehabilitation plan for the cooperative in question and then prepare a final report with recommendations of 3 potential rehabilitation courses of action (which are mutually exclusive). Finally, COSSEC must select the rehabilitation action that applies to a given cooperative by balancing the two main criteria: the lowest long-term cost to the COSSEC Insurance Fund and systemic risk. COSSEC is required by Section 20 of Act 114-2001 to choose from the below rehabilitation actions:

- *Involuntary merger* with a financially sounder cooperative. Specifically, merging at-risk cooperatives with an operationally sound one, keeping the capital reduction above 8%.
- *Sales of assets and liabilities* to the buyer of the cooperative.
- *Liquidation*, which applies if the cooperative's asset cannot satisfy the cooperative's debts and when there are no prospective investors to sell the cooperative to.

Additionally, in order for phase 3 to be successfully implemented, the Government should seek legislative change to allow COSSEC to successfully intervene and implement final resolution with insolvent cooperatives. The success of this Fiscal Plan depends in part on COSSEC convincing the Legislature to repeal article 11.02 (d) of Act 220-2015, pursuant to which COSSEC may not impose sanctions on or require additional reserves from a cooperative by reason of said cooperative's investments in bonds or notes issued by the Government of Puerto Rico and its instrumentalities. This limitation, as it currently exists, will prevent COSSEC from successfully reforming the cooperative system within the established period (24 months).

EXHIBIT 13: COOPERATIVE PHASE 3 INTERVENTION PROCESS



Bidding process for cooperatives with financial concerns

If the rehabilitation plan determines that a cooperative with financial concerns should be resolved through a sale of assets and liabilities (P&A), liquidation, or involuntary merger, the following elements must be part of the negotiation between COSSEC and the solvent cooperative’s management. Any negotiated solutions that will impact COSSEC’s finances are subject to approval by the Oversight Board:

- Insolvent cooperative’s accumulated loss
- Insolvent cooperative’s capital reserves
- COSSEC’s Insurance Fund hit or cost
- Solvent cooperative’s indivisible capital
- Impact upon municipality employment (See Appendix for more detail)
- Impact upon municipality salaries (See Appendix for more detail)
- Impact of the cooperative’s members to the municipality population (See Appendix for more detail)
- Geographic location within the Commonwealth

The implementation actions required for a typical resolution process include:

EXHIBIT 14: TIMELINE OF A TYPICAL RESOLUTION PROCESS

Phase	Goal	Milestone	Day (1-90)	
Identifica-tion of co-operatives at risk	Identify cooperatives at risk	<ul style="list-style-type: none"> Conduct actuarial analysis to classify cooperatives into 4 priority levels 	Complete	
	Conduct CAELS examination	<ul style="list-style-type: none"> COSSEC examiner to analyze at-risk cooperative's capital adequacy, assets, earnings, liquidity and sensitivity 	1 to 15	
Risk evaluation	Generate risk examination report	<ul style="list-style-type: none"> Identify capital conditions of at-risk cooperative Identify liquidity condition of at-risk cooperative Determine ability to continue of operations a of at-risk cooperative 	16 to 30	
	Take Informal Meassures	<ul style="list-style-type: none"> COSSEC Management to determine which informal measure to be taken (solicitation for action plans, follow up action plans, written warnings, supervisory visits) Inform at-risk cooperative's BOD of informal measure taken Cooperative to comply with informal measure taken 	31 to 35	
	Determine Formal Measure to be taken	<ul style="list-style-type: none"> COSSEC Management to determine if Cease and Desist Order will be Issued or if cooperative will automatically be placed on receivership 	36 to 40	
Corrective actions	Issue Cease and Desist Order	<ul style="list-style-type: none"> COSSEC management determines Cease and Desist Order is required Administrative hearing with he COSSEC official examiner, the COSSEC lawyer and/or management, and the insolvent cooperative's lawyer and/or management Official examiner to issue a final report to determine if at-risk cooperative will be placed on receivership 	41 to 45 46 to 55 56 to 70	
	Phase	Goal	Milestone	Day (1-90)
	Corrective actions (contd...)	Issue Order of Provisional Administration under Receivership	<ul style="list-style-type: none"> COSSEC Examiner to Issue preliminary Rehabilitation report 	71 to 80
Generate Rehabilitation Plan		<ul style="list-style-type: none"> COSSEC Examiner and COSSEC Management to generate final Rehabilitation plan for at-risk Cooperative 	81 to 85	
		<ul style="list-style-type: none"> Generate final rehabilitation plan 	86 to 90	
		<ul style="list-style-type: none"> Inform at-risk cooperative of final resolution (P&A, Involuntary Merger, Liquidation) 		
Rehabilitation plan key steps (Liquidation, P&A, Involuntary Merger, or Injection Plan)		<ul style="list-style-type: none"> Conduct due diligence on intervened cooperative Conduct liquidation basis financial audit Identify Coop's & Non-Coop's Partners P&A Transaction Data Room for Evaluated Partners Due dilligence and bidders process Identify possible acquisition partners Evaluation of proposals COSSEC to notify final decision to FOMB and AAFAF Conduct transaction 	91 to 120	

Following the typical resolution process above, COSSEC must take appropriate interventions for all Priority 1 cooperatives within 24 months under the following calendar:

