CNE

The ENDGAME

An Analysis of Puerto Rico's Debt Structure and Arguments in Favor of Enacting a Comprehensive Debt Restructuring Mechanism for Puerto Rico

Revised and Updated on
April 2016

The Endgame: An Analysis of Puerto Rico's Debt Structure and Arguments in Favor of Enacting a Comprehensive Debt Restructuring Mechanism for Puerto Rico

Sergio M. Marxuach
Policy Director
Center for a New Economy
San Juan, PR
Revised and Updated on
April 2016

Introduction

Puerto Rico currently faces two distinct, yet related, crises. The first, and most urgent, is the government's fragile financial situation. The second is the chronic stagnation of the Puerto Rican economy over the last ten years.

In this document we analyze Puerto Rico's debt structure, which has been described by some analysts as "insanely convoluted" and is one of the principal causes of the island's financial woes.[1] In other words, this paper is an attempt to explain this complicated structure in a relatively simple manner. In addition, we analyze some of the consequences of a default on Puerto Rico's debt and consider some of the principal arguments in favor of allowing Puerto Rico to avail itself of a comprehensive debt restructuring mechanism.

Before we continue, however, it is important to note that many of the Constitutional and statutory provisions that govern Puerto Rico debt have not been tested in Puerto Rico Courts so we are, to a large extent, trying to map uncharted territory. Therefore, this paper is *not intended*, and should not be construed or interpreted, to provide a formal legal analysis of the issues set forth herein. It should be used only as an informal and unfortunately incomplete guide for the perplexed trying to understand Puerto Rico's complicated financial structure.

I. Puerto Rico's Debt Structure

The following Puerto Rico-based entities have issued debt in the municipal markets in the United States and/or Puerto Rico: [2]

1. The Government of the Commonwealth of Puerto Rico
2. The Government Development Bank for Puerto Rico (GDB)
3. The Children's Trust
4. The Employees Retirement System of the Government of the Commonwealth of Puerto Rico and its Instrumentalities (ERS)
5. The Puerto Rico Aqueduct and Sewer Authority (PRASA)
6. The Puerto Rico Convention Center District Authority (PRCCDA)
7. The Puerto Rico Electric Power Authority (PREPA)
8. The Puerto Rico Highways and Transportation Authority (PRHTA)
9. The Puerto Rico Housing Finance Authority (PRHFA)
10. The Puerto Rico Industrial Development Company (PRIDCO)
11. The Puerto Rico Industrial, Tourist, Educational, Medical, and Environmental Control Facilities Financing Authority (AFICA)
12. The Puerto Rico Infrastructure Financing Authority (PRIFA)
13. The Puerto Rico Municipal Finance Authority (MFA)
14. The Puerto Rico Ports Authority (PRPA)

---

[1] Anne Gelpern, *Puerto Rico: A Flash of Federal Ambition*, Real Time Economic Issues Watch, Peterson Institute for International Economics, October 22, 2015. Accessible at http://blogs.piie.com/realtime/?p=5211.
[2] See the table at the end of this paper for the debt service due during FY2016.

15. The Puerto Rico Public Buildings Authority (PBA)
16. The Puerto Rico Public Finance Corporation (PFC)
17. The Puerto Rico Sales Tax Financing Corporation (COFINA)
18. The University of Puerto Rico (UPR)

For analytical purposes Puerto Rico debt can be sorted out by (1) payment source and (2) by the strength of the protections afforded to bondholders.

Payment Source

The table below sets forth the breakdown by payment source as of September 30, 2015:

Commonwealth of Puerto Rico
Public Sector Debt
(in millions)

	September 30, 2015
Good faith and credit bonds and notes issued by the Commonwealth	$12,655[1]
Bonds and notes guaranteed by the Commonwealth's good faith and credit [2]	5,648
SUBTOTAL - GOOD FAITH AND CREDIT BONDS AND NOTES	18,303
Debt supported by Commonwealth appropriations or taxes	4,061[3]
Tax and Revenue Anticipation Notes [4]	400
SUBTOTAL - DEBT PAYABLE FROM GENERAL FUND	$22,764
Bonds and notes payable from sales and use tax revenues (COFINA)	$15,213
Debt issued by the Commonwealth and its instrumentalities	23,099[5]
Debt issued by municipalities	3,907
Pension Funding Bonds (payable from employer contributions to ERS) [6]	2,948
Other limited obligation debt and non-recourse debt [7]	1,978
SUBTOTAL - OTHER PUBLIC SECTOR DEBT	47,145
TOTAL PUBLIC SECTOR DEBT	**$69,909**

Totals may not add due to rounding.

(1) Includes approximately $160.8 million of debt issued by the Treasury Department to GDB which is secured by a pledge of the Commonwealth's good faith and credit and is expected to be repaid with revenues of the Commonwealth or proceeds of a future bond issuance. This debt had been previously included under "Debt issued by the Commonwealth and its instrumentalities." Includes also $23.8 million debt from General Services Administration line of credit.

(2) Consists of $677 million of bonds issued by PRASA, $493.3 million of Puerto Rico State Revolving Fund loans made to PRASA under various federal water laws, $225.5 million of bonds issued by the POA (which are held by GDB), $195.3 million of bond anticipation notes issued by PRIFA, and $4.056 billion of PBA bonds. Excludes (in order to avoid double counting) $267 million of GDB bonds payable from available moneys of GDB, and $110 million of GDB senior guaranteed notes Series 2013B.

(3) Represents bonds and notes payable from the Commonwealth General Fund and Public Improvement Fund. Includes $1.090 billion of bonds issued by the Public Finance Corporation, $2.220 billion of appropriation debt notes issued by the instrumentalities and agencies (including $64.7 million of notes issued by PBA), $715.1 million of notes issued by the Treasury Department (such debt is excluded from the Public Corporations Debt Table) and $36.4 million of bonds issued by the Mental Health and Anti-Addiction Services Administration.

(4) Consists of $400 million in non-revolving notes purchased by GDB.

(5) Excludes (in order to avoid double counting) $4.2 billion of notes issued by GDB, the proceeds of which have been principally used to fund loans to the Commonwealth, instrumentalities, agencies and municipalities, which loans are included in the table in the corresponding line, and excludes a note for $64.7 million of PBA. Includes $116.0 million in notes issued by PBA.

