Puerto Rico Defaults

The island's debt crisis worsens. Will Congress act before July 1?

Provided by Hatcher Financial, P.C.

On May 2, Puerto Rico defaulted on its debt again. As it managed to negotiate with some of its creditors, its Government Development Bank did pay part of the $422 million it owed this week, but about $270 million in payments were missed.[1,2]

Puerto Rico's fiscal crisis made headlines last year when its total debt passed $70 billion, more than any U.S. state except for New York and California. Its government has defaulted three times on its debt since the start of 2015.[3,4]

Puerto Rico has been in a recession for the better part of a decade. About 45% of Puerto Ricans live in poverty, and people are leaving the commonwealth at a rate of 1,500 a week. Its schools, hospitals, and social services programs have already been hit with severe budget cuts.[3,5]

On May 1, Governor Alejandro García Padilla called the default "a painful decision," but also a necessary one. Faced simultaneously with "the inability to meet the demands of our creditors and the needs of our people, I had to make a choice. I decided that essential services for the 3.5 million American citizens in Puerto Rico came first."[5]

July 1 presents a critical deadline. On that day, the commonwealth must make about $2 billion in debt payments. Analysts are highly skeptical that Puerto Rico will be able to do that.[1]

Will Congress intervene? The pressure is certainly mounting on Capitol Hill lawmakers.

Will a bailout be necessary? Maybe not. Last spring, the House Natural Resources Committee attempted to put together a relief bill in response to the crisis. If passed, it would not represent a bailout, as it would not deliver any federal money to Puerto Rico. The bill is still in the works.[1]

In 2015, House Speaker Paul Ryan (R-WI) gave Congress a March 31, 2016 deadline to address this issue, but that deadline came and went without action. Treasury Secretary Jack Lew and the White House implored Congress to address the problem this week. In a letter to congressional leaders, Lew stated that minus "a workable framework for restructuring Puerto Rico's debts, bondholders will experience a lengthy, disorderly, and chaotic unwinding, with non-payment for many a real possibility."[1,2]

Lew also warned that without legislation including "appropriate restructuring and oversight tools, a taxpayer-funded bailout may become the only legislative course available to address an escalating crisis." Since Puerto Rico is not a state, a Chapter 9 bankruptcy is not an option.[4,5]

What does this mean for bond investors? Greater levels of concern. American investors have bought Puerto Rico's bonds for years, as they are exempt from federal and state income tax. Earlier this year, the commonwealth defaulted on $37 million of bonds issued by the Puerto Rico Infrastructure Financing Authority, which were not constitutionally backed. This week, Puerto Rico defaulted on bonds backed by its Government Development Bank. If the GDB cannot make the huge debt payment due July 1, then Puerto Rico will default on some of the general obligation bonds issued by its government.[4]

Most municipal bond funds have sold off their Puerto Rican debt and have not been greatly affected by these developments. Small investors holding Puerto Rican debt can take some solace in the fact that several Puerto Rican bonds are insured; in case of a default, the principal and interest would be protected by a bond insurance company. Contrast that with the plight of the funds still heavily invested in distressed Puerto Rican debt; as the commonwealth cannot declare bankruptcy, they may have to turn to regular courts in pursuit of payouts.[4]

Douglas M Hatcher may be reached at 602-955-8500 or doug@hatcherfinancial.com.
www.HatcherFinancial.com

Citations.

1 - thehill.com/policy/finance/278352-puerto-rico-defaults-as-islands-governor-pushes-congress [5/2/16]
2 - fortune.com/2016/05/03/puerto-rico-default-more-political-fallout-than-market-impact/ [5/3/16]
3 - bloombergview.com/quicktake/puerto-ricos-slide [4/28/16]
4 - abcnews.go.com/Business/wireStory/qa-puerto-ricos-debt-crisis-explained-38803972 [5/2/16]
5 - usatoday.com/story/money/2016/05/01/puerto-rico-expected-default-further-debts/83794076/ [5/1/16]