EXHIBIT 15: 24-MONTH INTERVENTION CALENDAR

Stage	Milestone	Date
First round of remedial actions (6-months)	▪ COSSEC to initiate corrective action process for cooperatives	July-December 2021
	▪ COSSEC to have mid-round touch-point with FOMB to report on corrective action progress	September 2021
	▪ COSSEC to have end-of-round debrief meeting with FOMB team to report progress on cooperatives under corrective action and outline lessons learned	December 2021
Second round of remedial actions (6-months)	▪ COSSEC to continue with corrective action process for cooperatives, applying lessons learned from first round of remedial actions	January-June 2022
	▪ COSSEC to have mid-round touch-point with FOMB to report on corrective action progress	March 2022
	▪ COSSEC to have mid-point session with FOMB team to report progress for cooperatives under corrective action, outline lessons learned, and to present plan for last 12-months	June 2022
Third round of remedial actions (6-months)	▪ COSSEC to continue with process for cooperatives under corrective action, applying lessons learned from first round of remedial actions	July-December 2022
	▪ COSSEC to have mid-round touch-point with FOMB to report on corrective action progress	September 2022
	▪ COSSEC to have end-of-round debrief meeting with FOMB team to report cooperatives under corrective action intervention progress and outline lessons learned	December 2022
Last round of remedial actions (6-months)	▪ COSSEC to continue with cooperatives under corrective action, following corrective action process and applying lessons learned from first round of remedial actions	January-June 2023
	▪ COSSEC to have mid-round touch-point with FOMB to report on corrective action progress	March 2023
	▪ COSSEC to have a closing meeting with FOMB team to report on all cooperative corrective action processes	June 2023

Focusing supervision resources on financial cooperatives

Under the current structure, COSSEC is the regulating entity for both financial (111) and certain non-financial (153) cooperatives in the Commonwealth. Financial cooperatives fall under the legal framework of Act 114-2001, and non-financial cooperatives are regulated under Act 239-2004. Non-financial cooperatives do not contribute to COSSEC’s resources yet consume some amount of COSSEC’s efforts that could be allocated to addressing the issues outlined in this Fiscal Plan related to financial cooperatives.

Using COSSEC resources to regulate non-financial cooperatives instead of regulating only financial cooperatives affects COSSEC’s ability to comply with the COSSEC Fiscal Plan due to the following:

- Increases COSSEC examiners’ workload
- Limits COSSEC’s capabilities of examination and receivership of financial cooperatives
- Results in additional delays in case of potential receiverships of non-financial cooperatives and COSSEC’s corrective actions

- Increases the long-term cost of the COSSEC Insurance Fund due to delays in implementing correcting actions.

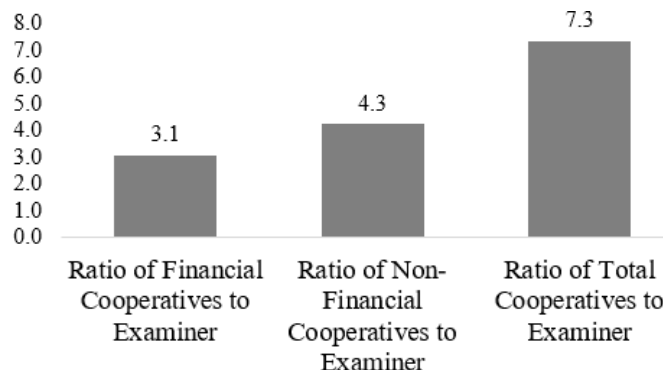
EXHIBIT 16: COOPERATIVES & EXAMINERS

Cooperatives & Examiners	Data
Non-Financial Cooperatives	153
Financial Cooperatives	111
Total Cooperatives	264
COSSEC Examiners	36
Ratio of Financial Cooperatives to Examiner	3.1
Ratio of Non-Financial Cooperatives to Examiner	4.3
Ratio of Total Cooperatives to Examiner	7.3
Notes:	
1. Based on information provided by COSSEC & AAFAF.	

COSSEC should pursue a legislative amendment to Act 239-2004 that would transfer the regulatory power over these non-financial cooperatives to CDC. With such a transfer, resources within COSSEC would be better employed, and only cooperatives that contribute to the insurance fund would be regulated by it. This is a measure that COSSEC should consider once more-immediate needs for FY2021 are met. The Government should submit legislation to affect the transfer of non-financial cooperatives to the CDC with a recommended effective date no later than the end of FY2023.

COSSEC should explore the benefits of Act 8 of 2017, known as “Single Employer Act” to transfer human resources from other government entities to CDC. Also, COSSEC should take advantage of the collaboration agreement between the University of Puerto Rico and the Commonwealth for seminars and training purposes. Additionally, it could incorporate students from the University of Puerto Rico Cooperative Institute “on-the-job training program” to gain practical skills and relevant training at CDC.

EXHIBIT 17: RATIO OF COOPERATIVES TO EXAMINER



Chapter 5. Measures to advance digital and technology capabilities of the cooperative system

Technology-enabling the Co-op system to better reach underserved communities

The cooperative system is fundamental to the economy of Puerto Rico, and its relevance to members and depositors goes beyond the restoration of capital and risk measures. The cooperatives' strategy must focus on effectively serving members in the next 5-10 years, while keeping an eye over the long term on members' trends, competitive environment, changes in regulation, and the growing role that digital and advanced analytics play in the industry.

The close relationship that cooperatives have with their members is one of their key differentiators, as it reinforces affinity by establishing strong ties to community activities. Cooperatives are also financial entities that provides market-leading value to the underbanked and unbanked segments with a tailored approach that improves their financial well-being. This must continue to be central for the cooperative system and its performance in the future, particularly given that future success will require banks and financial entities to develop an increasingly differentiated strategic positioning.

It is important, however, not to lose sight of the pace at which financial institutions are embedding technology into their processes and operations. Cooperatives must adopt a smart, defensive strategy in terms of digital options in order to survive and thrive in the mid- and long-term.

Today, financial entities around the world are leveraging technology and digital tools to lower the cost-to-serve, develop alternative risk models, unlock ubiquitous access, and rapidly and cost-effectively develop tailored products for clients. Collectively, these actions improve both members experience and the financial health of banking institutions. Going forward, COSSEC must evaluate how it and the cooperative system can update and adopt technology and digital tools.

The widespread use of smartphones, coupled with the reduced costs of technology, make digital banking solutions accessible even to smaller financial entities around the world. In 2020, Puerto Rico had 83% internet penetration (or ~3 million users) and 64% smartphone penetration.⁸ At the same time, there are significant economies of scale that derive from the use of technology: while the cost of a branch network grows in-line with customer growth, the cost of developing and adopting technological solutions does not grow proportionally to the member base. That reduced cost allows banks to scale up more quickly without incurring additional costs. These solutions also give financial entities a competitive advantage over their competitors.