(6) Represents Senior Pension Funding Bonds, Series A, B, and C issued by the Employees Retirement System, which are payable solely from employer contributions made to the Employees Retirement System by the Commonwealth and its instrumentalities after the issuance of the bonds. The Commonwealth does not guarantee such bonds. Employer contributions made to the Employees Retirement System by the central government and its agencies and therefore payable from the General Fund currently represent approximately 42% of such total employer contributions. The balance of these contributions is made by the instrumentalities and the municipalities.

(7) Includes the following: (i) $1.2 billion of Children's Trust bonds, which are payable solely from the payments to be received pursuant to the tobacco litigation settlement; (ii) $140.5 million of Housing Finance Authority bonds, which are payable from Puerto Rico Housing Administration's annual allocation of Public Housing Capital Funds from the United States Department of Housing and Urban Development ("HUD"); (iii) $295.2 million of Capital Fund Modernization Program Subordinate Bonds, Series 2008 issued by the Puerto Rico Housing Finance Authority and payable primarily from federal housing assistance payments made available by HUD; (iv) $129.8 million of Special Facilities Revenue Bonds issued by the Highways Authority, which are payable from net toll revenues collected from the Teodoro Moscoso Bridge; (v) $155 million of Special Facilities Bonds issued by the Puerto Rico Ports Authority, which are solely payable from the pledge of certain payments made by a private corporation under a special facilities agreement; (vi) $66.5 million of Educational Facilities Revenue Bonds, 2000 Series A (University Plaza Project) issued by Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority ("AFICA"), which are payable from rent payments made by the University of Puerto Rico; and (vii) approximately $15 million of bonds issued by AFICA to finance the construction of various government infrastructure projects, which are payable from rent payments made by various government entities.

Source: Government Development Bank

Strength of Bondholder Protection

Perhaps the best way to analyze the strength of the protection afforded to bondholders by the multiplicity of Commonwealth issuers is to imagine a set of concentric circles with the most secured bonds set forth right in the middle and less secured bonds spreading outward from that circle.

First in line are **General Obligation** bonds backed by the good faith, credit and taxing power of the Commonwealth, which would sit right in the bull's eye of our imaginary set of concentric circles. These obligations are known colloquially as the "Constitutionally guaranteed debt" because according to the Puerto Rico Constitution payment of these bonds has a "first claim on the 'available resources' of the Commonwealth".

Open Issue: The Spanish and English versions of the Puerto Rico Constitution contain slightly different wording for Article VI, Section 8, which establishes this first claim on Commonwealth resources.

The Spanish version reads as follows: "Cuando *los recursos disponibles* para un año económico no basten para cubrir las asignaciones aprobadas para ese año, se procederá en primer término, al pago de intereses y amortización de la deuda pública, y luego se harán los demás desembolsos de acuerdo con la norma de prioridades que se establezca por ley."

The English version states, "In case the *available revenues* including surplus for any fiscal year are insufficient to meet the appropriations made for that year, interest on the public debt and amortization thereof shall first be paid, and other disbursements shall thereafter be made in accordance with the order of priorities established by law."[3]

The difference between "available resources" and "available revenues" could turn out to be significant for two reasons. First, the term "available resources" has been interpreted to be broader than the term "revenues" in several opinions issued by the Secretary of Justice of the Commonwealth, thus allowing the Commonwealth to pay GO debt with non-recurring funds product, for example, of the issuance of additional debt, asset sales or the liquidation of financial investments.[4]

---

[3] Just to be clear, the term "public debt" in this context means only (1) debt backed by the good faith, credit and taxing power of the Commonwealth and (2) other obligations expressly guaranteed by the Commonwealth.

[4] The Commonwealth Supreme Court has never interpreted the term "available resources" and there is no discussion of the meaning of this term in the specific context of Article VI, Section 8 of the PR Constitution in the records of the proceedings of the Puerto Rico Constitutional Convention. The analogous concept of "total estimated resources" ("*recursos totales calculados*") is discussed in the Records of the Constitutional Convention in the context of Article VI, Section 7 of the PR Constitution, which provides that "the appropriations made for any fiscal year shall not exceed the total resources, including available surplus, estimated for said fiscal year." The Records of the Constitutional Convention suggest that "total estimated resources" is a broad concept that includes revenues that may be estimated because they are already established or known, such as taxes, federal aid, fixed income, surplus, royalties from public corporations, net revenues of public corporations, etc. (Records of the Constitutional Convention, p. 1090).

Second, it is important for the application of the so-called **Constitutional Clawback**. Article VI, Section 2 of the Puerto Rico Constitution states that "The Secretary of the Treasury may be required to apply the available revenues including surplus to the payment of interest on the public debt and the amortization thereof in any case provided for by Section 8 of this Article VI at the suit of any holder of bonds or notes issued in evidence thereof."

The question is: Do tax revenues that have been pledged for the payment of other obligations, including other bonded debt, constitute "available revenues" for the payment of General Obligation bonds in the event of a shortfall and are therefore subject to being clawed back to the general fund for payment of General Obligations bonds?

Specifically, the Commonwealth has assigned certain tax revenues to the Highways Authority, PRIFA, PRCCDA and PRIDCO. These consist of (i) motor vehicle fuel taxes, crude oil and derivative products excise taxes, cigarette excise taxes and license fees allocated to the Highways Authority; (ii) federal excise taxes imposed on alcoholic beverages and tobacco products produced in Puerto Rico and sold in the United States, which taxes are returned by the federal government to the Commonwealth and allocated to PRIFA; (iii) hotel occupancy taxes imposed by hotels on paying guests, which are allocated to PRCCDA; and (iv) federal excise taxes on rum rebated to the Commonwealth and corporate income taxes that are allocated to PRIDCO.[5] Are those revenue streams subject to the Constitutional Clawback? Can the holders of PRHTA, PRIFA, PRCCDA, and PRIDCO bonds affected by the clawback sue the Commonwealth if the payment source for their bonds is diverted towards the general fund? And of course there is the issue of COFINA bonds, which we will address later on.

