The US Senate’s Energy and Natural Resources Committee, which retains general jurisdiction over measures affecting US territories, convened a hearing on 22 October to discuss Puerto Rico’s economic and fiscal challenges. Puerto Rico bond prices moved marginally lower on higher volume in the wake of testimony by Governor Alejandro García Padilla and Resident Commissioner Pedro Pierluisi.

During the hearing, Governor García announced that the release of audited financial statements was still “weeks or months” away. The Commonwealth’s inability to produce an audited financial statement for a fiscal year that ended almost sixteen months ago is inexplicable. Meanwhile, the Governor indicated that the Commonwealth report, a quarterly document that provides updated information on various aspects of government finances, would be publicly available in the coming days.

We do not expect Congress to respond to Puerto Rico’s appeal for an amendment to the US Bankruptcy Code to allow it to file for protection from creditors in federal court. We do expect Puerto Rico to default on Government Development Bank obligations before the end of the calendar year, triggering prolonged litigation.

Governor García’s proposal to appoint a financial control board to oversee financial affairs will likely encounter legal obstacles. As envisioned, the board would retain power to impose sanctions on the Commonwealth itself and exercise unilateral authority over the Commonwealth budget. We expect political and legal challenges to limit the effectiveness of such power.

However, Congress does retain the necessary authority to impose a financial control board on the territory. We expect it ultimately will be forced to do so as the scale of financial distress becomes more apparent.

Another Senate hearing

Senator Lisa Murkowski (R-AK), chairman of the US Senate Committee on Energy and Natural Resources, convened a hearing on Puerto Rico’s fiscal crisis last Thursday. She opened the hearing by reiterating a request for verifiable financial data as a precondition to
the provision of financial assistance. Senator Maria Cantwell (D-WA), the ranking minority member, followed by reminding those in attendance that the island’s economy remains mired in recession and that US citizens that reside on the island are experiencing significant hardship.

Antonio Weiss, counselor to Treasury Secretary Lew, testified first and stated that the Commonwealth’s fiscal challenges were escalating and the prospects for a more widespread humanitarian crisis rising. Governor Alejandro García Padilla and Resident Commissioner Pedro Pierluisi followed Mr. Weiss, and reiterated their support for an amendment to the US Bankruptcy Code that would enable the territory to seek protection from creditors in federal court.

Senator Murkowski asked Governor García when an independent audit would be made available to members of the committee and to the public at large. The governor responded by conceding that an audit for fiscal year 2014 was still “weeks or months” away. He attributed the delay to requests for additional information from the auditors. Senator Murkowski subsequently asked Mr. Weiss for an estimate of the costs associated with a build-out of a new financial disclosure and accounting system. Mr. Weiss responded by saying that the “costs were low but the benefits were great” without providing further detail.

In his prepared remarks, Governor García described the demand for an audit as a “red herring” propagated by creditors eager to force Puerto Rico into a disorderly default. The governor cited the preparation of longer-term revenue and expense projections by Dr. Anne Krueger as an example of his administration’s commitment to transparency. We are inclined to believe that the governor’s arguments will fail to persuade a majority in Congress. García’s assertion during the hearing that Puerto Rico’s past disclosure practices were unreliable is also likely to undermine support for an immediate response by Congress. Our colleagues in the UBS US Office of Public Policy have expressed their belief that there are few catalysts available to move legislation forward on Capitol Hill.

Senator Bernie Sanders’ (I-VT) active participation in the middle of his own presidential campaign stimulated more widespread media coverage than the hearing might otherwise have received. He also may have created some anxiety among investors when he suggested that bonds issued in violation of the island’s constitution be set aside and not repaid.

While he did not specify which bonds would be subject to invalidation, the senator appeared to be referring to bonds issued by the Puerto Rico Sales Tax Financing Corporation (commonly referred to by its Spanish acronym, COFINA). We believe that any attempt to invalidate COFINA’s bonds on constitutional grounds will be met with fierce resistance by an array of institutional investors and creditors, and result in prolonged litigation.
**US Treasury report released**

The US Treasury Department released a new report on Puerto Rico’s Economic and Fiscal Crisis last week. The report refers to Puerto Rico’s projection that it is expected to deplete its cash balances before the end of the calendar year. Emergency measures, such as a postponement of tax refunds and the liquidation of pension plan assets, have been implemented to raise cash but there are few additional actions available to the island’s government.