In order to prevent the cooperative system from falling behind, and to help it better serve its clients, COSSEC must adopt guidelines and incentives to assist cooperatives in the process of implementing an integral technological strategy that includes innovative approaches to transform

⁸ Think with Google, 2020

customer journeys (e.g., through multi-channel products and services) and internal operational processes (e.g., to digitize end-to-end processes, better utilize data and analytics to improve members outcomes). Adopting these leading practices will benefit the broad base of cooperative members, but also boost financial performance among cooperatives to improve their long-term sustainability. COSSEC must submit an updated analysis of the opportunities to improve the cooperative system through digital and technology capabilities no later than March 31, 2022 based on a census of the 111 cooperatives digital and technology capabilities.

Chapter 6. Measures to improve contingency planning

The cooperative system is facing stress, which requires COSSEC to prepare for all contingencies. COSSEC maintains an insurance fund to provide the resources needed to address troubled and at-risk cooperatives. The most direct way to fund these interventions is to sell a portion of the investment fund (of bond positions with unrealized gains that will not have a negative impact on COSSEC revenues and budget), which exists for these purposes. However, there are alternatives that COSSEC should explore to avoid or reduce the need to sell down the portfolio should the need for resources grow.

Short term financing

Short-term financing solutions are viable to address the more immediate liquidity needs of cooperatives. These needs could be a result of the current financial standing of cooperatives, of the effect that COVID-19 and the moratorium will have upon cooperatives' capital, and/or of the mitigation measures that are to be taken for at-risk cooperatives. These measures are not a long-term solution; they can help buy time while more permanent reforms are implemented.

COSSEC's Insurance Fund (portfolio)

COSSEC's insurance fund exists in part to provide the resources needed to fund COSSEC's final resolutions for cooperatives. This measure is allowed under Act 114 -2001 and would need to follow COSSEC's Investment Policy. Potential amounts that could be tapped into MBS \$89.6, US corporate bonds \$72.1, US Treasury bonds \$50.2, US Agencies bonds \$33.1, & US municipal bonds \$93.2.

If COSSEC were to sell the part of its insurance fund that has unrealized profits, it would not incur interest expense (unlike other measures such as a credit line).

Credit from financial institutions

One potential alternative to access a line of credit from financial institutions willing to lend to COSSEC, as per section 29 of Act 114-2001, "Loans and Issue of Debt Instruments and other Securities." The rationale behind this short-term financing measure is to have the ability to spend and invest cash flows in the next 1-2 years to attend to current needs and repay in 1-15 years. This approach would require that private financial institutions be willing to lend to COSSEC on reasonable terms.

As part of its routine contingency planning, the Government must, within 60 days of certification of this 2021 Fiscal Plan, submit a plan showing how it would ensure adequate funding for COSSEC under the scenarios explored in Chapter 3 with actual sources of adequate funding of the reserve for expected losses with scenarios of annual payment of COSSEC assuming 100%, 75% and 50% of the loss of insolvent cooperatives. The funding gap will be the difference between adequate funding and annual payment.

Chapter 7. Measures to build COSSEC resources

In the longer term, COSSEC must find realistic ways to make the cooperative movement sustainable. Cooperative interventions will reduce the COSSEC Insurance Fund and the insurance premiums because there will be less shares and deposits to insure in the co-op system. Increasing premiums may not be an option in the short term, as cooperatives may not be able to withstand the resulting increased financial burden.

However, in the future (after the COVID-19 crisis and 4-month loan moratorium), COSSEC could increase premiums to obtain incremental annual funding. Increasing premiums within the cooperative system to rebuild COSSEC's financial resources will be necessary over the long term.

To increase premiums in the long term, COSSEC should conduct additional analyses on the amount of insurance premiums that would be commensurate with the income generating capacity of the cooperative system and with the risks that are being insured. To do so, COSSEC should benchmark against other similar systems and supervisory bodies (e.g. NCUA) to best determine the right level of premiums in the long term.

The Government must submit a feasibility study to the Oversight Board outlining the extent to which premiums can be increased to build longer-term COSSEC capital. That study must be submitted no later than December 31, 2021, and annually thereafter.

Chapter 8. Measures to optimize COSSEC organizational structure

Today, the regulatory and financial functions of COSSEC operate as a single organism. Optimization of COSSEC's organizational structure must focus on adopting a design that allows it to accomplish its present mission and comply with future goals. This includes decentralizing functions to promote specialization and improve managerial performance.

Looking to make operations more efficient and to help staff specialize in either function, COSSEC must separate the managerial functions of the administrative structure from the financial structure of the current COSSEC legal entity. This would replicate the basic organizational structure of NCUA.

Operations that fall under the financial function of COSSEC should include (but not be limited to) the following:

- Operating COSSEC’s Insurance Fund, insuring COSSEC member’s deposits up to \$250,000 each.
- Setting up an Investment Board and team that manages the endowment and consists of investment, operations, and administrative professionals.
- Setting up a central liquidity facility (similar to the NCUA liquidity facility) with the goal of improving the general financial stability of the cooperative system by providing short-term liquidity to cooperatives with securities pledged as collateral. Its management would be overseen by the COSSEC Board.

Similarly, operations of the regulatory function of COSSEC should include (but not be limited to) the following:

- Overseeing cooperatives’ financial standing and accounting, and ensuring they are operating in a sound and sustainable way.
- Managing losses associated with at-risk cooperatives, as well as intervention and rehabilitation programs associated with such cooperatives.
- Training examiners and staff, to ensure that they will continue to oversee cooperatives using the highest standards.

The operations side of the COSSEC administrative structure should be headed by COSSEC’s executive director.

To implement these internal re-organization measures, the Government should present legislation to amend Law 114-2001. Upon approval, the internal division of employees would need to take place between COSSEC Insurance Fund and COSSEC as the Regulator. These measures should take effect no later than December 2022.

