INVESTOR'S BUSINESS DAILY®

The High Cost Of Not Paying Your Bills: Puerto Rico's Bankruptcy Bodes Poorly For Its Future

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May 22, 2017

Earlier this month Puerto Rico essentially declared bankruptcy, marking its latest attempt to climb out of its fiscal black hole. However, this will not be any sort of panacea, and this drastic step — which is the largest government bankruptcy in U.S. history — could leave the island in a spot just as problematic as it is in today.

Bankruptcies are prone to being messy, complicated and contentious, whether it's a person, company or municipality that's declared bankruptcy. However, there are a few rules set forth in the bankruptcy law that delineate which creditors get paid back first and who goes to the end of the line.

The first rule is that creditors who lent money backed by some sort of collateral, or with an explicit promise that their claims take precedence, get their money before the rest. For instance, homeowners can't get out of their mortgage via bankruptcy because to get the mortgage they pledge their house as collateral. Companies often pledge certain assets to back their loans as well.

In the last few years, however, there has been a concerted attempt to circumvent such practices for political expediency.

For instance, in the Chrysler bankruptcy in 2009 the Obama administration applied no small amount of pressure to enable the UAW pension funds — which were low on the repayment list — to have their debts paid back at the expense of the bondholders, who lent money under terms that included an explicit provision that they would be paid back first.

When the city of Detroit went bankrupt, the administration again interceded to benefit the city's current and future pensioners at the expense of the secured creditors, who received a haircut on their promised repayments.

Puerto Rico is currently $73 billion in debt, which is close to 100% of the island's annual output. It owes a sizeable portion of this to the island's current and future pensioners: Puerto Rico's pension fund is woefully underfunded. It also owes billions to general obligation bondholders — whose investments are guaranteed by the island's constitution — and to COFINA (also known as Puerto Rico Sales Tax Financing Corp.) bondholders, who hold debt explicitly backed by sales-tax revenues.

The government wants to greatly reduce its payments to these creditors — and others — in order to avoid further spending reductions and to minimize necessary reductions in pension benefits, among other priorities. While such actions may appear to be a reasonable and fair outcome, the reality is that setting aside established law and precedent has long-term ramifications that go beyond Puerto Rico.

This is problematic because there are numerous other states — my home state of Illinois comes to mind — that are also in dire financial straits. The Prairie State has been effectively running a deficit for at least a decade and is burdened by a public pension that will likely go bust the next time there is a recession.

Illinois also has taken a page out of the Puerto Rico playbook by beginning to demonize its bondholders as greedy investment bankers profiting off the misery of others.

While such rhetoric plays well with the voters — and that is to whom Puerto Rico's new governor, Ricardo Rossello, is clearly playing — it makes escaping the island's financial predicaments more problematic. Once the Puerto Rican government and its oversight committee reach some sort of arrangement for moving the island forward, it will need to re-engage with capital markets to borrow money — whether it be for capital improvements, short-term credit arrangements, or something else.

If Puerto Rico spends the next year denigrating its lenders and trying to break contracts, few investors will want to take a chance lending money to the island again. Put simply, the market cannot credibly believe future repayment promises no matter what steps Puerto Rico takes — at least not until it returns to economic expansion and solvency.

What's more, if Puerto Rico successfully breaks these covenants, municipal bondholders in Illinois — and elsewhere — are going to perceive that their investments now contain much more risk than they had previously perceived, and will demand a higher interest rate to take it.

In short, Puerto Rico's shenanigans may hasten Illinois' insolvency.

The reality is that the island's government never negotiated in good faith with its creditors, as PROMESA requires. It postponed holding talks until the stay on litigation was about to expire, and then proposed that non-Puerto Rico Electric Power Authority bond owners would take up to a 77% haircut, an offer that they knew would be rejected.

What's more, the rhetoric that this is a fight between Wall Street bankers and the poor pensioners is a crock: The holders of Puerto Rico bonds are pensioners across the country (and some who happen to be Puerto Ricans) who put their savings into an investment they assumed was safe.

Puerto Rico should be forced to negotiate with their creditors in good faith before giving them access to a Title III bankruptcy, and the interests of the fifty states in the union should be considered before it is permitted to blithely stiff its creditors. Congress cannot simply walk away from this just because it passed legislation.

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