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Puerto Rico Is Not Pompeii. But ...

There is a very unusual thing going on in the municipal market right now: People are losing money by the bucket, and soon they'll be losing money by the boatload. While regrettable, this is what happens when reality intrudes upon a fantasy.

Because Puerto Rico has defaulted, is defaulting and will default on some or all of the $70 billion in tax-exempt debt it has run up in the modern era as it borrowed to build stuff, and then to fill big holes in its budget.

Finally last June, Governor Alejandro Garcia Padilla declared on the front page of the New York Times that, "The debt is not payable."

What makes it so unusual is that this is the municipal market, where states and cities promise they'll do everything they can in order to repay the money they borrow, including selling the streets and (gasp!) raising taxes. Instead, the governor was saying, Game Over.

The defaults, the millions and soon billions of dollars in losses, and the governor's startling admission are a little like the eruption of Mount Vesuvius in the municipal market. Although only a little, because it's Puerto Rico — a territory, not a state. Had an actual U.S. state done this, the municipal market would be like Pompeii, buried under six feet of ash.

As it is, because it's Puerto Rico, very few people in finance really care about it except for muni analysts, a handful of municipal mutual funds (which hold at least $7.9 billion of the bonds), some hedge funds (which hold about $20 billion of the debt), and of course Puerto Ricans (who apparently hold about $20 billion, much of it in their retirement accounts).

The U.S. Congress is getting around to doing something about it, setting up a whole framework to put Puerto Rico "on the path to fiscal responsibility," according to Rep. Rob Bishop of Utah, who is chairman of the House Natural Resources Committee.

The main element in the proposal is to set up a Financial Control Board to make sure that Puerto Rico lives within its means and balances its budget. It will also balance the needs of bondholders and pensioners, said Bishop — and not along the lines of the Detroit model, either.

In Detroit, which filed for Chapter 9 bankruptcy in 2013, bondholders bore the brunt of creditor losses. Rep. Bishop said most restructuring in Puerto Rico would be "consensual."

That's a very defusing word. It was good to hear after so many months of listening to hedge funds and their mouthpieces talk about the constitutional guarantees on general obligation debt, and how anything less than 100 percent repayment would be unacceptable.

Now, normally, I would be in the strict constructionist camp in regard to general obligation debt. Meaning: Hey, you borrowed this; you have to do everything in your power to repay it. But.

The "but" is a combination of the island's feckless management and flagging economy, the arrogance of the hedge funds who have been the island's lenders of last resort, and Wall Street's own culpability in stuffing this Caribbean piñata full of bonded debt it couldn't afford. Puerto Rico is a very special case.

Let's begin with the economy. The island has been in a tailspin since a special tax break that made it worthwhile for manufacturers to set up shop there expired in 2006. That was the Crack of Doom. The tax break led the island's management to imagine it had a full-fledged, manufacturing-based economy instead of a more typical Caribbean economy based on tourism.

Then there are the municipal bonds. There's a publication put out by Moody's every year called State Debt Medians, and it's just the Best Thing, tracking states and how much they borrow by various measures.

Every year they would publish this report, and every year you'd see the list of 50 states and then way at the bottom, below the states and on a line all its own, would be Puerto Rico, "not included in any totals, averages, or median calculations but provided for comparison purposes only." And every year I would see the Puerto Rico figure grow.

I reported in a column in 2004 that Connecticut had the most tax-supported debt per capita at $3,558. And then I wrote, "The actual No. 1 borrower isn't a state at all. Puerto Rico has $5,758 in net tax-supported debt per capita. That's a little scary." I wish now I had done a little more with that.

Incidentally, the 2015 State Debt Medians report, which covers 2014, showed that Connecticut still had the most tax-supported debt per capita, at $5,491, and Puerto Rico's had grown to $15,637. In terms of net tax-supported debt as a percentage of gross domestic product, Hawaii topped the state list at 9.18 percent. Puerto Rico's was 53.85 percent.

Wall Street underwriters profited handsomely, making about $908 million on the island's bond sales since 2000, Bloomberg News estimated in March of 2014 after Puerto Rico sold $3.5 billion in general obligation bonds.

Finally, let's talk about the hedge funds.

Some of the hedge funds bought those $3.5 billion Hail Mary general obligation bonds in 2014, which carried an 8 percent tax-exempt coupon. This was sold to give the island "breathing room," it was said, to clean up its finances.

Some of the hedge funds bought Puerto Rico bonds from investors eager to sell as the island began its descent into the financial maelstrom. Those who bought at 70 or 80 cents on the dollar might still make money, depending on how those consensual negotiations go.

It's been interesting to hear these guys, on Twitter and elsewhere, discuss Puerto Rico. First they discounted the sheer staggering, insane amount of bonded debt that Puerto Rico had incurred, claiming that the $70 billion was just fine and utterly reasonable.

Then they said that Puerto Rico was somehow in much better shape than it let on, even after the governor declared that the debt was not payable. (Actually, we don't know the true financial condition of the island, because the last audit we have is from fiscal 2013).

Finally, the hedgies dug in their heels and said the debt they owned was legally guaranteed, and that they expected to be repaid at par. As I say, I respect this argument, and even might have embraced it at one point. But for a municipality in extremis like Puerto Rico, the legal niceties no longer apply.

And this is why people are losing money — lots of it — on their municipal bonds. Which is a very unusual thing.

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Bloomberg View

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