With these longer-term measures, COSSEC will develop a more specialized, robust structure to be better able to serve cooperatives and their members in the most efficient, transparent way.

Chapter 9. Approach to organizational methods

Nearly three years ago, the Government of Puerto Rico committed to reform COSSEC to ensure its safety and soundness. Solvency and liquidity concerns turned this reform into a fundamental one that would ensure that cooperatives fulfill their role in municipalities and local communities. Notwithstanding the relevance of this reform, very little has happened in the past three years and the pace of interventions for cooperatives with financial concerns has been slow.

Transformation Management Office

With this in mind, this Fiscal Plan outlines a series of critical measures that should be implemented urgently. Successful system reforms go hand-in-hand with a strong and agile Transformation Management Office (TMO) oversees and follows up with all initiatives for cooperatives that underwent an intervention. Five members of COSSEC with +10 years of experience who have

worked in cooperative receivership processes should join the COSSEC TMO to coordinate, support and track the intervention processes. The TMO's role is to provide enough support and guidance to the examiners, lawyers, and information system staff responsible for cooperative interventions.

There are four core transformation functions of a TMO that will ensure that its mandate is effectively carried out: strategy, change management, delivery management and project management (PMO).

- *Strategy*: focus on strategic planning process of cooperative interventions, leading key initiatives within each phase of intervention, and managing stakeholders.
- *Change management*: focus on overseeing, planning, execution, and implementation of interventions, assessing human capital needs of each cooperative (examiners, lawyers, and supervisors of information system).
- *Delivery management*: focus on tracking interventions and ensuring they occur within defined timelines and budgets, resolving issues and conflicts that might arise from cooperative interventions.
- *Project management*: focus on tracking intervention KPIs and report progress updates.

Each of these functions should represent a role assigned to a COSSEC member. Moreover, the head of the TMO should be assigned to ensure effective communication, aggregate data, and support initiative owners. The TMO was created in FY21 and FOMB expects that it will continue the transformation as outlined in this Certified Fiscal Plan. The Government should ensure that a qualified individual is appointed to lead the TMO and, if no candidates are found within COSSEC, must lead the process to identify someone. The Government must, within 60 days of certification of this 2021 Fiscal Plan, submit an Updated Report of the Transformation Management Office.

Human capital and staffing

Cooperative intervention processes require the participation of examiners, supervisors of information systems and lawyers. Depending on the size of each at-risk cooperative, the intervention process will have different staffing needs. Each of these roles has distinct responsibilities during phase 2 and 3 of intervention.

Furthermore, to efficiently reform the system, COSSEC staff must intervene in the cooperatives in the most efficient way possible. To intervene efficiently, there must be certain adjustments to current assignments of human capital:

- COSSEC lawyers are currently on loan to other government agencies. Before considering the addition of any other lawyers to the COSSEC team, these lawyers should be recalled to COSSEC in order to permanently address critical needs or should be transferred out of COSSEC so that those positions become available.
- Some examiners with receivership experience are currently working on non-financial cooperatives (cooperatives under Act 239-2004). These examiners should be assigned to work only on financially at-risk cooperatives (cooperatives under Act 255-2002).

- Today, not all COSSEC Examiners occupy their role within the Examination Area (they occupy other vacant positions within COSSEC). These employees should return to their original roles to ensure that the Examination Area activities are fulfilled.
- Recently certified examiners should work together with and learn from more experienced examiners during the intervention process.

As previously mentioned, COSSEC’s actual workforce of 36 examiners to examine 111 financial cooperatives suggest a cooperative to examiners ratio of 3.1. When 153 non-financial cooperatives are considered for a total of 264 cooperatives, the cooperatives to examiners ratio is 7.3. The increase of cooperatives to examiner ratio from 3.1 to 7.3 (135%) when considering non-financial cooperatives, represents an extraordinary workload for COSSEC’s Examination Area that includes not only the Examiners, but Supervisors and Assistant of Vice-President. Workload could delay the implementation of milestone of complete intervention and final resolution of insolvent cooperatives in 24 months.

EXHIBIT 18: INTERVENTIONS AND HUMAN CAPITAL NEEDS

COSSEC human capital needs per cooperative under corrective actions

Context

- Cooperatives that will undergo corrective actions within the next 24 months have been grouped into 3 categories—small, medium and large—based on size of their assets

Cooperative asset size	
	Assets (\$)
Small	<20M
Medium	20M-60M
Large	>60M
Total	



Approach

- Corrective action processes staff needs and required dedication have been defined based on cooperative size and phase of corrective action process

	Examiners		IT		Lawyers	
	Phase 2	Phase 3	Phase 2	Phase 3	Phase 2	Phase 3
Small	2	2	1	1	1	0
Medium	3	3	1	1	1	0
Large	4	4	1	1	1	0

- Dedication requirements vary for each position
 - Examiners are fully dedicated to one cooperative
 - System can be dedicated to two cooperatives (at any given point in time)
 - Lawyers can be dedicated to three cooperatives (at any given point in time)

Furthermore, if additional training is required to guarantee the preparedness of COSSEC’s team, collaboration with NCUA must be sought for training purposes. Specifically, training for COSSEC examiners is necessary in the following areas: (i) audits, (ii) risk determination, (iii) fraud, (iv) financial analysis, (v) due diligence, (vi) portfolio valuation & (vii) key ratio computation.

Building COSSEC examiners’ skills and capacity commensurate with the challenges ahead

Building COSSEC examiners’ skills and capacity commensurate with the challenges ahead is key to successfully reforming the system. COSSEC must ensure that it has sufficient and well-trained

staff to promptly resolve and implement a final resolution for troubled cooperatives, enhance its approach to supervision, and establish risk-based controls on cooperatives’ operations. Furthermore, COSSEC should have specialized staff members who are dedicated to addressing at-risk cooperatives, as opposed to having staff members who are on loan to other government offices or institutions.

