

# **Puerto Rico's Peculiar Case: Bankruptcy of an Unincorporated Territory**

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## Overview

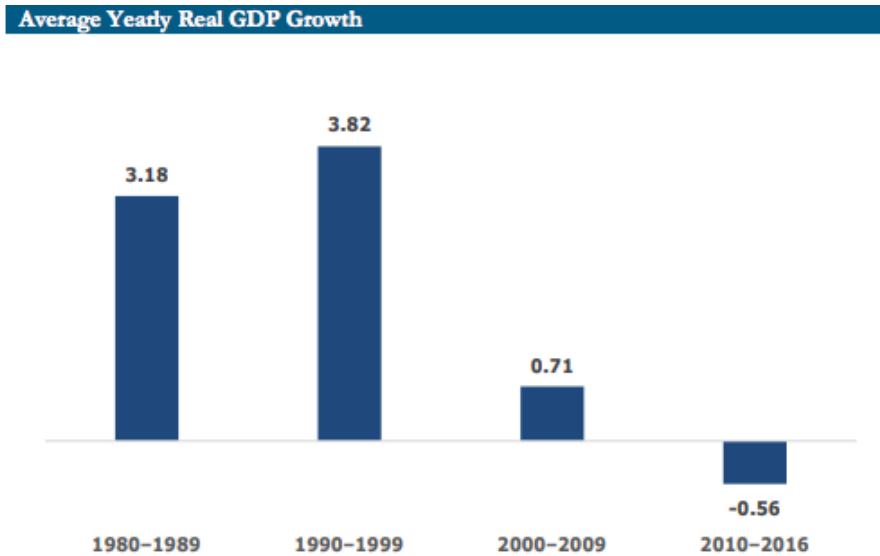
- Political Status
- The Economic Decline
- Fiscal Crisis and Default
- PROMESA
- The Oversight Board
- International Comparisons



## 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



Source: International Monetary Fund (2017).