Governor García observed in his own prepared remarks that illiquidity – as highlighted by the Commonwealth’s estimated negative cash balance of USD 29.8 million in November, based on current information - would only grow worse when a USD 355 million debt service payment on bonds issued by the Government Development Bank for Puerto Rico comes due on 1 December 2015. The bonds are supported by a guarantee from the Commonwealth, and the GDB is not expected to be able to make the payment from its own available resources.

Not accounting for the debt service payment, the Commonwealth expects the negative cash balance to increase to USD 205 million by the end of the calendar year, and to USD 512 million by June 2016.\(^2\)

These estimates are suggested to be optimistic as they assume the continued ability to defer payments to suppliers (where the past due amount now exceeds USD 1.6 billion) and USD 291 million of refunds due to taxpayers.

The Treasury report includes new information that was not otherwise readily available to market participants. For example, Treasury has now confirmed that Puerto Rico has not made any of the additional contributions to the public pension system as envisioned by the 2013 reform legislation. The three public pension funds now hold just USD 2 billion in net assets versus USD 46 billion in aggregate future liabilities. The systems’ remaining liquid assets are expected to be depleted by the end of fiscal year 2017, forcing the Commonwealth to pay pensioners on a pay-as-you-go basis. Once illiquid and restricted assets are depleted, this will require an additional USD 700 million to USD 1 billion of outlays per year, according to the report.

The report concludes by offering four primary recommendations, three of which we review here.\(^3\) The first proposal encourages Congress to amend the bankruptcy code and allow Puerto Rico to restructure its debt in federal court. As sovereign entities in our federal system of government, states are not eligible to seek protection from their creditors in bankruptcy. Municipalities within the 50 states may do so only with the consent of their respective state government. The Treasury Department recommends that Congress enact a statute that expressly authorizes the Commonwealth and its local municipalities and public corporations to file for bankruptcy protection.
Proponents argue that the debt burden is simply too high and constrains economic growth. In their view, the bankruptcy court is the best option to avoid a disorderly default. Critics contend that the government has been reluctant to consider other alternatives and has failed to honor contractual obligations, such as the imposition of a small electric utility rate increase to pay debt service even as fuel costs have declined. We expect persistent political debate in Washington over this issue but believe that Puerto Rico is unlikely to succeed in its efforts to gain access to federal bankruptcy court in the foreseeable future.

The second proposal envisions more direct fiscal oversight without interfering with the island’s political autonomy. The Treasury suggests that a fiscal oversight body would certify that subsequent expenditures by the Commonwealth are made in conformance with adopted budgets. While we agree with the concept that an oversight body is needed, we are skeptical that an outside board with limited power is going to be particularly effective. Direct oversight of the Commonwealth’s fiscal management by a Congressionally-appointed oversight board may require the temporary surrender of some sovereign powers.

Fig. 1: Select credits and price trends of Puerto Rico municipal bonds
Last price, in USD

Source: MSRB trade data, Bloomberg, UBS, as of 26 October 2015
The Obama Administration’s third recommendation also requires legislative action by Congress. It calls for increased funding for Puerto Rico’s Medicaid program, at levels that are more comparable to the mainland. This would be achieved by removing the cap on Puerto Rico’s Medicaid funding and increasing the level of federal support the Commonwealth receives through the Federal Medicaid match. In prior reports, we have cited escalating health care expenditures as a critical obstacle to financial stability. There are 1.6 million individuals enrolled in Medicaid on the island but federal funding levels are disproportionately lower in Puerto Rico than they are stateside. Approximately 600,000 individuals are scheduled to lose coverage when expanded funding through the Affordable Care Act ceases.

Rating agencies unmoved
The rating agencies were unmoved by the Administration’s proposals. Moody’s and Fitch did not offer an immediate comment. Standard & Poor’s Rating Services (S&P) affirmed its existing ratings on the island’s USD 47.5 billion of tax-backed debt. S&P reiterated its belief, with which we concur, that a default is highly likely before the end of the calendar year.

Bond prices remain suppressed
The price on the Commonwealth’s benchmark general obligation bonds, the 8s of 2035 now sits at USD 73.00 (11.48% yield). By comparison, these bonds traded at a price that was about ¼ point higher USD 73.769 (11.35% yield) on 21 October.

