Bond Case Briefs

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Commentary: How the Puerto Rico Dispute Threatens Bond Holder Rights.

The municipal bond market, for borrowers and investors alike, is fundamentally changing. Municipalities across the U.S. are struggling to provide essential services on top of skyrocketing pension and benefit obligations. In addition, although bankruptcy and default remain minimal, the Detroit bankruptcy case had a profound and sobering impact on the market, leading participants to reevaluate what a general obligation (GO), full faith and credit pledge actually means. Logically, there has been a market shift to bonds secured by a specific revenue stream – a securitized loan – as a means for issuers to enhance the attractiveness of their bonds and lower borrowing costs.

The outcome of a highly publicized court case currently being heard by Judge Laura Taylor Swain in U.S. Municipal Bankruptcy Court under Title III of PROMESA (No. 17-00257-LTS), COMMONWEALTH of PUERTO RICO vs. COFINA, is likely to set the course for where the municipal market goes from here.

COFINA bondholders are renouncing actions taken by the Commonwealth to impair or eliminate its debt. Clearly, this would be devastating for investors, including the Puerto Rican citizens who own approximately $2.8 billion of the bonds. Impairing this debt may also impede, if not eliminate, access to funding via securitized loans.

The background: The Puerto Rico Sales Tax Financing Corporation — in Spanish, Coporacion del Fondo de Interes Apremiante or COFINA — was created by PR Law No. 91, as amended, to establish an entity that was independent and separate from the Commonwealth in order to address one of the worst fiscal crises in Puerto Rico's history. In consideration for COFINA's help in this crisis, the legislature established and assigned to COFINA a priority lien on a newly imposed, island-wide sales and use tax (SUT). A summary of Puerto Rico Act No. 56., describes the bargain:

"A special fund is hereby created to be known as the Dedicated Sales Tax Fund. The Dedicated Sales Tax Fund and all of the funds deposited therein and all the future funds that must be deposited in the Dedicated Fund pursuant to this law are hereby transferred to, and shall be the property of COFINA. This transfer is made in exchange for COFINA's commitment to pay, all or part of the extraconstitutional debt outstanding as of June 30, 2006. The Dedicated Sales Tax Fund shall be funded each fiscal year from the first revenues of the SUT, deposited at the time of receipt and shall not be deposited in the Treasury of Puerto Rico, nor shall it constitute resources available to the Commonwealth of Puerto Rico, nor shall be available for use by the Secretary of the Treasury."

COFINA – revenue analysis: The Sales and Use Tax (SUT) pledged to COFINA is very strong, as reflected in all but one of the elements credit analysts consider when evaluating a bond.

- *Demographics and Economic Base* – **Poor.** The island has a declining population, low income levels, and high unemployment relative to the U.S. mainland.
- *Nature of the Dedicated Revenue* – **Superior.** The SUT applies to a very broad list of services and essential consumer goods, is very stable, and is enforced throughout the entire island.

- *Revenue Analysis and Fund Flows* – **Superior.** Fiscal year 2017 collections were a record high and double 2013 levels. A priority lien exists on collected taxes, going first to bondholders.
- *Debt Service Coverage* – **Superior.** The ratio of pledged revenue to annual debt service on the senior lien bonds was 11x in fiscal year 2017.

The problem: After following the law and the set-forth payment mechanism for many years, as well as countless legal opinions attesting to COFINA's property rights, multiple opinions rendered by the Commonwealth's own Department of Justice, year upon year of statements by Governors, Legislators, and Development Bank officials attesting to COFINA's rights the Commonwealth provided the following statement as part of its complaint filed with the bankruptcy court (Under Title III of PROMESA) on Sept. 8:

"This adversary proceeding is being commenced to resolve the Commonwealth-COFINA Dispute. As set forth, in this complaint, the SUT revenues, wherever located and whenever arising, are the exclusive property of the Commonwealth."

