

Answers by
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to the

Questions for the Record Submitted by

Senator Orrin G. Hatch

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Puerto Rico's Fiscal Problems: Examining the Source and Exploring the Solution

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The three questions submitted revolve around the issue of extending to the Government of Puerto Rico access to bankruptcy proceedings. Therefore, it seems important to preface my answers by expressing my two main objections to the use of bankruptcy as the way to solve the fiscal problems faced by the Government of the Island: (1) it would worsen the economic situation in Puerto Rico, and (2) it is not supported by the available evidence.

In my written testimony, and in the Q&A portion of the hearing, I addressed the impact of bankruptcy to the economy. In essence, I explained that the fiscal crisis was not caused by a weakening economy, but rather, that it was the government, in the way it handled its finances, that damaged the economy. It did so by using its limited borrowing capacity, that was supposed to be utilized only to finance public investments, and used it instead to finance spending. As a result, an already fragile economy experienced a significant loss of investments and deteriorated even more. To revert this trend, and to fix the economic crisis, public and private investments on the Island must be increased and the business climate in Puerto Rico should be improved. For these investments to take place, financing is necessary, for which access to financial markets is essential. Bankruptcy, however, would close access to financial markets for Puerto Rico for an indeterminate number of years, to the detriment of the quality of life of the residents of the Island.

Regarding the reason to seek bankruptcy, it is important to understand the debt burden calculation that serves as the basis for that option. To start, consider the consolidated budget for the entire Government of Puerto Rico, for fiscal year 2016, which totals \$28,808 million. Within that budget, the aggregate debt service for the entire public debt of Puerto Rico, including General Obligations, COFINA, all public corporations, and all other debts, amounts to \$4,491 million. That debt service payment represents 16% of the entire consolidated budget. Nevertheless, on page 17 of The Puerto Rico Fiscal and Economic Growth Plan, prepared by

the Working Group for the Fiscal and Economic Recovery of Puerto Rico pursuant to Puerto Rico Executive Order 2015-022, dated September 9, 2015, the debt service as a percent of revenues for fiscal year 2016 is calculated to be 42%. On that same page, they make the same calculations for the projected figures for fiscal years 2017 through 2020 and the result amounts to approximately 40% for the five years presented. That 40% figure is cited by many people as the public debt burden of the Government of Puerto Rico, and it is used as the justification for seeking the right to declare bankruptcy. On closer examination, it is easy to see that the calculation of a 40% debt burden is wrong. To see why, let's examine the detailed calculations for fiscal year 2016 presented in the following table.

**Puerto Rico Public Debt Burden for Fiscal Year 2016:
Working Group vs. Consolidated Budget**

	Working Group	Consolidated Budget
Revenues		
General Fund and other select revenues (1)	\$8,503	\$8,503
GDB net operating revenues (1)	(96)	(96)
COFINA (1)	696	696
HTA revenues (1)	677	677
Increased sales tax and VAT (2)		1,121
Other revenues (plug)		10,535
Federal transfers (1)		6,477
Loans and bond issues (2)		895
Total revenues	\$9,780	\$28,808
Debt service		
GOs and selected agencies (1)	\$4,130	\$4,130
Other debt service (plug)		361
Total debt service	\$4,130	\$4,491
Debt service as a % of total revenues	42%	16%

Notes to table:

- (1) From page 17 of The Puerto Rico Fiscal and Economic Growth Plan ("FEGP") prepared by the Working Group for the Fiscal and Economic Recovery of Puerto Rico pursuant to Puerto Rico Executive Order 2015-022, dated September 9, 2015.
- (2) Available at: <http://www2.pr.gov/presupuestos/presupuestoaprobado2015-2016/Pages/default.aspx>.

As can be seen from the table, to make its calculations, the Working Group uses only \$9,780 of revenues, which represent only 34% of the consolidated budget, but includes \$4,130 for debt service, which represents 92% of the entire aggregate debt service required for the year. When you include the rest of the resources available in the budget, even when you add the rest of the debt service, the proper debt service as a percent of the total budget is significantly lower, at 16%.