In the meantime, subordinate lien COFINA bonds remained range-bound. For example, prices on the sales tax revenue bonds, 5 3/8% of 2039, have hovered around USD 45.00 (12.82% yield) for the past two weeks. Shifting to senior lien COFINA bonds, 6s of 2031, prices rest at about USD 59.28 (11.65% yield) versus USD 59.942 (11.51% yield) on 20 October, based on relatively low trading volume.

Conclusions
In a report in January 2012, we noted that Puerto Rico’s economy was hamstrung by an extraordinarily low labor force participation rate. An economic recession had bedeviled the island since 2006 and the underground economy prevented the government from capturing the necessary tax revenue to support a bloated public payroll. In that report, we also cited the Commonwealth’s reliance on market access to finance a structural deficit as a key risk. Almost four years later, Puerto Rico remains mired in recession and reliant on external funding to operate.

The rapid depletion of pension plan assets will trigger an immediate call on operating revenue to make pension payments to beneficiaries. While a well-reasoned argument can be made that other contractual

Fig. 2: Price trends, Puerto Rico GO 8.00% due 1 July 2035
Last price, in USD

Note: Puerto Rico GO 8.00% 2035 was issued at USD 93.00 on 11 March 2015. Source: MSRB trade data, Bloomberg, UBS, as of 26 October 2015.
obligations should take precedence, we believe the current adminis-
tration, and any administration that follows, will elect to make those
payments on a priority basis ahead of other expenditures. Meanwhile,
the island’s health care system is under exceptional stress. Any reform
of Puerto Rico’s current Medicaid funding regime by Congress is likely
to be a time-consuming process.

In light of current economic conditions and absent additional federal
funding, we cannot envision a scenario where the Commonwealth
can afford to pay its pensioners on a pay-as-you-go basis while simul-
taneously absorbing a substantial increase in expenses associated with
reduced federal funding for health services.

The current administration has thus far failed to reach a consensual
agreement with its creditors on its bonded debt obligations. We are
not in a position to assign responsibility for those failures but are
obliged to note that the current gubernatorial administration has
adopted a more confrontational approach to negotiations.

As we have suggested in prior reports, we expect the Commonwealth
to default on its obligations. We believe a unilateral moratorium on
the payment of debt is likely, with protracted litigation to follow. As
noted in the Treasury report, more than 20 creditor committees have
already formed around Puerto Rico’s 18 different debt issuers, each
with its own competing interests. In our view, the degree of security
offered to holders of general obligation bonds versus COFINA’s sales
tax revenue bonds will be a central focus of courtroom debates.

End notes
1 Written Statement of Alejandro J. Garcia Padilla, Governor of the
Commonwealth of Puerto Rico, 22 October 2015.
2 ibid
3 The fourth and final proposal is to promote greater participation
in the formal economy by providing access to an earned income tax
credit.
Appendix

Statement of Risk

Municipal bonds - Although historical default rates are very low, all municipal bonds carry credit risk, with the degree of risk largely following the particular bond’s sector. Additionally, all municipal bonds feature valuation, return, and liquidity risk. Valuation tends to follow internal and external factors, including the level of interest rates, bond ratings, supply factors, and media reporting. These can be difficult or impossible to project accurately. Also, most municipal bonds are callable and/or subject to earlier than expected redemption, which can reduce an investor’s total return. Because of the large number of municipal issuers and credit structures, not all bonds can be easily or quickly sold on the open market.

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Rating Agencies

S&P Moody’s Fitch/IBCA Definition

AAA Aaa AAA Issuers have exceptionally strong credit quality. AAA is the best credit quality.

AA+ Aa1 AA+ Issuers have very strong credit quality.

AA Aa2 AA Issuers have high credit quality.

A+ A1 A+ Issuers have adequate credit quality. This is the lowest Investment Grade category.

BBB+ Baa1 BBB+ Issuers have weak credit quality. This is the highest Speculative Grade category.

BB Baa2 BBB Issuers have very weak credit quality.

BB- Baa3 BBB- Issuers have extremely weak credit quality.

CCC+ Caa1 CCC+ Issuers have very high risk of default.

CCC- Caa3 CCC- Obligor failed to make payment on one or more of its financial commitments. This is the lowest quality of the Speculative Grade category.
Appendix

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