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The Puerto Rico Problem Is On Its Way to Getting Bigger.

This is a good moment for any US political figure to do or say something that will outrage a substantial number of people, even people with money. The noises the victims make will be drowned out by the sounds of the political conventions or retweeted mobile phone recordings of street violence.

So when hedge funds with several billion dollars of Puerto Rican government bonds filed a lawsuit on Thursday against the governor of the commonwealth, along with several subordinate officials, they had to know that it would not get much notice. Even many people on the fixed income buyside have a hard time caring about their hedge fund colleagues. After all, the Republicans in Congress voted to give Puerto Rico a pass with that last minute deal, didn't they?

Not exactly. The Republicans thought they were making a compromise to avoid having to appropriate money for Puerto Rico in an election year. Politically, screwing hedge funds, or for that matter, other investors is OK. Taxpayer bailouts, not OK.

Unfortunately for Congress, its Puerto Rican problem is on its way to getting bigger over the next few months, rather than going away. The outgoing Padilla administration, with the support of senior US Treasury officials, is setting a series of precedents for how to handle future defaults in the US municipal bond world.

To begin with, the usual narrative that "Puerto Rico stopped paying on its bonds in July" does not describe what actually happened. The commonwealth government had about $2bn in interest and principal due on July 1, and chose to pay about half of that, but not according to the various bond issues' relative seniority.

Instead, Puerto Rico did not pay any interest or principal on the most senior, or general obligation bonds, but did make interest payments on more junior bonds. The government also paid its employees' pension funds $170m more than what was required for this year, despite the pensions supposedly being legally subordinated to bondholders.

According to the Promesa legislation the Republicans passed through Congress, this was not supposed to happen. But it did. And Governor Padilla and his fellow officials were not acting in defiance of the US Treasury and the administration. Treasury officials were at his side, advising him. Even Republican senators and members of Congress have not voiced objections to this unilateral reordering of debt priorities.

The intention of the law was for Puerto Rico to be given temporary protection from legal sanctions by creditors so it could restructure its obligations in an orderly way, and to maintain essential services. That makes sense. Nobody wants children to go without immunisation shots or water mains to shut down.

There could, though, be some reasoned debate over the essentiality of some of the spending incorporated in the budget the commonwealth government adopted after July 1. The mayors of all 78 municipalities will reportedly continue to have dedicated police escorts. And there is $2.488m appropriated for the “Office of the First Lady”, who, along with her husband, will be leaving at the end of the year.

The last could be considered just a bad PR move, so to speak, on the part of a governor who will not be seeking a new elected office anytime soon . More significant, over the longer term, is the reordering of bonds’ relative seniority, and overriding bondholders’ previous ranking over pension obligations.

The bonds on which interest payments were made on July 1, such as the Puerto Rico convention center district and the Puerto Rico Highways and Transportation Authority, are disproportionately owned by bondholders on the island. Supposedly more-sophisticated mainland US investors had avoided these lower ranked issues on the misinformed premise that financial and legal analysis should outweigh political calculation.

Puerto Rican officials brush off objections to these spending priorities and to the inversion of the previous seniority ranking of the commonwealth’s bonds. They point out that the Federal Oversight Board, set up under the Promesa law, can take back any inappropriate payments made by the commonwealth after July 1.

There are a couple of problems with that “solution”. To begin with, the board’s powers of “review and rescission” cannot be exercised until after it is appointed by the president, sometime in September, if not later. Then the board members have to agree on staffing, procedure, and office decoration. So it is likely not many “rescissions” will be demanded by the board before the governor leaves at the year’s end.

Even then, it will be difficult to take back the flowers bought for the office of the First Lady, or recapture the gasoline bought for the mayors’ escorts. Getting back interest payments from the convention center bondholders would be a legal and administrative nightmare.

Commonwealth bondholders probably put too much faith in the supposedly autocratic powers of the board. Despite Puerto Rico’s colonial status, the board will find it difficult, if not impossible, to operate without the strong support of Governor Padilla’s successor. Otherwise, it will be preoccupied with endless lawsuits and intermediating fights with a resentful Congress.

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