the weekly Standard

Treasury Pretends Not to Know What a 'Bailout' Is

As it promotes a terrible proposal for Puerto Rico.

Ike Brannon

May 20, 2016

Following the reintroduction of the Puerto Rico debt legislation this week, it appears that the battle over how to restructure the insolvent island may soon be headed for a Congressional vote. The basic problems with previous approaches to fixing what ails the island have been papered over, to be conveniently ignored until the bill passes and Congress can move on to the next thing.

The biggest flaw with previous legislative attempts to construct a plan to fix Puerto Rico's finances is that neither the Republicans in the Natural Resources Committee that have been writing the legislation nor the Treasury Department see any problem with reducing the payments made to the general obligation bondholders to offset funding for other obligations, especially for its hugely underfunded $46 billion pension system.

Those bondholders lent money to the government based on a constitutional edict that their debts, backed with the full faith and credit of the Puerto Rican government, had absolute priority over all other government obligations. The problem with doing this is that every state and municipality in some degree of financial distress is going to find it more difficult to borrow money once investors realize that Treasury's game plan is to impose this same solution elsewhere.

The new bill will not explicitly cut payments to bondholders, but it will empower a fiscal control board to decide how to best return the island to solvency. It will be able to reduce, postpone, or eliminate the payments being made to the island's creditors, including the general obligation bondholders. At the same time, the bill's legal stay provisions will bar bondholders from seeking recourse in the court system for default on the obligations owed to them, greatly weakening their position at the negotiating table with Puerto Rico's government.

The new proposal met with approval from the Treasury, which has played an outsized role in advising the House of Representatives as essentially an advocate of the island's government. Shortly after the release of the new proposal it sent out a press release that praised the latest Puerto Rico reform plan, and giving special praise for the fact that the legislation would not "bail out" any creditor. This throwaway line speaks volumes about Treasury's deceit in this whole sordid negotiation.

How, precisely, does one bail out a creditor? If I lend my friend $20 and I ask for it back, am I seeking a bailout? How about if I lent him that money with the explicit promise, written on a contract, that he will pay me back before he does anything else with his spare cash when the money is due? If I see him spending money at the track am I seeking a bailout by asking for my sawbuck?

The Treasury public affairs staffer who wrote this tripe clearly doesn't understand the difference between a creditor and debtor, or the various classes of creditors, or even what a bailout is. He simply knows that the word bailout connotes something bad to Republicans, and that everyone at Treasury is sick of the harping by bondholders that own general obligation debt, and he needed to denigrate them in some way. It is a complete subversion of the actual situation: Puerto Rico can't pay back its debts and some people aren't getting paid back. It is, in fact, Puerto Rico that is being bailed out, and the only question here is who will be left holding the bag. While the legislation may spare the federal government from writing any big checks, at least right away, taxpayers will still be on the hook.

Treasury is happy about the revised proposal because the general obligation bondholders, who lent at a lower interest rate than other creditors because their debt was supposedly backed by the full faith and credit of the Puerto Rican government will likely get the same treatment as the other creditors despite their efforts to have their contracts honored. That has been its goal all along, for reasons that have nothing to do with actually helping Puerto Rico.

The reality is that there are three different groups fighting here, all of whom are doing so on behalf of different groups of retirees. The general obligation bondholders are not just rich Wall Street denizens: they are mostly retirees, pensioners, and other individuals across the country who—foolishly, it turns out—assumed that Puerto Rico would honor the laws established by its Constitution.

These general obligation bondholders are competing with the other bondholders, who stand to benefit if prioritized bondholders are brought down to their level.

The third group is the Puerto Rican pensioners, for whom Treasury has essentially become an advocate. Lest you think that the absences of moneyed types in their group gives them the moral upper hand, keep in mind that working side by side with them are various Wall Street investment banks, each of whom has a twisted incentive in this thing. Treasury's point man for Puerto Rico, Antonio Weiss, is working shoulder to shoulder with Lazard, the investment bank that used to employ him and that gave him a $21 million buyout when he left to take his current job. Another adviser to the island is Richard Ravitch, who is a board member of the one bond insurance company that doesn't have exposure to Puerto Rico—imposing a deep haircut on bondholders puts money in his pocket.

The island has paid over $100 million to investment banks for their advice in negotiating with bondholders and Congress, money that could have gone to pensioners. The advice has been pretty basic: Do what Argentina did and pretend that the next dollar the island must do without will come directly from the salary of a teacher, doctor, or policeman and that there is no fat left to cut.

The control board will be able to haircut any and all debt, and while the stay is in place it will have the power to put as much money as it can grab into the island's bankrupt pension plan. It's the ineluctable end-game for any control board tasked with putting the island on a firm footing. If the bankrupt pension isn't addressed, then the island's problems will remain, and the pressure Treasury will apply to avoid increasing contributions, raising taxes, or decreasing benefits will be enormous. Taking the money from bondholders is the easiest route to go, politically.

The island's long-term financial outlook won't be improved by lumping in general obligation bonds along with the other bonds. They constitute only $18 billion out of the total debt of $72 billion, and imposing a loss on these investors will mean the island will ultimately face higher borrowing rates for the foreseeable future once it emerges from its reorganization. It will never be able to issue a credible promise to investors that they will have any priority. Several Puerto Rican politicians have publicly opposed Treasury's stance on general obligation debt precisely because of this implication.

Treasury doesn't care about Puerto Rico. It cares about Illinois, for which this will serve as a template, and their friends there like Rahm Emanuel and the government employees' unions in the state who don't want their pensions touched. Its officials also probably care for their friends who are making lots of money from the Puerto Rico morass and where they will undoubtedly go to work in eight months' time, to rake in millions advising Illinois and Chicago on how to wiggle out of their debt.

The morality tale Treasury likes to spin of its noble battle against the rapacious hedge funds is a crock, a story they have concocted to distract from their ulterior motives. Any deal should be examined solely on the basis of whether it will help the island return to solvency with a functional economy, and how it will impact other states and municipalities with shaky finances. It's difficult, to put it mildly, to objectively judge the current legislation as a success by those standards.

Ike Brannon, an economist, is a visiting fellow at the Cato Institute and a former Treasury Department official.