Compliance with Government-wide policy on employer-sponsored health coverage

Health insurance is a core benefit provided to all government employees. However, the degree of coverage varies widely across government agencies, with some employees receiving superior coverage compared to their peers. To ensure fairness and reduce expenditures, COSSEC and the Government must implement the Government’s policy to standardize employer health insurance contributions so that all Commonwealth agencies contribute \$125 per employee per month, or \$1,500 per year, with the exception of public corporations, which must also maintain current employer contribution levels for those employees with pre-existing conditions (as per Law 26-2017).

Implementation Milestones

The required implementation milestones are summarized in Exhibit 19 below.

EXHIBIT 19: SUMMARY OF MILESTONES

Theme	Area of reform	Milestone	Deadline
Milestones required to improve governance, oversight and supervision	Governance	COSSEC submits legislation for board of <u>directors</u> reform	<u>January, 2022</u>
		Implement Board of Directors changes	<u>March, 2022</u>
	Transparency in accounting	COSSEC submits legislation for RAP to GAAP Accounting	<u>January, 2022</u>
		Widespread adoption of GAAP accounting	<u>June, 2025</u>
	Supervisory interventions	COSSEC submits legislation to repeal article 11.02 (d) of Act 220-2015 to allow for interventions of insolvent cooperatives	<u>January, 2022</u>
		Complete interventions of insolvent cooperatives	<u>June, 2023</u>
		COSSEC submits legislation to allow non-cooperatives to participate in P&A bidding process (Sec 7.02 Act 255 of 2002)	<u>January, 2022</u>
	Non-financial cooperatives	COSSEC submits legislation submit legislation to <u>effect</u> the transfer of non-financial cooperatives to the CDC	<u>January, 2022</u>
		COSSEC transfers non-financial cooperatives to CDC	<u>December, 2023</u>
	Milestones required to advance digital and technology capabilities	Digital ad technology capabilities	COSSEC submits an analysis of the opportunities to improve the cooperative system through digital and technology capabilities
Milestones required to improve contingency planning	Financing	Government must submit a plan showing how it would ensure adequate funding for COSSEC	Within 60 days of certification of this 2021 Fiscal Plan

Theme	Area of reform	Milestone	Deadline
Milestones required to build COSSEC resources	<ul style="list-style-type: none"> COSSEC Resources 	<ul style="list-style-type: none"> The Government must submit a feasibility study to the Oversight Board outlining the extent to which premiums can be increased to build longer-term COSSEC capital 	December, 2021
Milestones required to optimize COSSEC organizational structure	<ul style="list-style-type: none"> Organizational structure 	<ul style="list-style-type: none"> Government must present legislation to amend Law 114-2001 	January, 2022
		<ul style="list-style-type: none"> The internal division of employees needs to take place between COSSEC Insurance Fund and COSSEC as the Regulator 	December 2022
Implementation milestones	<ul style="list-style-type: none"> TMO 	<ul style="list-style-type: none"> Updated Report of the Transformation Management Office 	Within 60 days of certification of this 2021 Fiscal Plan
	<ul style="list-style-type: none"> Health coverage 	<ul style="list-style-type: none"> COSSEC and the Government must implement the Government's policy to standardize employer health insurance contributions so that all Commonwealth agencies contribute \$125 per employee per month, or \$1,500 per year 	July 2021

Part III: Financial projections and required reporting

Chapter 10. COSSEC 5 Year Financial Projections

EXHIBIT 20: FY20-FY26 EXPENSE SUMMARY

COSSEC Expenditures		FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026
000s								
Pre-measures expenditures (baseline)	Inflation	(0.14)%	0.26%	1.12%	1.32%	1.44%	1.49%	1.52%
	COSSEC Payroll (w/o employees' addition)	\$7,351	\$7,350	\$7,433	\$7,531	\$7,640	\$7,554	\$7,872
	COSSEC OPEX	\$2,966	\$3,297	\$3,334	\$3,378	\$3,427	\$3,478	\$3,530
	Total pre-measures expenditures¹	\$10,317	\$10,644	\$10,767	\$10,909	\$11,066	\$11,231	\$11,402
OPEX measures	Total OPEX measures	\$0	\$0	(\$415)	(\$420)	(\$427)	(\$433)	(\$439)
Payroll measures	Total Payroll measures	\$0	(\$69)	(\$70)	(\$71)	(\$72)	(\$73)	(\$74)
Budgetary Reserves	Examiner budgetary reserve (10 examiners)	\$0	\$393	\$397	\$403	\$408	\$415	\$421
Post-measures expenditures	COSSEC post-measures expenditures	\$10,317	\$10,972	\$10,680	\$10,821	\$10,977	\$11,140	11,310

1. For FY17-FY21 post-measures revenues are composed of Payroll and OpEx, as no measures were taken during these years

Source: COSSEC 2017, COSSEC 2020

EXHIBIT 21: COSSEC 5-YEAR PROJECTIONS

COSSEC 5-year projections

000s		FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026
Revenues	Regular Premiums ¹	\$23,982	\$24,962	\$24,905	\$25,097	\$26,326	\$27,585	\$27,585
	Interest income	\$10,526	\$10,086	\$9,473	\$8,860	\$8,248	\$7,635	\$7,635
	Other revenue	\$126	\$0	\$0	\$0	\$0	\$0	\$0
	Total operating revenues²	\$34,364	\$35,048	\$34,378	\$33,957	\$34,574	\$35,220	\$35,220
Post-measures expenditures	Post-measures expenditures³	\$10,317	\$10,972	\$10,680	\$10,821	\$10,977	\$11,140	\$11,310
Net	Net	\$24,317	\$24,075	\$23,698	\$23,136	\$23,597	\$24,080	\$23,910

1. Premiums after FY21 are subject to change contingent on the premium increase feasibility study to be conducted by COSSEC

2. Net revenues exclude non-cash items such as change in investment value and bond premium amortization

3. For FY17-FY21 post-measures revenues are composed of Payroll and OpEx, as no measures were taken during these years

Source: COSSEC 2017, COSSEC 2020

Expense measures

No measures were required in FY21. In FY22, COSSEC must implement the following measures (per annum amounts, beginning in FY2022)

1) OPEX measures

- \$415,600 reduction to professional services expenditures, reflecting a return to FY 2019 levels of expenditures
- \$27,000 reduction to eliminate travel allowance outside of Puerto Rico (as examiners will be focused on interventions within the island)
- \$5,000 reduction to eliminate funding for employee uniforms
- \$20,000 reduction to eliminate funding for advertisements and publicity not required by law

2) Payroll measures

- \$69,600 reduction to remove funding for Christmas bonuses

3) Milestone budgeting

The 2021 COSSEC Fiscal Plan recognizes the significant effort needed to make progress on the requirements of this Fiscal Plan. This new Fiscal Plan includes approximately ~\$400,000 in funds that are held and will be released subject to the completion of the milestones.