The Working Group performed its calculation using as its basis the report by Krueger, Anne O., Ranjit Teja, and Andrew Wolfe, *Puerto Rico - A Way Forward*, June 29, 2015 (updated on July 13, 2015), the so called “Krueger Report”. Accordingly, the argument is that “the General Fund alone ... does not adequately capture the total financing needs of the Commonwealth.” (See the FEGP, p. 15.)

Although it may be true that the General Fund represents only a portion of the Government of Puerto Rico, and although certain items in the consolidated budget (e.g., federal funds, loans and bond issues) are not available to pay debt service, the entire consolidated budget represents the total amount of resources available to the Government of Puerto Rico to pay debt service and to provide services to the people. Therefore, if we accept the premise of the Governor of Puerto Rico, that in this fiscal crisis the debt payments must be balanced against the need to provide services to the people of the Island, the entire consolidated budget should be the basis of the analysis. After all, the funds that are not available to pay debt service may be used to provide services to the citizens. The usage of these funds for these purposes, therefore, would liberate resources that then could be used to pay debt service. Accordingly, the needs of the people and the commitments to honor debt obligations, would be effectively balanced.

It must be noted that the Krueger Report “was prepared at the request of legal counsel.” (See the Krueger Report, p. 2.) As such, it may well serve as the basis for a particular legal strategy like, for example, bankruptcy. It is doubtful, however, that it should serve as the basis upon which to base a sound public policy.

Based on the above, the proper debt service burden of the Government of Puerto Rico, when correctly calculated, is 16%¹, and not 40%. In that regard, it is worth mentioning that in a report by Moody’s Analytics (Zandi, Mark, Dan White, and Bernard Yaros, *Puerto Rico Looks Into the Abyss*, November 2015), that unquestioningly accepts the 40% debt service figure calculated by the Working Group, the authors argue that a debt service burden of 20% of government revenues is “sustainable” (p. 1). By the same logic, if 20% is sustainable, a 16% debt burden does not justify the use of bankruptcy.

In summary, the use of bankruptcy is not justified by the available evidence.

¹ In my written testimony at the hearing I indicated that the debt service represents 16.8% of the consolidated budget of the Government of Puerto Rico. That calculation was based on the proposed budget. Based on the budget that was finally approved, the debt service is 16%, like it was indicated above.

I now proceed to answer each of the questions specifically.

Question #1: Would extending Chapter 9 to Puerto Rico carry any negative consequences for the island? I'm not talking just about bondholders. I'm talking about the commonwealth as an entity. If Congress extended Chapter 9 to Puerto Rico and island municipalities began taking advantage of Chapter 9, how would that impact the island's bond rating, its creditworthiness, its attractiveness as an investment location, etc.? Is there a scenario under which extending Chapter 9 to Puerto Rico would actually make the island's fiscal situation worse?

Answer to Question #1: First, it is important to make the distinction between having access to bankruptcy proceedings and actually using it. That distinction is relevant because every state of the Union has access to bankruptcy protection for their public corporations and that access does not seem to have affected their credit quality.

As I indicated in the introduction, if the Government of Puerto Rico were to use bankruptcy as the way to solve its fiscal crisis that would worsen the economic situation of the Island because it would close access to financial markets for an indefinite number of years which would make it impossible to undertake necessary investments on the Island. That outcome would come about, at least, for three reasons:

1. The use of bankruptcy is not justified and to argue otherwise the government and its consultants had to resort to data manipulation, as I demonstrated in the introduction.
2. Reneging on its debt commitments would constitute a drastic change in the financial tradition of the Government of Puerto Rico that, until now, had an unblemished record of meeting its debt commitments.
3. Using bankruptcy protection would constitute a change of the rules under which bonds were issued. This change of rules not only could constitute a violation of constitutional provisions that protect contractual relations, but it also would erode the confidence on the Island of potential investors.

That situation would be even worse under the proposal by the Department of Treasury that would allow the Government of Puerto Rico to seek bankruptcy protection even for debt guaranteed by the Island's Constitution.

