Puerto Rico Hill Update – Muni Market Impacts
March 18, 2016

Action is Needed Now

Puerto Rico is in distress. It has begun defaulting on its debt, and it no longer has access to credit markets. Upcoming debt payments on May 1st threaten a worsening crisis. Health, education, and public safety services have been curtailed because the government cannot pay all of its bills. Hospitals are closing floors and people and businesses are leaving the Island. Congress must take action to assist the 3.5 million Americans living in Puerto Rico.

The Necessary Tools to Address the Crisis

The Administration has put forward a comprehensive proposal to help solve Puerto Rico's financial problems. The proposal includes a debt restructuring mechanism paired with fiscal oversight, healthcare transformation, and tax incentives to reward work and encourage economic growth. While we believe all elements of our plan are essential to Puerto Rico's recovery and long-term growth, Puerto Rico urgently needs federal legislation that pairs an orderly process to restructure all of its debts with strong, independent fiscal oversight. This combination has proven effective in responding to past financial crises, costs taxpayers nothing, and is a prerequisite to put Puerto Rico on a sustainable path forward.

Today's Update

Separating Fact from Fiction on Potential Municipal Market Impacts of Federal Action. Without action by Congress, Puerto Rico faces a cascading series of disorderly defaults and mounting litigation. Granting Puerto Rico access to territorial restructuring authorities would not have a negative impact on the broader municipal market. An orderly restructuring would ultimately facilitate reinvestment in Puerto Rico, not shut it off permanently from the capital markets, as others have charged. While Puerto Rico's credit challenges have not had an adverse effect on the broader municipal bond market thus far, a drawn-out and disorderly default in Puerto Rico could have consequences for the broader market. Moreover, market participants generally agree the best solution for markets and Puerto Rico is for Congress to provide the Commonwealth with access to an orderly restructuring regime.

Market Views on Ideal Outcome on Puerto Rico for Municipal Bond Markets

Traditional municipal investors want a quick and orderly end to the Puerto Rico crisis. Because the municipal market is dominated by retail investors sensitive to headline news, market professionals have told Treasury the best outcome for the broader municipal market – in addition to Puerto Rico – would be a quick and orderly resolution.

The worst outcome would be a series of cascading defaults and litigation, resulting in a disorderly process that continues to make negative headlines in the municipal market for the next five to ten years. In fact, the longer the crisis remains unresolved, the greater the risk other unforeseen market events, combined with a disorderly Puerto Rico default, will cause adverse spillover to the broader market.

Most traditional municipal market participants do not agree with assertions made by hedge funds that providing Puerto Rico with restructuring tools will adversely affect the market for high quality, municipal bonds. The overwhelming demand in the municipal market is for high quality, investment grade bonds.

Due to their below investment grade ratings, even though a large portion of the debt is still held by individuals, Puerto Rico bonds mostly trade among a select group of sophisticated institutional investors and hedge funds that historically have rarely participated in the municipal market.
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Nuveen Asset Management, which manages roughly $100 billion in municipal market assets, recently published a report that encapsulates the view of many traditional municipal market participants:

"We believe the final legislation must include a path for Puerto Rico to restructure these liabilities."

"The restructuring – painful as it may be – provides greater value to creditors than lobbying for maintaining the status quo."

"We believe most institutional investors understand Puerto Rico's unique situation, and the coming debt restructuring will not create widespread negative credit implications for other issuers."

"We don't see Puerto Rico creating contagion for the municipal market via investor reticence over purchasing securities from mainland states, other municipal issuers scrambling to seek debt relief or a general increase in municipal borrowing costs."

"Puerto Rico attempting to restructure its obligations won't encourage other states to do the same."

PIMCO, a leading global investment management firm, has also echoed Nuveen's assessment in a recent blog post and countered arguments against a restructuring as "myths":

"Myth 1: Restructuring Puerto Rico's general obligation (G.O.) debt will spill over to the broader municipal market. This risk is greatly exaggerated. Municipal investors understand Puerto Rico is an anomaly… Investors also understand that investing involves varying degrees of risk, including risk of default…"

"Myth 2: Restructuring Puerto Rico's G.O. debt could result in states requesting debt restructuring authority in the future. State access to a theoretical bankruptcy is a fantasy."

"Myth 3: Restructuring Puerto Rico's G.O. will lock out the Commonwealth from future market access. The municipal market has evolved and financial markets are forward-looking. Capital will return to Puerto Rico…"

Alliance Bernstein, another large buyer of municipal debt, wrote recently:

"In Puerto Rico's case, the debt load is clearly unsustainable…"

"In our view, both Puerto Rico and its creditors should support [restructuring and control board] legislation; better financial controls and economic policies should be part of the solution, too. The sooner these happen the better—for creditors and citizens alike…"

"Lawsuits would likely take years to resolve, creating more uncertainty, impeding economic recovery and accelerating Puerto Rico's debt spiral…"

Respected economists and journals have endorsed the Administration's proposal, including the American Enterprise Institute, Moody's Analytics, the Urban-Brookings Tax Policy Center, the Center for a New Economy, and the Wall Street Journal Editorial Board.

