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Puerto Rico's Bankruptcy Hearing Marks Reset of Asset Scramble.

NEW YORK — Puerto Rico is due to embark on a bankruptcy process on Wednesday that could take years to resolve, as investors scramble to get the highest recovery on their bonds.

The debt is still trading at elevated levels versus what the government has set aside for payment under its financial recovery plan, and creditors worry about whether they will be able to recoup at those prices.

Whether they get that level of recovery is debatable, according to investors and analysts, as the U.S. territory seeks to restructure more than $70 billion in debt, from multiple agencies, and another near $45 billion in underfunded pension liabilities.

"The 25 percent may be what the Commonwealth identified as a available to cover debt service but it doesn't necessarily mean that will be the ultimate recovery," said Shaun Burgess, portfolio manager and lead trader for Puerto Rico strategy at Sarasota, Florida-based Cumberland Advisors.

Puerto Rico, with 3.5 million U.S. citizens, has spent the last ten years in recession with debt piling up to pay for basic services. The poverty rate is at 45 percent, unemployment is at 11 percent and the population is shrinking as islanders emigrate to the mainland United States in search of a better life.

Burgess, who owns insured Puerto Rican debt, did not want to speculate on the final recovery prices, or the potential losses for major mutual funds, but said negotiations could include lowering the coupon rates, reducing principal and extending maturity dates.

"There isn't enough information, especially as it relates to time frame and potential recoveries," he said.

Yet to be worked out is how an $800 million pot of money set aside in the government's certified 10-year fiscal recovery plan will be apportioned between competing claims including those of constitutionally backed general obligation debt (GO) and sales-tax backed bonds known as COFINA.

That pot of money represents less than a quarter of what is needed to service debt annually.

That question will ultimately be settled by U.S. District Judge Laura Taylor Swain of the Southern District of New York when the bankruptcy-like proceeding begins in a San Juan courtroom on Wednesday.

Swain, appointed by U.S. Chief Justice John Roberts on May 5th, is operating under the authority granted by the U.S. Congress, which passed a law last year known as PROMESA (Puerto Rico Oversight, Management, and Economic Stability Act).

PROMESA established a federal oversight board with the authority to negotiate the restructuring of the island’s debt. It includes a provision known as Title III that establishes a legal pathway, previously unavailable, for Puerto Rico to settle its obligations through a bankruptcy-like process.

Normally, GO debt is the most senior in a municipality’s capital structure and the first to be paid. COFINA creditors are fighting to ensure its revenue stream doesn’t get diverted to pay other debt.

“Clearly we don’t know what to expect, but it is going to be a lengthy and tortuous process. This is going to take longer than Detroit,” said Mikhail Foux, municipal research director at Barclays Capital in New York. Detroit’s case took 18 months.

“I would assume the final solution should also address the pensions because if you are bondholder why would you take a haircut knowing the pension liability question could just send you back to square one again,” he said.

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Puerto Rico’s bankruptcy dwarfs Detroit’s, the previous record holder for municipal bankruptcy at $18 billion in debt and obligations that was ultimately reduced by $7 billion.

“The main take-away I have from the experience of Detroit or GM (General Motors) is that politics trumps contracts. I expect the final result to involve big haircuts, low coupons and long maturities for bondholders, and it probably doesn’t matter if its GO’s or COFINAS,” said Robert Rauch, senior partner and portfolio manager at emerging market asset manager Gramercy.

Currently Puerto Rico’s benchmark general obligation debt, an 8 percent coupon bond maturing in 2035, last traded at a bid price of 60, according to Thomson Reuters data. <74514LE86=MSRB>

“Current prices reflect the fact that the muni market doesn’t permit shorting. As long as the current core of bondholders is supporting the market it won’t go down to a level that reflects realistic recoveries,” said Rauch, whose firm specializes in emerging markets and distressed debt.

COFINA bondholders were the first to sue the government after the freeze on creditor litigation under PROMESA expired at Midnight May 1st. They accuse Puerto Rico, Governor Ricardo Rossello and other officials of angling to repurpose the tax revenue earmarked to pay COFINA debt.

“If COFINA is pierced, many people would say it is one-off situation and not precedent setting. But it could have some effect on other municipal credits,” Foux said.

Senior COFINA debt carrying a 5.25 percent coupon maturing in 2057 was bid at 57 with a yield of 9.39 percent on Tuesday. <74529JAR6=MSRB>

The 6 percent 2042 subordinated COFINA bond has steadied, last bid at 23.71 with a yield rising to 25.5 percent <74529JHN8=MSRB>. This bond has dropped by more than 50 percent since the board certified the government’s fiscal plan in March.

“The fiscal plan only allows for a certain amount of money for debt servicing and it isn’t enough. Why are market prices still implying higher recoveries? One factor to remember is there are competing claims between GO and COFINA. They can’t both be right. Therefore, in aggregate prices to need to go lower,” said David Hammer, head of municipal bond portfolio management at Pimco in New York.

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(Reporting By Daniel Bases; editing by Diane Craft)