Open Issue 2: While it is clear that GO bondholders have a "first claim" on the available resources of the Commonwealth it is not clear what *remedies* they may seek in order to enforce that claim. According to the most recent Commonwealth Report "The Commonwealth's general obligation bonds are not secured by any lien on any physical asset of the Commonwealth. Accordingly, no physical assets of the Commonwealth may be foreclosed on to produce amounts to pay such bonds. In the event the Commonwealth fails to make a payment of interest or principal on the bonds, the bondholders are only entitled to require the Secretary of the Treasury to apply available resources according to the constitutional priority provisions and do not have the right to compel the exercise of any taxing power of the Commonwealth."[6]

In addition, the Constitution of Puerto Rico provides that public property and funds of the Commonwealth shall only be disposed of for public purposes, for the support and operation of state institutions, and pursuant to law. Finally, the Puerto Rico Supreme Court has determined that Commonwealth property cannot be attached or garnished in an

---

[5] Commonwealth of Puerto Rico, *Financial Information and Operating Data Report,* 6 November 2015, p. 120. PRIDCO bonds are also secured with lease payments receivable by PRIDCO from lessees of certain real estate facilities owned by PRIDCO.

[6] Id. at p. 48.

attempt to enforce a judicial order, as it could undermine the Commonwealth's ability to operate and use its property for a public purpose.

Second in terms of bondholder protections would be **Bonds and Notes Guaranteed by the Commonwealth's Good Faith and Credit.** This group of obligations consists of (1) $1.170 billion of PRASA bonds and loans, including $284.8 million of revenue refunding bonds sold to the public, $392.6 million of bonds issued to the United States Department of Agriculture, Rural Development, and loans made by the State Revolving (Clean Water and Safe Drinking Water Act) Funds for the benefit of PRASA with an outstanding principal amount of $493.3 million; (2) $226 million of bonds issued by the Port of the Americas (which are held by GDB); (3) $4.056 billion of PBA bonds; (4) $267 million of GDB bonds; and (5) $246 million of bond anticipation notes issued by PRIFA. In theory, bonds and notes guaranteed by the Commonwealth are considered "public debt" for purposes of the Constitution and enjoy the same priority of payment and protection that is afforded by the Constitution of Puerto Rico to bonds and notes issued by the Commonwealth for which its good faith, credit and taxing power has been directly pledged.[7]

Third in line would be bonds issued by the **Puerto Rico Sales Tax Financing Corporation**, otherwise known as COFINA. Bonds issued by COFINA are secured by Act 91-2006, as amended ("Act 91"), which allocates a portion of the Commonwealth sales and use tax to pay debt service on the bonds issued by COFINA. Act 91 provides that the Dedicated Sales Tax Fund created by such law, the funds on deposit therein and the Commonwealth sales and use tax pledged to COFINA, do not constitute "available resources" of the Commonwealth for purposes of Section 2 and Section 8 of Article VI of the Commonwealth Constitution and are not available for use by the Secretary of the Treasury.

According to an opinion of the Secretary of Justice of the Commonwealth, the portion of the Commonwealth sales and use tax allocated to COFINA is not available for the payment of principal of and interest on General Obligation bonds. The validity of this legislative allocation, however, has not been challenged in or ruled upon by any court and *thus remains an open question*. Therefore, it is not clear whether tax revenues pledged to COFINA would be subject to the Constitutional Clawback.

Open Issue: Another open issue regarding COFINA bonds arises in the context of Article VI, Section 7 of the Puerto Rico Constitution, which states that "The appropriations made for any fiscal year shall not exceed the total revenues, including available surplus, estimated for said fiscal year **unless the imposition of taxes sufficient to cover said appropriations is provided by law**." Most of the proceeds of COFINA bond offerings were in fact used for deficit financing or to cover current expenses, financial uses that *prima facie*

[7] However, we note that the Commonwealth has taken the position that debt service payable on such guaranteed obligations is not taken into consideration for purposes of the Constitutional debt limit unless the Commonwealth is actually paying such debt service pursuant to its guarantee. See page 10, *infra*.

appear to be Constitutionally prohibited. However, in the absence of a binding court decision this legal issue remains open to judicial interpretation.

Next in line are bonds issued by the **Municipal Finance Agency**. These bonds are payable from the following sources:

(1) The payment of principal and interest on general obligation municipal bonds and notes pledged by MFA under their respective indentures. The general obligation municipal bonds and notes are secured by *ad valorem* taxation, without limitation as to rate or amount, on all taxable property within the issuing municipalities. The good faith, credit and unlimited taxing power of each issuing municipality are pledged for the payment of its general obligation municipal bonds and notes; and

(2) The moneys in a Reserve Account created under their respective indentures. MFA's Enabling Act provides that the Commonwealth shall annually apportion and pay to MFA such sum as shall be necessary to maintain the Reserve Account in the required amount. The payment of such sum by the Commonwealth is subject to appropriation by the Legislature of Puerto Rico, which appropriation is authorized but not legally required to be made.

Open Issue: Are municipal tax revenue streams subject to the Constitutional Clawback? To the best of our knowledge this is an unresolved legal question. However, the fact that a coalition of mayors recently filed a lawsuit against the current government to require the GDB to set aside municipal funds deposited at the GDB in a special trust solely for the benefit of the municipalities strongly suggests the central government could make a good legal argument, under the "available resources" theory, for clawing back those revenues in case of insolvency or to avoid a default.

Fifth in line would be revenue bonds issued by **Puerto Rico State-Owned Enterprises or Public Corporations**, as they are commonly known. These bonds *are payable solely* from the revenues generated by each of these public corporations, *with the exception*, as we stated above, of those public corporation bonds that have been expressly guaranteed by the Commonwealth of Puerto Rico. Bondholder rights and remedies are set forth in the Trust Indentures executed by each state-owned enterprise. The amount of bonds and notes issued by public corporations as of September 30, 2015 is set forth in the following table:

Commonwealth of Puerto Rico
Outstanding Debt of Public Corporations
September 30, 2015
(in thousands)

