Bond Case Briefs

Municipal Finance Law Since 1971

Treasury Plan for Puerto Rico Favors Pensions Over Bondholders.

WASHINGTON — If it's up to the Treasury Department, public employees in Puerto Rico who were promised pensions could be better off than investors who bought the island's bonds.

A broad plan being put forward by the Treasury Department to ease Puerto Rico's financial crisis would put pension payments to retirees ahead of payments to bondholders — a move that some experts fear could rattle the larger municipal bond market.

The proposal was being driven by evidence that Puerto Rico's pension system is nearly out of money, leaving retirees who are dependent on it financially vulnerable.

"The major problem is, the entire pension system is close to being depleted," said Antonio Weiss, counselor to Jacob J. Lew, the Treasury secretary. "But 330,000 people depend on it. It's unfunded, and they have to be protected."

Shielding retirees from pension cuts, the thinking goes, would not only protect thousands of older residents on the island, but it might also encourage younger retirees to stay there, rather than move to the United States mainland in search of new jobs and incomes.

Out-migration is considered a prime cause of Puerto Rico's financial tailspin, because it shrinks the island's economy, leaving fewer people and fewer dollars to support the crushing debt.

Puerto Rico is said to have about $72 billion of financial debt outstanding, most of it in the form of municipal bonds. By some estimates, it has incurred an additional $43 billion in unfunded pension obligations.

But deciding that pensioners' interests should be put above those of bondholders — if a choice must be made — is not without certain risks.

Some public-finance experts say they fear that if Puerto Rico can renege on promises to pay debts to investors, while sparing retirees, other municipalities might try to do the same, casting a pall over the larger market in municipal bonds, where American towns and cities have gone for decades to get the money they need to build roads, schools and other public works.

If Puerto Rico gets special treatment, "you have huge contagion risk to the entire municipal market," Andrew N. Rosenberg, a partner at the law firm Paul, Weiss, Rifkind, Wharton & Garrison, said at a recent gathering of creditor representatives.

Treasury officials said such concerns were unfounded. The framework they are proposing would be designed only for distressed United States territories, like Puerto Rico, and could not be used by states or municipalities on the mainland.

Officials pointed to a report by an investment firm, Nuveen Asset Management, which said, "We believe most institutional investors understand Puerto Rico's unique situation and the coming debt restructuring will not create widespread credit implications."

Still, moving public pensions to the top of the stack would infuriate at least some bondholders — especially those who paid close to face value for their bonds years ago, when they were still rated investment grade, and who had expected to hold them to maturity and get all their principal back.

Although the bondholders have often been portrayed as deep-pocketed vultures since Puerto Rico's debt crisis began, many of them are small investors, themselves trying to save for a comfortable retirement.

"Most Puerto Rican debt is held by individuals," said Thomas Moers Mayer, a lawyer representing two large mutual fund companies, Franklin Advisers and OppenheimerFunds, which together own about $10 billion in Puerto Rican debt securities. "They are mostly over 65, and they mostly have incomes of less than $100,000 a year. They are not vulture funds. They are your friends and neighbors."

Some Republican senators — notably Charles E. Grassley of Iowa and Orrin G. Hatch of Utah — whose constituents are among the bondholders, have expressed similar views. Puerto Rico's debt is unusually widely held because it offered above average yields and interest that was exempt from federal, state and local taxes, no matter where the buyer lived.

Treasury officials have said they are willing to work with Congress to find a suitable way of handling the different categories of creditors.

Financial help for Puerto Rico will be the subject of a hearing on Thursday by the House Committee on Natural Resources. Mr. Weiss is scheduled to be the sole witness.

Any rescue plan would need congressional approval and various committees in the House and Senate are weighing ways to help the island reduce its debt and better manage its economy.

Paul D. Ryan, the Republican speaker of the House, has set a deadline of March 30 for a House version of a bill. A version of Treasury's plan was outlined in a draft bill presented to a Senate committee; it has not been voted on.

The draft, obtained by The New York Times, also calls for a five-member "fiscal reform assistance council" appointed by the president to hold the island to meaningful budgeting, disclosure and fiscal reform practices. The board would have the power to make across-the-board budget cuts if necessary.

Members of Congress, especially Republicans, have expressed concern about whether Puerto Rico has the wherewithal to manage its future finances, even if it gets help in the short term. Credit markets have also been reluctant to invest further in Puerto Rico's bonds without some assurances that the island's finances will be better managed in the years to come.

The idea of an oversight board has rankled residents, however, who say it has overtones of colonialism.

The part of the proposal that gives priority to pensioners has received little attention. Currently, Puerto Rico's laws and Constitution give top priority to general-obligation bonds — the type backed by the government's "good faith, credit and taxing power."

Puerto Rico is not unique in this respect; for decades, the general-obligation bonds of all the states have been marketed as virtually default-proof, safe enough for widows and orphans. The concept was developed after the Civil War, as a way to rebuild investor trust after a number of notorious bond defaults.

Other bonds carry with them varying degrees of legal repayment security. Puerto Rico's debt is extraordinarily complex, but in general, its bonds can be ranked in a hierarchy of eight levels, with general-obligation bonds at the top. The ranking is described in an analysis of the debt by the Center for a New Economy, a nonpartisan research group in San Juan.

Public workers' pensions, the center found, fall on a second hierarchy altogether, which sets priorities for the government's operational disbursements. Here again, however, payments due on general-obligation bonds come first, followed by payments due on legally binding contracts. Outlays for pensions come third.

That means that under existing law in Puerto Rico, if there is not enough money to pay both general-obligation bonds and public retirees' pensions, the money would go to bondholders.

But the Treasury's proposed restructuring framework would change that. It would require that the restructuring plan "not unduly impair the claims of any class of pensioners."

General-obligation bondholders, on the other hand, would get such protection only "if feasible," according to the draft that outlined the plan.

This new legal framework is being created because Puerto Rico, as a United States territory, has no access to bankruptcy laws, where complicated claims by creditors can be worked out in a court under the supervision of a bankruptcy judge.

Puerto Rico has already defaulted on some of its bonds. More payments are due in May and June. Bonds are now nearly impossible to sell, and members of Congress, especially Democrats, as well as financial experts say the island's troubles will become increasingly enormous if some kind of restructuring framework is not approved soon.

THE NEW YORK TIMES

By MARY WILLIAMS WALSH

FEB. 24, 2016