Revenue measures

The Fiscal Plan includes a requirement to conduct a feasibility study on options to increase revenues through premium increases. Future revenue measures will be required based on the findings of this study.

Chapter 11. Required reporting

COSSEC must report the following items to FOMB:

EXHIBIT 22: COSSEC REPORTING REQUIREMENTS

Area	Reporting Requirement	Closing the 1st reporting period	Cadence for FOMB Reporting	Cadence for Public Reporting	Reporting Requirement Source
Budget reporting	Monthly Budget to Actual Report - Including Revenues, provision for losses, changes to investment value, and premium bond amortization	1-Jul	Monthly	Monthly	Budget
	COSSEC Liquidity vs Budget	1-Jul	Monthly	N/A	Budget
	Revenue forecast	1-Jul	Monthly	N/A	Budget
COSSEC Governance reporting	BOD meetings updates	1-Jul	Monthly	N/A	Fiscal Plan
	Changes to BOD members update	1-Jul	Monthly	Monthly	Fiscal Plan
Cooperatives' reporting	Insolvent cooperatives interventions	1-Jul	Quarterly	Quarterly	Fiscal Plan
	Cooperatives Receivership update	1-Jul	Monthly	Monthly	Fiscal Plan
	Cooperatives liquidity report	1-Jul	Monthly	N/A	Fiscal Plan
	Cooperatives cross-deposit report	1-Jul	Quarterly	N/A	Fiscal Plan
	Cooperatives cash flow report	1-Jul	Monthly	N/A	Fiscal Plan
	Changes to cooperatives' Executive Presidents	1-Jul	Quarterly	Quarterly	Fiscal Plan
	All Cooperatives' Call Report	1-Jul	Quarterly	Quarterly	Fiscal Plan
	Updated Triage Report for Priority 1 and 2 Cooperatives	1-Jul	Quarterly	N/A	Fiscal Plan
Insurance Fund Funding reporting	Insurance Fund Liquidity	1-Jul	Monthly	N/A	Fiscal Plan
	Investment Portfolio average yield to maturity	1-Jul	Monthly	N/A	Fiscal Plan
	Investment Portfolio average coupon	1-Jul	Monthly	N/A	Fiscal Plan
	Investment Portfolio modified duration	1-Jul	Monthly	N/A	Fiscal Plan
	Investment Portfolio effective duration	1-Jul	Monthly	N/A	Fiscal Plan
	Investment Portfolio average credit rating (S&Ps, Moodys, and Fitch)	1-Jul	Monthly	N/A	Fiscal Plan
	Investment Portfolio Interest Cash Flow	1-Jul	Monthly	N/A	Fiscal Plan
	Investment Portfolio Principal Cash Flow	1-Jul	Monthly	N/A	Fiscal Plan
Changes to regulation reporting	Changes to governance	1-Jul	Monthly	Monthly	Fiscal Plan
	RAP accounting to GAAP accounting Transition	1-Jul	Monthly	Monthly	Fiscal Plan
	Changes to P&A participants (amendment of section 7.02 of Act 255-2002)	1-Jul	Monthly	Monthly	-
Stakeholder engagement reporting	Meetings with Stakeholder groups	1-Jul	Monthly	Monthly	Fiscal Plan
	Meetings between COSSEC and AAFAP	1-Jul	Weekly	Weekly	Fiscal Plan
Certifications, Trainings and Others reporting	COSSEC Employee hires	1-Jul	Monthly	Monthly	Fiscal Plan
	COSSEC Examiners Training	1-Jul	Quarterly	Quarterly	Fiscal Plan
	COSSEC Payroll and Headcount	1-Jul	Monthly	Monthly	Fiscal Plan
	COSSEC KPIs	1-Jul	Monthly	Monthly	Fiscal Plan

In addition, any interventions in cooperatives with financial concerns should be consistent with this 2021 COSSEC Fiscal Plan and subsequently certified budget(s). Any applicable legal agreements must be submitted for Oversight Board approval consistent with the Board's contract review policy and with PROMESA.

The Oversight Board generally considers capital injection transactions to be inconsistent with this Fiscal Plan because they are typically not the option with the lowest long-term cost to the Insurance Fund.

Chapter 12. Conclusion

The 2021 COSSEC Fiscal Plan is focused on maintaining the financial stability of COSSEC and the cooperative system in Puerto Rico, ensuring that its ~1M members are served in the best possible way. The starting point of this plan urges reforms to the cooperative system on three main axes: overall changes in governance, adapting of accounting standards, and adoption of stabilization measures.

While the aftermath of the COVID-19 crisis and the effect of the 4-month moratorium will pose heightened challenges for some cooperatives, the “new normal” will also set the stage for cooperatives to serve communities of Puerto Rico in new dimensions. The 2021 COSSEC Fiscal Plan lays out a series of reforms that allow COSSEC to address the cooperatives with the most pressing needs, while paving the way for the cooperative system in the future.

