Puerto Rico’s Peculiar Case: Bankruptcy of an Unincorporated Territory

Lara Merling
Overview

- Political Status
- The Economic Decline
- Fiscal Crisis and Default
- PROMESA
- The Oversight Board
- International Comparisons
Political Status

- US Commonwealth; Territory
- Residents are US citizens
- Receives less federal funding than states do
- Puerto Rican residents have no voting representatives in DC
- US decides on trade and monetary policy
- Puerto Rico is under US jurisdiction
Economic Decline

Average Yearly Real GDP Growth

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Value</td>
<td>3.18</td>
<td>3.82</td>
<td>0.71</td>
<td>-0.55</td>
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</tbody>
</table>

Source: International Monetary Fund (2017).
The Economic Decline

- Puerto Rico’s economy was growing at reasonable pace in 80s and 90s
- Island was manufacturing hub for US companies
- Some of the things that happened since the 90s:
  - NAFTA
  - WTO
  - China joining WTO
  - Manufacturing tax incentives phased out for Puerto Rico
The Economic Decline

**Fixed Capital Investment as a Percent of GDP**

<table>
<thead>
<tr>
<th>Year</th>
<th>Public Sector</th>
<th>Private Sector</th>
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<tbody>
<tr>
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<td>5.3</td>
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<td>2004</td>
<td>11.5</td>
<td>3.8</td>
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<tr>
<td>2005</td>
<td>11.3</td>
<td>3.8</td>
</tr>
<tr>
<td>2006</td>
<td>10.6</td>
<td>3.4</td>
</tr>
<tr>
<td>2007</td>
<td>10.7</td>
<td>2.5</td>
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<tr>
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<td>1.2</td>
</tr>
<tr>
<td>2016</td>
<td>7.0</td>
<td>1.0</td>
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</table>

**Source:** Government Development Bank for Puerto Rico (2016).
The Economic Decline

- Between 2005 and 2016 economy shrank by 13 percent
- Poverty rate in 2016 was 46 percent and 58 percent for children
- First wave of spending cuts started around 2009:
  - Government consumption dropped from 9 to 7 percent of GDP
  - About 70,000 public sector employees were laid off
- 10 percent population loss before storm, another 14 percent predicted until 2019
Note on Spending

- High poverty means a lot of people qualified for social programs
- Puerto Rico receives less support from federal government than states for those programs
- Puerto Rico would receive 83 percent reimbursement of Medicaid costs under state formula; instead, it is subject to a hard cap that covers less than 15 percent of costs
- For example: calculating just for 2016, under the cap the reimbursement was $1.7 billion lower than under the state formula
The Fiscal Crisis

- As the economy shrunk, so did government revenue
- The government had no monetary or exchange rate policy tools to mitigate the crisis
- So, the government started to borrow to cover the gap
- Bonds were “triple-tax exempt” (local, state, federal), and part of US municipal bond market
- As PR approached constitutional General Obligation debt limit, bonds got more “creative”
- Despite clear financial problems creditors continued to lend counting on strong legal protections
The Fiscal Crisis

Debt Issued by Puerto Rico, billions of dollars

- Total: $74.0
  - 2017: $29.5
    - Public corporations and other
      - $21.1
    - General obligation bonds for public works
      - $10.4
    - Prepa bonds for power utilities
      - $6.0
    - Sales-tax-backed Cofina bonds for deficits and refundings
      - $4.6
  - Total: $39.5
    - 2006: $2.0
      - Prasa bonds for water utilities

Default

- In 2014, the bonds were downgraded
- Institutional investors limited exposure
- Hedge (vulture) funds bought large amounts of bonds at steep discounts
- Puerto Rico had been excluded by US Congress from Chapter 9 bankruptcy in 1984
- In 2015, Puerto Rico declared debt unpayable but had no legal means for bankruptcy
- US Supreme Court struck down Puerto Rico’s attempt at passing its own bankruptcy law
▪ US Congress responded and drafted a bill to address the situation

▪ Puerto Rico Oversight, Management and Stability Act (PROMESA) became law in 2016

▪ It created the Financial Oversight and Management Board of Puerto Rico (the Board) that is now at the helm

▪ The Board is tasked with certifying a long-term fiscal plan that makes all fiscal policy decisions and the appropriate debt repayment level

▪ The bill sets guidelines for Fiscal Plans and restructuring

▪ Interpretations on those guidelines are not clear: “essential services”, “sustainable debt”, “adequate pensions”
The Board is also tasked to either reach consensus with creditors or handle bankruptcy proceedings in a newly created legal bankruptcy process. The court procedures draw from municipal and corporate bankruptcies. Includes a Collective Agreement Clause (75% per bond class). Put a stay on the debt during proceedings. The decision on what will happen to the debt is now in the hands of US Courts, starting with NY District Court Judge Laura Taylor Swain. While case proceeds Board is proudly taking IMF inspired austerity approach.
The Board’s Fiscal Plan

- Sets aside more money for creditors now than it did in pre-storm plan
- The projected surplus is $6.6 billion over six fiscal years (compared to $4.5 billion in pre-storm plan)
- There have already been six iterations of post-storm plan
- The available surplus for debt payments increased with expectations of more federal relief funds
- In January 2018, the first post-storm version of plan projected a $3.4 billion deficit
The Board’s Fiscal Plan

- The plan proposes “savings” of $12 billion over six fiscal years
- A large number of cuts directly target public sector compensation and pensions
- The Board assumes structural reform agenda will more than offset austerity’s drag on economic growth within three years
- Austerity does not extend to the Board, which budgeted $1.5 billion for its own expenses over the length of the plan
- Creditors rejected the plan and court proceedings started
- The government of Puerto Rico is also refusing to follow the plan
Conflicts of Interest

- Same key players involved in debt restructuring were involved in the issuance (underwriters, accountants, legal advisers, consultants)
- Board chair was at helm of government bank when large share of unsustainable debt was incurred
- Other board member is part of family that owns Banco Popular (largest underwriter)
- A few board members and their close associates have close ties with Santander Bank
- There is little interest in challenging the debt
COFINA Agreement

- COFINA (sales tax backed bonds) restructuring is very favorable
- Pledges more money than fiscal plan predicts, with push to adapt fiscal plan to match
- Proposed recovery of 75% of initial bonds
- Keeps same type of dubious instruments - Capital Appreciation Bonds (CAB)
- On an initial principal of just $2.7 billion, the restructured CAB bonds’ total value is over $15.4 billion
- GoldenTree owned $1.5 billion in COFINA bonds in August 2018, up from $587 million in August 2017 (trading around 20 cents on dollar in this period)
International Comparisons

▪ Argentina (2001)
  ▪ Defaulted
  ▪ Recovered fairly fast (reached 1998 level by 2005)
  ▪ Then settled with most creditors
  ▪ Litigation (in US courts, judge Griesa) with vultures caused another default
  ▪ Eventually paid vultures to regain market access
International Comparisons

- Greece
  - Accepted Troika bailouts and austerity attached to them
  - Years after the crisis still in terrible shape
  - Debt-to-GDP ratio up to >190 percent (from 103% at start of crisis)
  - Bound by Eurozone membership
Summing Up

- There are both advantages and disadvantages to PROMESA
- Assessing the framework depends on the final results
- Austerity is likely to exacerbate downward spiral of outmigration and economic decline reducing debt sustainability
- Most creditors knew what they were getting into
- The Board has failed to gain public trust as an institution
- Puerto Rico also needs a clear mechanism to make sure relief funds go toward recovery and not debt repayment
- The political status is what makes this case unique
Thank you!