In Depth Discussion of Puerto Rico's Impact on Municipal Markets

Treasury and the National Economic Council share the assessment of a broad group of municipal market participants that restructuring for Puerto Rico would be a positive development for the broader markets.

First, extending territorial restructuring authorities to Puerto Rico will not lead to higher borrowing costs for states and municipalities:

There is limited evidence that the mere availability of restructuring authorities alone has a significant impact on the pricing of municipal debt. Rather, it is the perception of the risk of default that matters. Approximately half of the states currently permit their municipalities to access Chapter 9 for debt restructuring. If the availability of restructuring authorities alone were a signal to markets, there should be materially higher interest rates and insurance premiums for issuers in states that permit their municipalities to use Chapter 9, and market participants do not report such a trend. Moreover, monoline bond insurers have not historically charged a higher price for their insurance when they underwrite policies for municipalities that have access to Chapter 9 as opposed to the price charged for policies written for municipalities without such access.

Municipal markets clearly recognize Puerto Rico as a unique case. Compared to the broader municipal market, Puerto Rico is a true outlier in terms of its fiscal and economic challenges. Puerto Rico's debt-to-revenue ratio is over 33 percent, compared to a U.S. state median of 5 percent. Even Illinois and New Jersey, two of the lowest rated state credits, have debt-to-revenue ratios of around 10 percent. Similarly, Puerto Rico's public pensions, with an aggregate funded ratio of only 4 percent, have a lower funding than any state in the country by a multiple of ten. Additionally, Puerto Rico's depressed economy—measured in poverty, unemployment, household income, or economic output—remains far worse than that of any state, and it continues to deteriorate.

Enacted under Article IV, territorial restructuring authority would apply only to territories (like Puerto Rico), not states. States have an entirely different relationship with the federal government under the 10th Amendment. Furthermore, the strict federal oversight that is being proposed for territories as a condition of restructuring would likely deter states from seeking similar authorities.

Second, extending territorial restructuring authorities to Puerto Rico will not prevent it from accessing the municipal market once its credit fundamentals are restored:

Puerto Rico currently does not have market access. Puerto Rico has not had access to traditional municipal market investors for more than two and a half years. Its last bond offering in March 2014—$3.5 billion of general obligation bonds rated below investment grade—was overwhelmingly sold to hedge funds, not traditional municipal investors.

Puerto Rico can only regain market access at reasonable rates by stabilizing its economy and finances. The best path to achieving this is through an orderly restructuring process. If Puerto Rico defaults and has no access to an orderly restructuring regime, there will be a long period of unwinding through defaults and litigation, which would take many years to resolve. The municipal market differentiates among states and municipalities according to their individual credit fundamentals. Once Puerto Rico can demonstrate a clear path to sustainable debt levels, fiscal governance reforms and renewed economic growth, market capital investment will return.

Numerous U.S. cities regained market access after fiscal restructuring and oversight, including New York City, Washington, D.C., Cleveland and Philadelphia. Detroit, the largest recorded U.S. municipal bankruptcy ever, issued new debt at interest rates of less than five percent in September 2015, less than a year after emerging from bankruptcy. Debt investors understand restructuring can lead to better outcomes for all parties.

Third, while Puerto Rico's credit challenges have not had an adverse effect on the broader municipal bond market thus far, market participants generally agree that the best result for markets would be access for Puerto Rico to an orderly restructuring regime:

<u>Puerto Rico's crisis has not had an adverse effect on the municipal market</u>

Puerto Rico's bonds were downgraded to below-investment grade over two years ago. Over this long period, most traditional municipal market investors have significantly reduced or eliminated their exposures to Puerto Rico's debt – mutual funds decreased ownership from 25 percent of Puerto Rico's debt to only 15 percent today. At the same time, demand for municipal securities has remained strong. Over this period, municipal bonds have had the highest returns of any major financial asset class and the market has experienced more than 20 consecutive weeks of capital inflows to municipal bonds amounting to roughly $1-2 billion of new capital per month – a key metric watched by market professionals.

In fact, Puerto Rico's debt is isolated from that of the broader municipal market. The ten largest single-day price movements in Puerto Rico general obligation bond yields and Barclays' muni market index have no overlap. The rolling weekly correlation between the two over the past two years has been calculated at -0.06. Similarly, price movements between bonds of Puerto Rico and those of the few handful of lower rated issuers, such as Illinois, New Jersey, and Chicago, display little to no correlation.