Naturally, any situation that weakens the economy of Puerto Rico would make the fiscal situation even worse.

Question #2: We've heard arguments that extending Chapter 9 to Puerto Rico would be unfair to bondholders because it would reduce their return on their investments. Some have argued that any Chapter 9 extension should apply only to future debts. As an initial matter, it would be helpful to know whether past bankruptcy code reforms have applied to existing debts, or whether bankruptcy reforms have typically applied only to future debts. Can you offer any insight on this matter? And if past reforms have applied to existing debts, have any of those reforms been analogous to what we're considering here—namely, extension of bankruptcy access to entities who previously had no such access? I asked this question at the hearing, but I didn't get a complete answer and I believe it's extremely important.

Answer to Question #2: I am aware of the constitutional impediments, both locally and at the federal level, to enact laws that may affect contractual relationships. At the same time, I am also cognizant of the fact that those very same Constitutions protect the power of Congress, at the federal level, and of state legislatures, at the local level, to approve laws. Balancing those two constitutional provisions is not an easy task and may require court intervention. Given that my area of expertise is not the law, on this question, I defer to those who do have that expertise.

From an economic standpoint, however, even if it were legally permissible, granting Puerto Rico access to bankruptcy protection for its existing debts is both troublesome and extremely dangerous. Utilizing bankruptcy when the debt service burden is 16% is equivalent to saying that "we can pay our debts, but we rather not pay them." Any jurisdiction acting that way, and one that does it with the express approval of Congress (via the contemporaneous extension of Chapter 9), will find it incredibly difficult to access the markets thereafter, since they are, plain and simply, refusing to pay their debts. In fact, it seems fair to say that an act of Congress that would allow a jurisdiction to avoid paying debts that it can otherwise pay would not only be unique, but it also would have disastrous consequences.

Question #3: Another question on Chapter 9 and retroactivity: If Congress steps in and changes the rules of the game after the fact to allow municipalities to discharge existing debts, do we need to worry about the message that sends to other debtors and other creditors across the country? Parties negotiate contracts according to existing laws. If we step in and suddenly change the rules, does that tell parties in other situations that the rules are actually more up for grabs than they might think? Does that tell other states or other municipalities outside Puerto Rico that if things get bad enough, Congress will simply change the rules to help ease the pressure?

Answer to Question #3: To ascertain whether granting Puerto Rico access to bankruptcy proceedings would constitute a change in the rules under which bonds were sold, I examined the official statements issued by the government of the Island as part of prior bond offerings. I did not find a direct reference to the issue of bankruptcy until the official statement issued in March 11, 2014, in which case the following disclosure was included:

The Commonwealth is not currently eligible to seek relief under Chapter 9 of the United States Bankruptcy Code. In the future, however, new legislation could be enacted by the United States Congress or by the Legislative Assembly that would entitle the Commonwealth to seek the protection of a statute providing for restructuring, moratorium and similar laws affecting creditors' rights. This could affect the rights and remedies of the holders of general obligation bonds and notes of the Commonwealth, including the Bonds, and the enforceability of the Commonwealth's obligation to make payments on such general obligation bonds and notes. (Commonwealth of Puerto Rico, Official Statement issued in relation with the issuance of the \$3,500,000,000 General Obligation Bonds of 2014, Series A, March 11, 2014, page 9.)

This disclosure constitutes an admission by the Government of Puerto Rico that if it were granted bankruptcy protection the rules under which bonds were issued would change. Otherwise, they would not have felt obligated to make the aforementioned disclosure.

Since it would constitute a change of rules, that would be another reason not to advocate bankruptcy as the tool to use to solve Puerto Rico's fiscal crisis. Thus, the only way in which Puerto Rico should be given access to bankruptcy protection is through a process in which that protection, instead of the primary objective, would be incidental to another decision as would be, for example, as a result of a change in the political status of Puerto Rico. Even under those conditions, however, for the reasons indicated before, I would not advocate for the Island to use that mechanism.

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