Implementation of measures is the most critical step in reforming COSSEC and ensuring the long-term stability and soundness of the cooperative system. Unfortunately, since the August 2017 COSSEC Fiscal Plan was approved by FOMB, structural reforms and cooperative rehabilitation have been slow and incomplete. Few cooperatives with financial concerns have been addressed in the past 24 months, and there is no detailed plan to address failing cooperatives with actions, milestones, accountable leaders, and phased by the level of risk. Moreover, a clear vision for the future of the cooperative system is required with an understanding of how to modernize the system and ensure it does not fall behind other financial services in Puerto Rico and on the U.S. mainland. With sustained dedication to implement the 2021 COSSEC Fiscal Plan, and with the ambition to seek the necessary reforms for the future, COSSEC can overcome the challenges that afflict the cooperative system and its members today and ensure improved strength and reach of the cooperative system on the Island.

Chapter 13. Supporting information

Appendix

Appendix 1: Case Studies on restoring financial system

When dealing with banking systems in distress, there are typically three main components to a solution. The first is transparency in accounting, which allows stakeholders to understand the financial resources that are required to stabilize the system and helps articulate reforms for the long-term benefit of the financial system that are realistic and based on an accurate picture of the problem. Such an initiative requires the relevant actors to gather sufficient and clear data so as to gain a full picture of the financial resources that are needed. The second component is adopting stabilization measures to bolster confidence in the system and prevent a run on the system's institutions. Lastly, the establishment of robust regulatory supervision and internal governance and risk management systems in each financial institution is key to ensuring safe and sound development of the financial system and preventing problems from reemerging.

Two examples of these levers being applied in practice are the U.S. Savings & Loan crisis of the 1980s and 1990s and the Spanish banking crisis of 2008-2012. More specifically, these cases can provide guidance as to the steps that COSSEC and the cooperative system can take to ensure long-term financial stability and soundness.

U.S. S&L Crisis (1980s)

In the early 1980s, there were 4,000 S&Ls (Savings and Loans associations, also known as “thrifts”) in the U.S. with total assets of \$600 billion, most of which were mortgage loans. However, most S&Ls relied on short-term deposits for the bulk of their funding, thereby creating a mismatch between assets and liabilities that left them particularly sensitive to changes in interest rates. Further worsening matters was the fact that S&L rates were capped by the government, which limited the rates that S&Ls could offer on deposits. As other financial institutions offered customers more attractive rates, this caused significant deposit withdrawals from S&Ls. Initially, the government's response was one of forbearance, as the political and monetary cost of “saving” these thrifts was perceived as “too expensive” at the time (according to the Fed, in 1983 the cost to pay off insured depositors of failed S&L was ~ \$25 billion⁹), and hence it seemed better to patch the system and buy time in hopes that the problem would resolve on its own. However, the mismatch between S&L's floating-rate funding and fixed-rate income only worsened further, resulting in significant declines in S&L net worth. Ultimately, in the late 1980s, 747 S&Ls with assets worth over \$407B were closed, and the total cost to taxpayers was estimated at ~\$130B¹⁰.

⁹ Federal Reserve History, 2013

¹⁰ Federal Reserve History, 2013

Despite the government's initial response to the crisis, comprehensive solution to the S&L crisis required changes along the three components outlined at the beginning of this section. Firstly, transparency in accounting was implemented by replacing Regulatory Accounting Principles (RAP) by Generally Accepted Accounting Principles (GAAP), which is the accounting system that is still used today and is overseen by the Financial Accounting Standards Board (FASB). The reason behind this transition in accounting principles was that under RAP the true financial condition of S&Ls was not apparent.

Moreover, several measures were taken to stabilize the S&L system: minimum capital requirements were implemented, insurance premiums were raised, non-mortgage and mortgage-related holdings were limited, and the divestment of junk bonds was required. In the end, most S&Ls were absorbed by commercial banks, as statutory and regulatory changes were being implemented. Lastly, there were several changes in terms of governance: the main S&L regulator was replaced, thrift insurance was transferred to the Federal Deposit Insurance Corporation (FDIC), and the Resolution Trust Corporation (RTC) was established and funded to address the remaining troubled S&Ls.

Spain's banking crisis (2008-2014)

A similar situation was observed with the banking system in Spain following the financial crisis. The problem was specifically centered around savings and loans banks that were government-owned but self-regulated and competed against private or commercial banks. As a result of the real estate boom of 2004-2007, retail mortgages and developer loans had come to represent a larger portion of savings banks' balance sheets, and lenient criteria for issuing such loans had resulted in exposure to lower-quality assets (contrary to private banks, which were less aggressive with these loans). With the onset of the global financial crisis and downturn in real estate bubble, Spanish banks were left facing both liquidity and solvency issues, especially with the loss of investor confidence. The impacts of this situation were particularly pronounced: banks witnessed a significant reduction in wholesale funding availability, solvency levels eroded due to massive spikes in non-performing loans, and most savings banks went bankrupt. This necessitated large-scale intervention by both the Spanish and European governments (in comparison, most private banks incurred significant losses but did not require government aid).

The recovery path for the Spanish banking system can also be analyzed in the context of the same three-step framework. In terms of greater transparency in accounting, extraordinary provisioning for real estate-related assets was exercised to reflect real underlying losses in the portfolio (regardless of whether realized) in order to provide a more accurate picture of savings bank balance sheets. This consisted of replacing the previous "incurred loss" model with an "expected loss" model that required the recognition of provisions when there existed objective evidence of impairment. Additionally, asset transfer pricing started to be based on the stress-test base scenario.

Several stabilization measures were also taken: banks were consolidated by merging weak institutions into sounder ones through the Fund for Orderly Bank Restructuring (FROB, by its Spanish acronym), a public entity with its own legal regulation; impaired assets were transferred to a government-backed national wind-down unit; transferred assets were focused on real estate

related-only assets; and savings banks' funding structures were bolstered by issuing senior bonds. Finally, steps were taken to fundamentally change governance in these savings banks: as boards and top management teams drastically changed as part of the conditions of government rescue; new oversight policies for banks were instituted by the European Central Bank; and 45% of financial institutions that received government aid eventually became government owned and controlled through FROB¹¹.