	Bonds			Notes			Total Bonds and Notes		
	With Guaranty	Without Guaranty	Total	With Guaranty	Without Guaranty	Total	With Guaranty	Without Guaranty	Total
Aqueduct and Sewer Authority	$677,360	$3,393,260	$4,070,620	$493,325	$95,256	$588,581	$1,170,685	$3,488,516	$4,659,201
Convention Center District Authority	-	397,740	397,740	-	145,285	145,285	-	543,025	543,025
Electric Power Authority	-	8,238,709	8,238,709	-	731,838	731,838	-	8,970,547	8,970,547
Highways and Transportation Authority	-	4,618,177[1]	4,618,177	-	1,805,144	1,805,144	-	6,423,321	6,423,321
Housing Finance Authority	-	88,442[2]	88,442	-	167,172	167,172	-	255,614	255,614
Industrial Development Company	-	171,080	171,080	-	86,325	86,325	-	257,405	257,405
Infrastructure Financing Authority[3]	-	1,850,273	1,850,273	195,295	49,267	244,562	195,295	1,899,540	2,094,835
Port of the Americas Authority	225,482	-	225,482	-	1,700	1,700	225,482	1,700	227,182
Ports Authority[4]	-	-	-	-	285,635	285,635	-	285,635	285,635
Public Buildings Authority	4,056,264	-	4,056,264	-	180,706	180,706	4,056,264	180,706	4,236,970
Public Finance Corporation	-	1,090,740[5]	1,090,740	-	-	-	-	1,090,740	1,090,740
Sales Taxes Financing Corp. (COFINA)	-	15,212,521	15,212,521	-			-	15,212,521	15,212,521
University of Puerto Rico	-	451,760[6]	451,760	-	81,578	81,578	-	533,338	533,338
Others[7]	-	-	-	-	2,515,074	2,515,074	-	2,515,074	2,515,074
Total[8]	$4,959,106	$35,512,702	$40,471,808	$688,620	$6,144,980	$6,833,600	$5,647,726	$41,657,682	$47,305,408

(1) Excludes $129.8 million of Special Facilities Revenue Bonds issued by PRHTA, which are payable by a private party from net toll revenues collected from the Teodoro Moscoso Bridge.
(2) Excludes the $140.5 million of Housing Finance Authority bonds, which are payable solely from Puerto Rico Public Housing Administration's annual allocation of Public Housing Capital Funds from HUD; and $295.2 million of Housing Finance Authority Capital Fund Modernization Program Subordinate Bonds, Series 2008 issued by the Housing Finance Authority and payable primarily from federal housing assistance payments made available by HUD.
(3) Includes, among other debt, (i) $36.4 million of Mental Health Infrastructure Revenue Bonds, 2007 Series A (MEPSI Campus Project), which bonds are limited obligations of the Infrastructure Financing Authority payable solely from the pledge of certain payments made by a governmental entity under a lease agreement, (ii) $192.3 million of Revenue Bonds (Ports Authority Project), Series 2011, which are limited obligations of the Infrastructure Financing Authority payable solely from loan payments made by the Puerto Rico Ports Authority, and (iii) $195.3 million of bond anticipation notes payable from petroleum taxes and guaranteed by the Commonwealth.
(4) Excludes $155.4 million of Special Facilities Revenues Bonds issued by the Puerto Rico Ports Authority, which bonds are payable solely from the pledge of certain payments made by a private corporation under a special facilities agreement.
(5) Payable primarily from Commonwealth appropriations.
(6) Excludes $66.5 million of Educational Facilities Revenue Bonds, 2000 Series A (University Plaza Project) issued by AFICA, which bonds are payable from rent payments made by the University of Puerto Rico.
(7) Includes lines of credit from GDB and private banks.
(8) Excludes accretion of interest from the respective issuance dates on capital appreciation bonds. Also excludes the debt listed in footnote 6 of the Public Sector Debt table above.

Source: Government Development Bank

Open Issue: In a typical debt restructuring by a public utility, payment to bondholders is subordinated to the payment of operating expenses of the municipal utility. After all, municipalities do have an obligation to keep the lights on, the water flowing, and the trains running. However, the case of PRASA, the state-owned water company, provides an interesting twist to this analysis. In 2012, PRASA issued approximately $2 billion worth of bonds secured with a pledge on its **gross revenues**. Thus, in the event of a debt restructuring by PRASA, holders of these bonds could claim that their lien is not subject or subordinated to the payment of PRASA's operating expenses. PRASA's options at that point presumably would be to default or increase its rates to pay for its operating expenses. However, how would a court ultimately resolve this issue is an open legal question. [8]

[8] It is our understanding that in addition to the PRASA, the PRHTA has also issued bonds with a gross revenue pledge.

Sixth in line is debt supported by **Commonwealth Appropriations or Taxes**. These obligations depend on action(s) by the Puerto Rico legislature for their repayment. Bondholders, in general, cannot sue at law or equity to require that a law be enacted, thus, their expected recovery is at the mercy of the political process. These obligations include: (1) $1.090 billion of bonds issued by the Public Finance Corporation; (2) $2.220 billion of appropriation debt notes issued by the instrumentalities and agencies (including $64.7 million of notes issued by PBA); (3) $715.1 million of notes issued by the Treasury Department (such debt is excluded from the Public Corporations Debt Table); and (4) $36.4 million of bonds issued by PRIFA to finance the construction of certain facilities for the Mental Health and Anti-Addiction Services Administration.

Seventh in the line up would be bonds issued by the **Employees Retirement System**. These bonds are payable solely from employer contributions made to the Employees Retirement System by the Commonwealth and its instrumentalities after the issuance of the bonds. The Commonwealth *does not* guarantee such bonds. Employer contributions made to the Employees Retirement System by the central government and its agencies and, therefore, payable from the General Fund represent approximately 59% of such total employer contributions. The instrumentalities and the municipalities make the balance of these contributions. [9]

Finally, limited obligation and non-recourse debts offer the weakest bondholder protection. [10] This category includes the following:

(i) $1.2 billion of Children's Trust bonds, which are payable solely from the payments to be received pursuant to the tobacco litigation settlement;

(ii) $129.8 million of Special Facilities Revenue Bonds issued by the Highways Authority, which are payable from net toll revenues collected from the Teodoro Moscoso Bridge;

(iii) $155 million of Special Facilities Bonds issued by the Puerto Rico Ports Authority, which are solely payable from the pledge of certain payments made by a private corporation under a special facilities agreement;

(iv) $66.5 million of Educational Facilities Revenue Bonds, 2000 Series A (University Plaza Project) issued by AFICA, which are payable from rent payments made by the University of Puerto Rico; and

(v) Approximately $15 million of bonds issued by AFICA to finance the construction of various government infrastructure projects, which are payable from rent payments made by various government entities.

---

[9] With the exception of the Department of Education (teachers only), the Puerto Rico Court System, PREPA and UPR, each of which has a separate retirement system.

