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It's More Important To Get Puerto Rican Pension Reform Right Than To Do It Fast

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The drumbeat for an immediate and permanent solution to Puerto Rico's pension crisis has been growing louder since Congress passed PROMESA last year, and it is underscored by recent developments on the island. Earlier this year, the Oversight Board put out a Request for Proposals for a "pension and retirement consultant," the hiring process being run by former California Department of Finance chief Ana Matosantos and American Enterprise Institute pension expert Andrew Biggs. That consultant's mandate is, among other things, to produce "a review of the existing benefits and their sustainability."

That request came one day after Elias Sanchez, Puerto Rico Governor Ricky Rossello's representative to the Oversight Board, announced a "major restructuring" of government spending that would allow his administration to continue to pay into pension systems, citing the need to provide for their 180,000 pensioners. Part of that restructuring appears to be already underway in the form of recently introduced "single employer" legislation on the island. The bill has been lauded by many as a step in the right direction, although there is a risk that it could push billions in pension liabilities of municipalities and public corporations to the Commonwealth's already overburdened General Fund if not done properly.

However, while Puerto Rico's pension system is a mess and needs major changes to make it solvent, we would all do well to slow down and take a breath. As we outlined in a previous piece, actuaries estimate that the system will be more or less cash flow neutral for the next few years, and there is enough money in the system, together with contemplated current year contributions, to keep pensions running on schedule for several more years. The government should take heed to avoid letting a crisis mentality force it to piece together a substandard reform plan in haste that fails to make structural reforms to its pension plan.

Governments with fiscal problems often resist making significant pension reform, since those affected complain quite loudly. For instance, despite a court ruling that cities could alter their pension obligations in Chapter 9 during Stockton, California's protracted bankruptcy battle, several bankrupt California cities, including Stockton, Vallejo, and San Bernardino, ultimately chose to forego reform, fearing a ferocious and costly fight from the California Public Employees Retirement System. In his ruling approving Stockton's eventual exit from bankruptcy protection, the same judge called CalPERS a "bully" with an "iron fist."

Instead, these cities pursued more draconian service reforms that reduced their citizens' quality of life. For instance, San Bernardino plans to outsource more services, including its fire department, and its citizens have seen both crime rates and taxes jump. Vallejo's pensions continued to be a major drag on the city's balance sheet long after it exited bankruptcy, and its vice mayor described them the "biggest part of (Vallejo's) problem" two years after its bankruptcy ended.

While it is understandable that municipalities would hesitate to adjust pensions, it's regrettable: history shows that governments do not get a second chance to get pension reform right, and those who fail to insufficiently address the problem in their first pass only kick the can further down the road and exacerbate the difficulties of economic recovery.

Of course, the most recent major government bankruptcy occurred in Detroit, which is the poster child for how to mishandle a municipal restructuring -- too much debt restructuring and insufficient fiscal and pension reform. While that city was allowed to declare Chapter 9 bankruptcy--an escape hatch unavailable to Puerto Rico--the way the city handled pensions was artless, to say the least.

The Detroit restructuring ultimately set aside established law and gave lenders a disproportionate haircut to minimize the impact to pension recipients, a maneuver championed by the Obama Administration that it also employed elsewhere. As a result, Detroit cannot borrow money without the state of Michigan's assistance, an outcome that doesn't bode well for Detroit's future. If lenders are wary immediately after a restructuring, when a city exits with a greatly improved balance sheet, a return to normalcy over the longer term will be even more complicated.

Puerto Rico Oversight Board member David Skeel decried the Detroit approach in an op-ed he penned for the *Wall Street Journal* last year, writing that "the rule of law took a beating in the Detroit bankruptcy. Holders of the city's general-obligation bonds, which had the same priority as pensions, got stiffed, receiving roughly 41% of what they were owed. Pensioners got at least 60%."

Despite the unambiguous failure of Detroit to protect creditors' rights and re-establish market access, a few concessions extracted from pensioners by Detroit warrant further scrutiny. The City obtained court approval for a small reduction in base benefits as well as modest reductions in system administered benefits, including cost-of-living-adjustments. And in yet another potential blueprint for Puerto Rico, active employees received a different deal than the then current retirees. However, the city continues to struggle financially because it punted on numerous other difficult decisions, leaving Detroit with the need to address its impending pension funding cliff.

In contrast, the Northern Mariana Islands, a U.S. Territory with a population of 55,000 afflicted with its own pension woes, developed more creative solutions that are worth examining. After unsuccessfully filing for Chapter 11, the pension system reached a class action settlement with the labor unions that shifted obligations into a VEBA-type structure at 75% of the current benefits, with benefits ratcheting up under certain fiscal conditions.

While Puerto Rico has access to a different restructuring regime through PROMESA and would not have to work within these exact frameworks, the lessons from California, Detroit and the Northern Mariana Islands should sow the sort of creative thinking that Gov. Rossello and the Board need to engage in if they hope to secure Puerto Rico's financial future and keep its pensions solvent in the long run.

Pension reform in Puerto Rico is important and it should resolved as soon as possible, but in the case of something that could make or break the island's future, it's more important to get it done right than to get it done fast.

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