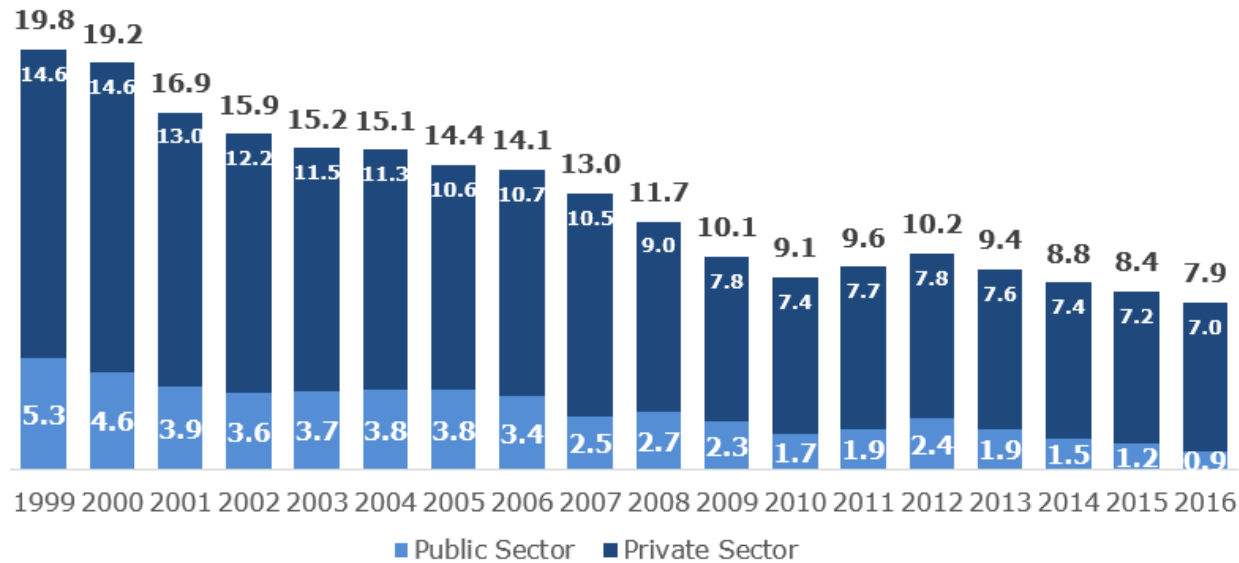
# The Economic Decline



- 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



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

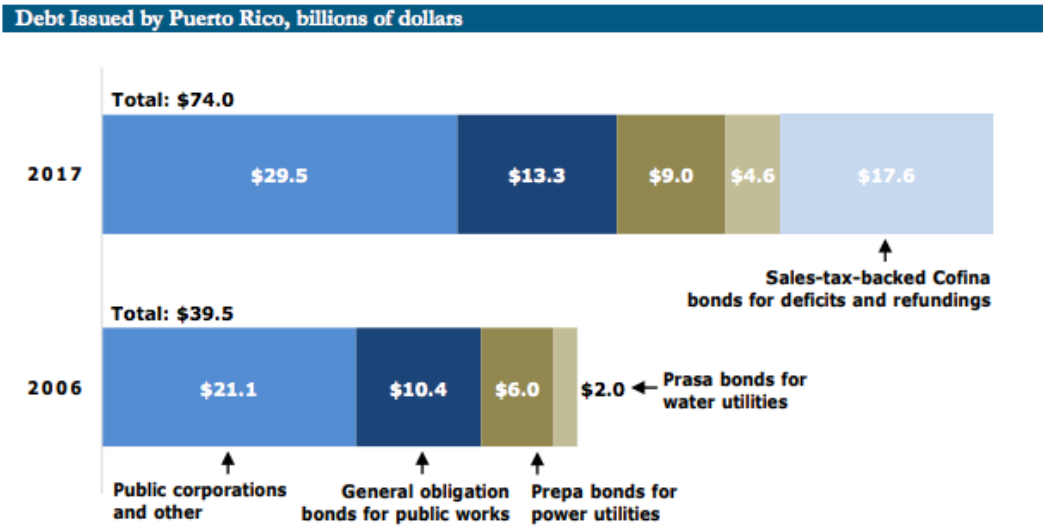


# The Fiscal Crisis



- As the economy shrank, 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



Source: Puerto Rico Fiscal Agency and Financial Advisory Authority (2017).

# 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

# PROMESA



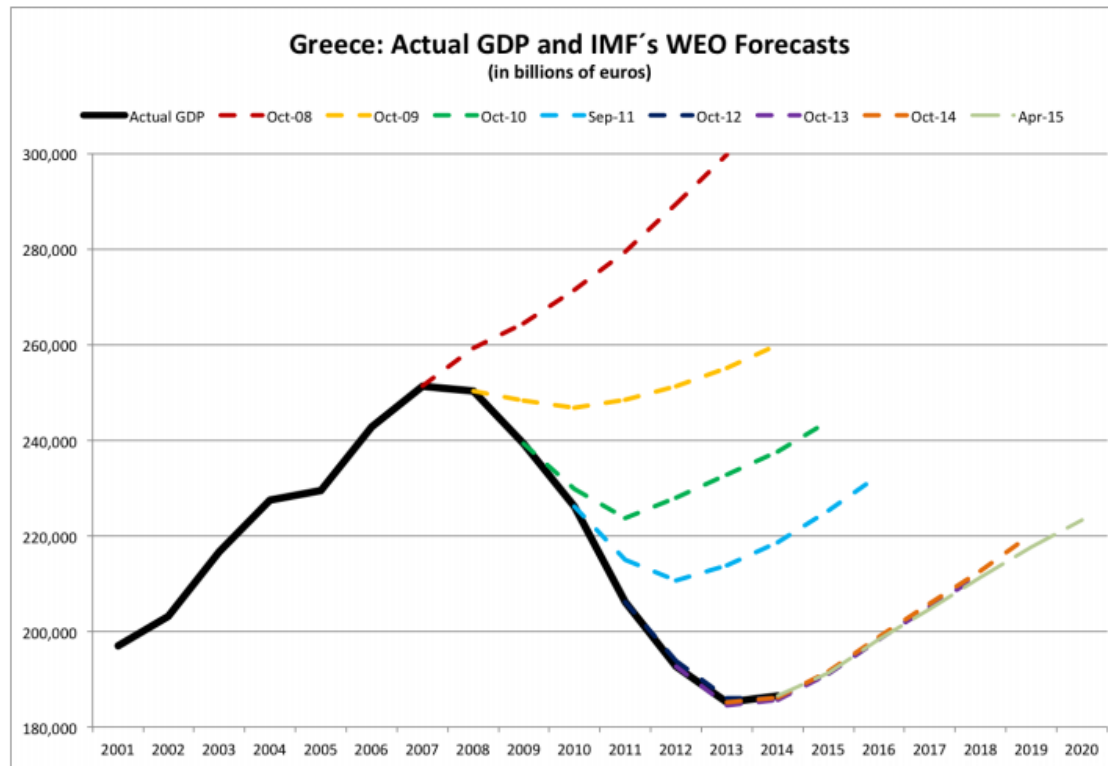
- US Congress responded and drafted a bill to address the situation
- Puerto Rico Oversight, Management and Stability Act (PROMESA) became law in 2016
- It created the Financial Oversight and Management Board of Puerto Rico (the Board) that is now at the helm
- The Board is tasked with certifying a long-term 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”

# PROMESA



- 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

# IMF's Track Record



## 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 (larges 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!**