[10] This table excludes $140.5 million of Housing Finance Authority bonds, which are payable from Puerto Rico Housing Administration's annual allocation of Public Housing Capital Funds from the United States Department of Housing and Urban Development ("HUD"); and $295.2 million of Capital Fund Modernization Program Subordinate Bonds, Series 2008 issued by the Puerto Rico Housing Finance Authority and payable primarily from federal housing assistance payments made available by HUD.

Constitutional Limitation on Issuing Debt

The Constitution of the Commonwealth provides that the Commonwealth may not issue general obligation debt if the principal and interest on all such debt payable in any fiscal year, together with any amount paid by the Commonwealth in the prior fiscal year on account of bonds or notes guaranteed by the Commonwealth, exceed 15% of the average annual internal revenues of the Commonwealth in the two preceding fiscal years. Based on the Commonwealth's current debt service requirements for these obligations and its average revenues for fiscal years 2014 and 2015, this percentage is currently 13.6%.[11] Therefore, we expect the Commonwealth's capacity to incur additional general obligation debt will be significantly limited for the next several years as a result of this Constitutional limit, among other factors.

As a result, the Commonwealth may be limited in its capacity to issue general obligation debt in the future to cover projected financing gaps, including financing capital improvement projects, providing working capital, and meeting short-term obligations. Although the Commonwealth could seek to issue debt for which the good faith, credit and taxing power of the Commonwealth is not pledged, there may not be sufficient demand for such debt. An inability to issue general obligation debt may affect the Commonwealth's ability to finance essential services, honor its financial obligations and make required investments in infrastructure.

Relationship between Payment of Public Debt and Operational Expenses of the Government

As we stated above, Article VI, Section 8 of the Puerto Rico Constitution declares that: "In case the available revenues including surplus for any fiscal year are insufficient to meet the appropriations made for that year, interest on the public debt and amortization thereof shall first be paid, and other disbursements shall thereafter be made *in accordance with the order of priorities established by law*."

These "priority norms" are set forth in the organic law of the Puerto Rico Office of Management and Budget. In summary form, these priority norms are:

First, the payment of the interest on and amortization requirements of the public debt (again, defined to include *only* Commonwealth general obligations and guaranteed debt for which the Commonwealth's guarantee has been exercised);

Second, the fulfillment of obligations arising out of legally binding contracts, court decisions on eminent domain, and other unavoidable obligations to protect the name, credit and good faith of the Commonwealth;

[11] This calculation does not include debt service on debt guaranteed by the Commonwealth, unless the Commonwealth is actually paying such debt service pursuant to its guarantee.

Third, current expenditures in the areas of health, public safety, education, welfare, and retirement systems; and

Fourth, for all other purposes.

This statutory "waterfall" is useful in providing some guidance as to how government funds would be allocated in the event of a liquidity crisis, but the statutory language is so ambiguous as to practically invite litigation. For example, what exactly constitute "unavoidable obligations to protect the name, credit and good faith of the Commonwealth", outside the context of General Obligation bonds or debt expressly guaranteed by the Commonwealth? To our knowledge this issue has never been litigated in Puerto Rico.

Acceleration and Cross-Default Provisions

According to the most recent Commonwealth Report: "the maturity of the Commonwealth's general obligation bonds cannot be accelerated in the event that the Commonwealth defaults in the payment of any installment of interest or principal due on such bonds. There are no cross-default provisions among general obligation bonds, so any default with respect to any particular issue of bonds would not provide any remedy to holders of other bonds which are not affected."[12] However, it is not clear to us whether other bonds issued by Puerto Rico entities contain such acceleration and/or cross-default provisions.

Issues Related to GDB

In the normal course of business, the GDB is a party to transactions involving financial instruments with off-balance-sheet risk. The table below sets forth those off-balance sheet commitments incurred by GDB as of the date of its most recent audited financial statements:

At June 30, 2013, the off-balance-sheet risks consisted of the following (in thousands):

Financial instruments whose credit risk is represented by contractual amounts:		
Financial guarantees – Private sector	$	596,537
Standby letters of credit – Public sector		1,328,927
Commitments to extend credit – Public sector		1,358,305
Commitments to extend credit – Private sector		94,856

Source: Government Development Bank, Comprehensive Annual Financial Report 2013, June 30, 2013, p. 92

In this context it is particularly important to note that the GDB has issued guarantees in favor of Autopistas Metropolitanas de Puerto Rico, LLC (Metropistas) and Aerostar Airport Holdings, LLC (Aerostar) for any "Termination Damages" that may become due and payable by PRHTA or the Ports Authority, respectively, in connection with the termination of certain long-term concession agreements executed in 2011 and 2014.

[12] Commonwealth of Puerto Rico, *Financial Information and Operating Data Report,* 6 November 2015, p. 50.

In addition, several of GDB's subsidiaries and affiliates have outstanding contingent liabilities worth noting. For example:

- **The Puerto Rico Housing Finance Authority** – This Authority operates a mortgage loan insurance program, which insures a portfolio of approximately $560 million mortgage loans mainly to low and moderate-income families.
- **The Puerto Rico Tourism Development Fund** – This fund was created in 1993 to facilitate the development of Puerto Rico's hotel industry. As of June 30, 2015, TDF had $324.6 million in guarantees and $151.6 million in loans (net of $169.1 million in allowances for losses on guarantees and loans). It also had $160.9 million in cash and in marketable securities, and a net deficit of $198.0 million.

It is not clear at this point how a court-appointed receiver would treat these contingent liabilities in the event GDB were to be declared insolvent or bankrupt.

Known Unknowns

In addition to the open issues set forth above, there is a set of questions to which we know that we don't know the answers. Among these we find the following:

1. Are there any bonds outstanding, excluding General Obligation bonds, with cross-default or acceleration covenants?
2. Are there any bonds subject to "*pari passu*" clauses?
3. How would a court-appointed receiver treat outstanding guarantees and letters of credit issued by the GDB if the GDB goes bankrupt or is rendered effectively insolvent?
4. We know that a significant amount of outstanding Puerto Rico debt is insured by so-called "monoline insurers." However, we do not know of any estimate of the amount of Puerto Rico debt currently insured by those companies.

II. Possible Effects of a Default on Puerto Rico Debt

Determining effects, *ex ante,* of a default on Puerto Rico's debt is a difficult analytical endeavor due to the complicated structure of that debt. Nevertheless, we set forth below what we believe are some of the most significant effects of such an event of default.