With 25 years of experience as a municipal bond analyst and portfolio manager, I have never witnessed such apparent disregard for property rights, existing statutes, and Constitutional law. Since July 2015, while remaining current on debt payments, the Commonwealth has increasingly made bondholders uneasy by their actions and inactions with regard to COFINA's rights and priorities. With this complaint, however, they essentially deny COFINA's existence altogether. Even in Title III bankruptcy, the Commonwealth's actions appear almost contemptuous of US Municipal Bankruptcy law as amended in 1988, which had the sole purpose of distinguishing between certain revenue bonds and general obligation (GO) debt. At least in this matter, it appears that promises, obligations, commitments, liens, contracts, and bargains carry little weight with the Commonwealth government.

The ramifications: Should the Commonwealth of Puerto Rico prevail, I foresee it setting a disastrous precedent.

- Access to the securitized loan market could be restricted for all borrowing municipalities. This would be most damaging to state and local borrowers with weak GO ratings. Over time, this may affect higher-rated issuers as well.
- Local governments and municipalities could be forced to choose between default and austerity.
- The ratings of some existing revenue bonds may see multiple downgrades.
- Future Puerto Rican bonds will necessitate a specific revenue pledge separate from their general fund. Oddly, this is the COFINA bond structure the Commonwealth is arguing against.
- Rating agencies will have the challenge of squaring up ratings among different securitized bonds.
- An alarming moral hazard would be created if interest rates (borrowing risk) are determined based on the political and judicial landscape – eschewing property rights and collateral.
- Bankruptcy will become a more popular option for politicians as an "easy" short-term solution to more difficult long-term problems.
- There could be a significant impact on the U.S. municipal market if the control board and the Commonwealth push through a Detroit-like bankruptcy result favoring pensioners over secured borrowers and other creditors with constitutional priority.
- If a borrower's ability to repay is in doubt, and complying with the law is optional, that borrower could be forced to pay higher interest rates, which could be a budget-busting proposition for financially fragile municipalities.
- Higher government borrowing costs may crowd-out the ability to provide and maintain essential services. This could lead to higher taxes or a reduction of services, resulting in a U.S. taxpayer bailout nonetheless.

The numbers: Consider the Virgin Islands Electric and Water Authority. In July 2017, it was shunned by “once burned, twice shy” municipal investors leery of a Puerto Rico-like restructuring, leaving officials no choice but to issue a three-year note paying 10.85% interest. Contrast this with Philadelphia Gas Works Authority, which issued three-year notes yielding 1.2%. That is an interest penalty spread of 9.65%. Applying this to half of Puerto Rico’s estimated outstanding debt of $60 billion equates to an annual financial impact of $3 billion.

The bottom line: I cannot begin to imagine the current struggles for the people of Puerto Rico. Without electricity, adequate shelter, and dependable water supplies, I am at a loss to relate to the challenges people on the island face today, and for the foreseeable future. Yet, I firmly believe that if debt relief is the action taken by the Commonwealth against COFINA, it will only hurt, not help, the territory as it emerges from this crisis. The ability to raise funds to deliver needed services is one of the most broadly essential functions a government can provide, and the cost of those funds affects all citizens.

All things considered, I’m an understanding holder of Puerto Rico general obligation debt, but I’m an angry COFINA bondholder.

Policymakers and the public must recognize that bonds are not all structured the same. Each bond has very separate and unique security features which need to be considered and respected, not just in the case of COFINA, but for the overall health of the municipal bond market. For if all bonds are treated the same, and politics trump property rights and the sound application of bond analysis, then the unintended consequences will be costly and far-reaching.

In closing, as a Chartered Financial Analyst and Certified Financial Planner®, I pride myself on taking a long-term view, doing extensive research, and adhering to a moderately conservative risk profile. My clients are accepting of lower returns in lieu of lower overall portfolio volatility — and like me, they are pleased to provide capital to state and local governments in need of infrastructure development. They are not vultures or unscrupulous speculators, and I take offense to the generalization by public officials and others who insist they are – and the last thing any of us expects is to be “wiped out.” Risk is certainly a part of this business, but my hope is that we will all look to the future and craft solutions that protect not only investors and borrowers, but also our fellow citizens of Puerto Rico who desperately require our help.

The Bond Buyer

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The views expressed in this article are the author’s own and do not in any way reflect the opinions of Spire Wealth Management. Mr. Ryhanych personally owns General Obligation, Highway & Transportation, and COFINA bonds issued by the Commonwealth of Puerto Rico.