The U.S. S&L Crisis and the Spanish banking crisis were both challenging times for the financial industry, but nevertheless offer important insight into how banking and financial systems can be restored. Reforming the cooperative system in Puerto Rico is needed to protect not only the members and depositors of the cooperatives, but also the economy of the Commonwealth at large.

Cooperative's relation with Puerto Rico Macroeconomics & Demographics (2008-2020)

Cooperatives monetary aggregates reflect a connection with the Puerto Rico's macroeconomics and demographics in divergent pattern that is important to address to prevent forecast future trends. In the case of the macroeconomics, cooperatives shares, and deposits have grown in line with Puerto Rico's nominal Gross Nation Product (GNP). This fact is important to be considered by COSSEC as regulator and insurer of cooperatives to take in advance measures to protect cooperative from a potential economic cycle that could affect the source of funds of cooperatives.

In terms of the demographics, even as population in Puerto Rico is decreasing, cooperative membership have reached more than 1 million members. Relative to total employment, even in periods of reduction of employment due to the Puerto Rico's economic cycle, membership as grown.

¹¹ Bank of Spain, 2020

Appendix 2: Statistical Information About Cooperatives

EXHIBIT 23: COOPERATIVE SHARES RELATIVE TO GNP

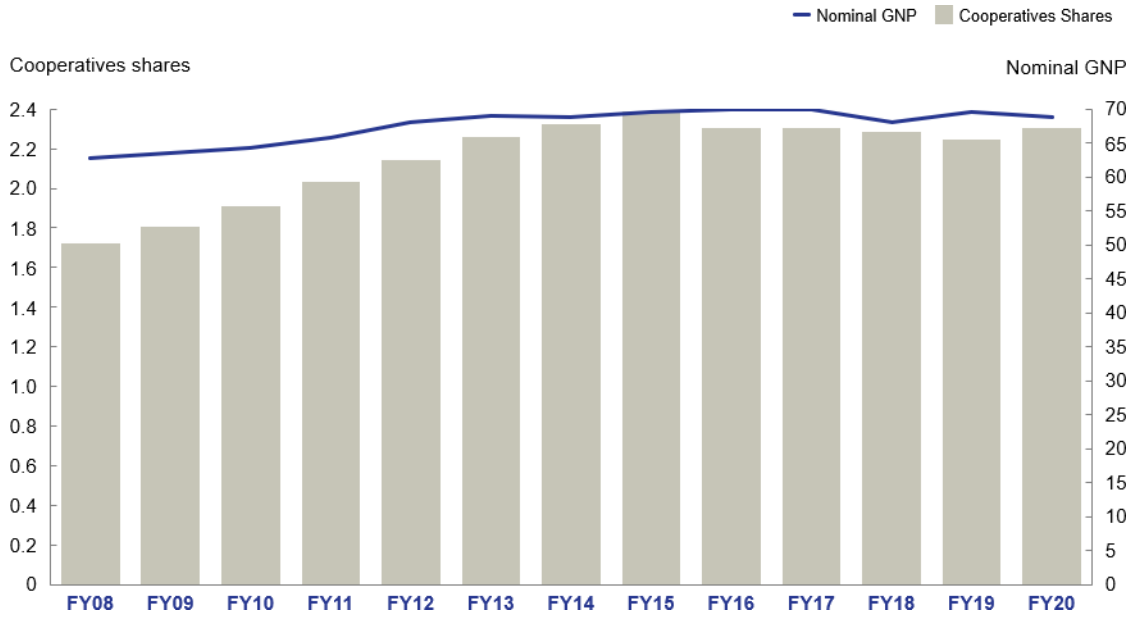


EXHIBIT 24: COOPERATIVE DEPOSITS RELATIVE TO GNP

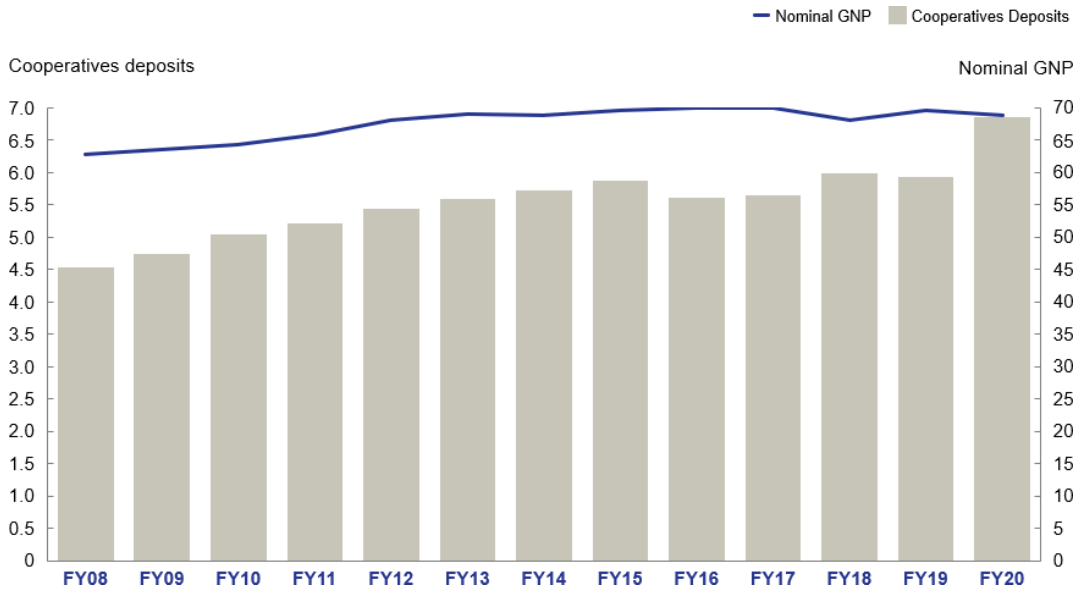


EXHIBIT 25: COOPERATIVE MEMBERS RELATIVE TO POPULATION



EXHIBIT 26: COOPERATIVE MEMBERS RELATIVE TO EMPLOYMENT