- *First*, if a default on *General Obligation* bonds were to occur, then the statutory priority funding norms would go into effect. According to those norms, as we stated above, current expenditures in the areas of health, public safety, education, welfare, and retirement systems come third in the priority hierarchy. Thus, there is a significant risk that these essential government operations could be adversely affected.
- *Second*, an outright default by the *Government Development Bank* could trigger several adverse economic consequences. The most immediate impact would be on

the Puerto Rico Treasury Department, several State-Owned Enterprises, and many Municipalities that could lose their principal source of short-term liquidity, which in turn, would negatively affect the ability of these entities to carry out their day-to-day operations. In addition, the GDB has close to two billion dollars worth of financial guarantees and standby letters of credit outstanding, whose value could be adversely affected. Uncertainty as to the GDB's ability to honor its commitments under those financial instruments may trigger events of default on the agreements that rely on those financial instruments as security or collateral. Third, the Puerto Rico Housing Finance Authority, a subsidiary of the GDB, insures a portfolio of approximately $560 million of mortgage loans to low and moderate-income families. If the solvency of the GDB is called into question, then the value of such insurance may be substantially reduced, limiting the ability of private financial institutions to sell those loans on the secondary market and perhaps forcing them to write-down the book value of at least some of those assets. Finally, Puerto Rico's inter-bank clearing system is run from the Government Development Bank, and while these operations eventually could be transferred elsewhere, there is the potential for the short-term disruption of the island's payments system.[13]

- *Third*, a default by one of the island's *state-owned enterprises*, such as, for example, the Puerto Rico Electric Power Authority, the Puerto Rico Highways and Transportation Authority, or the Puerto Rico Ports Authority, could result in the short-term disruption of services provided by those enterprises, as well as in higher rates and/or user fees, adversely affecting Puerto Rico's economy in the short-term.
- Finally, a default on *any bond instrument widely held in the island* could adversely affect pension funds, retirement accounts, portfolio investments held by financial institutions—especially credit unions—mutual funds sold exclusively in Puerto Rico and invested mostly on Puerto Rico debt, as well as the value of holdings of high net worth individuals. This could generate a negative wealth effect, further depressing the island's economy.

III. Arguments in Favor of Debt Restructuring

Decades of fiscal and economic mismanagement by the Puerto Rican government have engendered an economy characterized by: (1) chronic primary deficits; (2) high debt-to-GNP ratios; (3) low employment levels in the formal economy; (4) a large informal economy, encompassing both legal and illegal activities; (5) significant government corruption and predatory rent-seeking behavior in both the public and private sectors; (6) substantial tax evasion; (7) a hollow productive base; and (8) high levels of private consumption and indebtedness enabled by having access to a stronger currency than its economic fundamentals would warrant. In our opinion the parallels with Greece are quite evident, there for all to see and none to misunderstand.

[13] We note that at the time of this revision the GDB is negotiating with several of its creditors to avoid an event of default on May 1st. In addition, the government of Puerto Rico has implemented several measures to minimize the impact of GDB's insolvency. Whether those measures will be effective in achieving their stated purpose is uncertain as of this time.

Consistently running a primary deficit has real consequences, especially for a country that cannot devalue or print its own currency. Puerto Rico, just like many governments facing this situation, has ended up issuing large amounts of debt, at ever-higher costs, just to cover the payment of existing debts, a situation that eventually becomes simply unsustainable.

Debt (Un)Sustainability

According to the IMF framework for analyzing debt sustainability, debts will be serviceable as long as the growth rate of debt does not exceed the growth rate of output. This requires maintaining a primary surplus, that is, keeping expenditures (net of the cost of debt service) below revenues.

The problem is that the growth rate of Puerto Rico's debt between 2000 and 2014 was twice the growth rate of its output. In addition, Puerto Rico sustained substantial primary budget deficits during that period.

Therefore, both factors point to a significant increase in the debt stock, both in absolute terms and as a percentage of GNP, which is what actually happened. Indeed, Puerto Rico's public debt to GNP ratio has increased from a relatively manageable 58.4% in 2000 to approximately 100% in 2015.

Reversing this trend will require a combination of at least two of the following:

(1) Running a primary budget surplus on a regular basis for many years into the future;

(2) Puerto Rico's GNP to grow at a nominal rate that consistently exceeds the interest rate on Puerto Rico's debt; or

(3) Obtaining some form of debt relief.

In our opinion obtaining some form of debt relief and using the cash flow that would otherwise be dedicated to debt service to fund public investment and stimulate economic growth is the only realistic policy combination in the short-term for the following reasons:

First, the fiscal consolidation required to eliminate the primary deficit is approximately 1.1% of GNP, and to obtain an overall fiscal balance is approximately 3.8% of GNP. These amounts may not seem high to non-economists but they imply a massive retrenchment in government spending and/or significant tax increases, this in an economy that is currently *contracting*, in real terms, at a rate of 1.2%.

Second, while it is true that Puerto Rico's capacity to repay its debt ultimately depends on restoring economic growth in the island, *there can be no economic recovery*

without debt sustainability and that, in turn, is not possible without significantly restructuring at least some of its debt.

Third, given (1) that the current administration has already stated its firm intention to keep essential government operations running and (2) the lack of access to an emergency liquidity facility, it is clear that Puerto Rico needs to obtain some debt relief in order to avoid social chaos or a disorderly default.

Allowing the Commonwealth of Puerto Rico and its distressed agencies, instrumentalities, and municipalities access to a debt restructuring mechanism could be a useful mechanism to obtain that much needed debt relief.

The Arguments for Comprehensive Debt Restructuring

There are several reasons why this makes sense for Puerto Rico and its creditors—from hedge funds with billions in assets to mom and pop retail investors—given the current state of affairs in the island:

First, allowing Puerto Rico to restructure its debts is not a federal bailout as it would not cost the federal government a single cent. Furthermore, it could be argued that the probability of a bailout by the federal government would *increase* significantly if Puerto Rico and its agencies and instrumentalities *were not allowed* to restructure their debt.

Second, as we have demonstrated above, Puerto Rico's debt is spread across a variety of debtors (18 issuers in total) representing a complex web of claims in an uncertain regulatory and legal framework. This situation makes it very difficult for creditors to work as a class because one set of creditors will worry that any relief they provide the island will simply make it easier for a different set of creditors to recover a larger amount of their claims.[14]

In game theory terms, Puerto Rico faces a game in which there are multiple players, which sometimes have common and sometimes-opposing interests, and not making a deal leaves everyone worse off. In this type of game the final outcome could be one of any number of possible "Nash equilibria", which would generate sub-optimal results for all parties involved.

A court-supervised process would help ensure fair treatment to all parties, including small, retail investors currently not "at the table". The alternative—an untested and potentially disorderly process with numerous creditor lawsuits and years of scorched-earth litigation—would depress the local economy, increase restructuring costs, and make long-term recovery harder to achieve. Absent an orderly process, all stakeholders stand to lose in the face of continued deterioration of Puerto Rico's economic and financial conditions and

[14] Approximately 20 creditor committees have already formed. See, Mark Zandi, Dan White, and Bernard Yaros, *Puerto Rico Looks Into the Abyss,* Moody's Analytics, November 2015, p. 3.

ongoing uncertainty. **In sum, no one benefits from the chaos of a disorderly default, years of nonpayment, protracted multi-forum litigation, and social unrest in Puerto Rico.**

Third, the proposed restructuring regime would provide all the essential protections of bankruptcy: a stay on creditor collection actions, priority for new private short-term cash flow financing, and voting by creditor classes on any proposed restructuring. Such an approach would provide a well-structured framework within which to conduct orderly negotiations, which benefits both creditors and debtors.

Fourth, an orderly debt restructuring process would allow Puerto Rico to ensure the uninterrupted provision of essential public services. In the words of former bankruptcy Judge Steven Rhodes: "The advantage of bankruptcy is that people will still continue to get their police, their fire, their emergency medical, their roads, their educations, their power, their water, even though the defaults are taking place".[15] The continuous provision of these government services is critical to avoid a humanitarian and social crisis in Puerto Rico.

Fifth, postponing the inevitable restructuring only increases economic and social costs over the long-term. According to a 2013 report published by the Committee on International Economic Policy and Reform:

> "There is evidence that policymakers are often reluctant to restructure their debts and sub-optimally postpone unavoidable defaults. Delayed defaults can lead to the destruction of value because a prolonged pre-default crisis may reduce a country's capacity and willingness to pay. Its capacity to pay is reduced because procrastination prolongs the climate of uncertainty, high interest rates, and restrictive fiscal policies that are ineffective in avoiding default but amplify output contractions. Delayed defaults reduce its willingness to pay because electors that have suffered long periods of economic austerity are less likely to support a creditor-friendly debt restructuring."
>
> Furthermore, "late restructurings may be caused by self-interested agents that have incentives to gamble for redemption, even when delays entail economic costs for society as a whole. Myopic policymakers who do not take into account the long-run costs of excessive debt accumulation may also decide to delay a default in order to have continuous access to external resources. Short political horizons may also create incentives to undertake policies that increase the vulnerability of the financial sector to government default. This generates short-term benefits in terms of a higher capacity to borrow, but at the expense of higher future default costs if the accumulated debt turns out to be unsustainable."

Source: Committee on International Economic Policy and Reform, Revisiting Sovereign Bankruptcy, October 2013.

Finally, it is in the best interests of the United States for Puerto Rico to successfully ride out this economic crisis. If Puerto Rico becomes an international embarrassment for the United States, it will only weaken the moral standing of the American government and its

[15] Jack Casey, "Rhodes: Bankruptcy Critical for All of Puerto Rico", *The Bond Buyer,* November 16, 2015.

ability to effectively utilize its "soft power" in the international arena when it argues, for example, for better treatment for Hong Kong by China, for the Palestinians by Israel, or for Greece by members of the Eurozone.[16]

Conditions to Obtain Relief

We agree with those who argue that debt restructuring, by itself, would not solve Puerto Rico's structural problems. In fact, we strongly support that in exchange for obtaining some from of debt relief, Puerto Rico should be required to *implement substantial reforms* to address the fundamental problems that caused the island's government to become insolvent in the first place.

In this context we strongly recommend that any savings derived from a reduction in debt service be dedicated *exclusively* to develop and implement a new industrial policy for Puerto Rico based on (1) a set of coherent horizontal policies such as reforming an unnecessarily complicated permitting and licensing system that stifles innovation, lowering energy and other costs of doing business in the island, and substantially improving educational standards; (2) restructuring corrupt and obsolete institutions; (3) discovering new sectorial opportunities through a process of dialogue and consultation with key stakeholders in the private and civic spheres; and (4) identifying spillovers, externalities, and other areas where [Puerto Rican] society could learn more.

This new learning, in turn, would lead to: new investment in R & D, increased innovation and productivity, identifying new areas of comparative advantage for Puerto Rican firms, higher economic growth and the creation of high-quality jobs, which is what will categorically end Puerto Rico's long economic stagnation.

Conclusion

In sum, Puerto Rico has been under severe economic and financial stress during the past nine fiscal years. During that period the Commonwealth enacted a series of austerity and fiscal consolidation measures. Yet, in contrast with other jurisdictions that could complement those policies with either (1) a currency devaluation to boost exports or (2) loans from emergency liquidity facilities negotiated with international multilateral institutions, Puerto Rico, due to institutional constraints, cannot devalue its currency nor does it have access to such emergency liquidity facilities.

In our opinion, putting on an IMF policy straitjacket without receiving any of the scant benefits that usually accompany IMF conditionality programs does not make sense and the implementation of these kind of policies may, in a perverse way, *decrease* Puerto Rico's short and medium-term capacity to pay its debt by amplifying an already prolonged economic contraction.

[16] See Joseph S. Nye, Jr., Soft Power: The Means to Success in World Politics, (Public Affairs: New York, 2005).

Therefore, allowing Puerto Rico to restructure its complex debt under the aegis of a court-supervised process, as complicated, imperfect, and painful as such process may be in the short-term, is the optimal policy solution for all parties involved given the current economic and fiscal conditions in the island.

GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO
DEBT SERVICE SCHEDULE REPORT
FISCAL YEAR 2015-2016
CONFIDENTIAL - FOR INTERNAL USE ONLY

ISSUER		OUTSTANDING PRINCIPAL	Aug-15	Sep-15	Oct-15	Nov-15
COMMONWEALTH OF PUERTO RICO	COMMONWEALTH	12,470,402,455.80	1,552,166.67	1,552,166.67	1,552,166.67	1,552,166.67
PUERTO RICO ELECTRIC POWER AUTHORITY	PREPA	8,107,995,000.00			7,736,099.55	
PUERTO RICO SALES TAX FINANCING CORPORATION	COFINA	15,223,820,615.80	329,885,600.88		-	3,095,468.75
PUERTO RICO AQUEDUCT AND SEWER AUTHORITY	PRASA	3,991,181,404.41	2,632,197.12	2,632,197.12	2,632,197.12	2,632,197.12
PUERTO RICO MUNICIPAL FINANCE AGENCY	MFA	699,555,000.00	91,549,111.25		-	-
PUERTO RICO PUBLIC BUILDINGS AUTHORITY	PBA	4,056,263,666.60			2,698,997.85	-
PUERTO RICO PUBLIC FINANCE CORPORATION	PFC	1,090,740,000.00	57,903,256.67	1,422,845.42	1,422,845.42	1,422,845.42
PUERTO RICO PORTS AUTHORITY	PUERTOS	155,410,000.00			-	-
PUERTO RICO INFRASTRUCTURE FINANCING AUTHORITY	AFI	1,621,592,916.15			-	-
PUERTO RICO INFRASTRUCTURE FINANCING AUTHORITY	AFI (PORT AUTHORITY)	192,280,000.00			-	-
PUERTO RICO INFRASTRUCTURE FINANCING AUTHORITY	AFI (ASSMCA)	36,400,000.00			1,870,750.00	-
THE CHILDREN'S TRUST FUND	CHILDREN TRUST	871,975,000.00			-	23,998,634.38
PUERTO RICO HIGHWAY & TRANSPORTATION AUTHORITY	HIGHWAY	4,618,176,679.75			-	-
PUERTO RICO HIGHWAY & TRANSPORTATION AUTHORITY	HIGHWAY (T. M. BRIDGE)	129,777,270.45			-	-
EMPLOYEES RETIREMENT SYSTEM OF PUERTO RICO	RETIRO	2,947,648,342.65	13,876,582.50	13,876,582.50	13,876,582.50	13,876,582.50
PUERTO RICO CONVENTION CENTER DISTRICT AUTHORITY	CENTRO CONVENCIONES	397,740,000.00			-	-
PUERTO RICO INDUSTRIAL DEVELOPMENT COMPANY	PRIDCO	171,080,159.20			-	-
UNIVERSITY OF PUERTO RICO	UPR	451,760,000.00			-	-
UNIVERSITY OF PUERTO RICO	UPR (PLAZA UNIV.)	66,485,000.00			-	-
Sub total		$ 57,300,283,510.81	$ 497,398,915.09	$ 19,483,791.71	$ 31,789,639.11	$ 46,577,894.84
GOVERNMENT DEVELOPMENT BANK	GDB	4,241,962,000.00	169,633,107.71	9,873,347.29	9,873,347.29	22,841,603.54
Total		$ 61,542,245,510.81	$ 667,032,022.80	$ 29,357,139.00	$ 41,662,986.40	$ 69,419,498.38

Dec-15	Jan-16	Feb-16	Mar-16	Apr-16	May-16	Jun-16	Jul-16	FISCAL YEAR TOTAL PAYMENT
1,552,166.67	331,617,703.14	1,552,166.67	1,552,166.67	1,552,166.67	1,552,166.67	1,552,166.67	779,957,703.14	1,127,097,072.98
	176,640,224.35			7,736,099.55			423,894,674.35	616,007,097.80
-	-	318,373,725.88	-	-	3,095,468.75	-	-	654,450,264.26
2,632,197.12	99,070,253.88	2,632,197.12	2,632,197.12	2,632,197.12	2,632,197.12	2,632,197.12	147,580,352.61	272,972,577.69
-	887,087.50	15,087,323.75	-	-	-	-	7,577,087.50	115,100,610.00
-	91,159,734.97	-	-	2,698,997.85	-	-	177,284,734.97	273,842,465.64
1,422,845.42	1,422,845.42	21,524,520.42	1,422,845.42	1,422,845.42	1,422,845.42	1,422,845.42	1,422,845.42	93,656,231.29
4,866,515.00	-	-	-	-	-	4,866,515.00	-	9,733,030.00
-	35,940,943.75	-	-	-	-	-	77,055,943.75	112,996,887.50
6,802,006.25	-	-	-	-	-	5,110,756.25	-	11,912,762.50
-	-	-	-	1,148,875.00	-	-	-	3,019,625.00
-	-	-	-	-	23,998,634.38	-	-	47,997,268.76
-	114,624,495.83	-	-	-	-	-	232,564,495.83	347,188,991.66
-	3,278,756.25	-	-	-	-	-	10,473,756.25	13,752,512.50
13,876,582.50	13,876,582.50	13,876,582.50	13,876,582.50	13,876,582.50	13,876,582.50	13,876,582.50	13,876,582.50	166,518,990.00
-	9,504,656.25	-	-	-	-	-	20,829,656.25	30,334,312.50
-	12,950,715.00	-	-	-	-	-	12,718,549.38	25,669,264.38
11,294,000.00	-	-	-	-	-	31,264,000.00	-	42,558,000.00
-	1,693,578.13	-	-	-	-	-	4,008,578.13	5,702,156.26
								-
$ 42,446,312.96	$ 892,667,576.97	$ 373,046,516.34	$ 19,483,791.71	$ 31,067,764.11	$ 46,577,894.84	$ 60,725,062.96	$ 1,909,244,960.08	$ 3,970,510,120.72
354,751,972.29	9,873,347.29	29,214,853.54	9,873,347.29	9,873,347.29	422,841,603.54	10,619,097.29	9,873,347.29	1,069,142,321.65
$ 397,198,285.25	$ 902,540,924.26	$ 402,261,369.88	$ 29,357,139.00	$ 40,941,111.40	$ 469,419,498.38	$ 71,344,160.25	$ 1,919,118,307.37	$ 5,039,652,442.37

CNE

Center for a New Economy
San Juan, PR

The Center for a New Economy (CNE) is an independent, non-partisan think-tank that advocates for the development of a new economy for Puerto Rico. Founded in 1998, CNE produces rigorous public policy research and analysis, and is one of the most credible and influential voices on Puerto Rico's economy. CNE is organized as a 501(c)(3) non-profit entity that does not solicit nor accepts government funding. It relies solely on funding by individuals, private institutions and philanthropic foundations.

www.grupocne.org www.facebook.com/grupocne www.twitter.com/grupocne