ARIAS – US 2024 Spring Conference

General Session #4: Law, Economics and Risk in Puerto Rico

Brief Description of PROMESA and Status of the Restructuring of Puerto Rico Public Debt

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The Puerto Rico Oversight Management and Economic Stability Act (PROMESA)[1] was enacted during the summer of 2016 to provide Puerto Rico with a legal mechanism to restructure its public debt, which was necessary after the Government defaulted on the payment of part of its public debt, this after Puerto Rico went through a nine-year recession, from 2006 to 2015, when the public debt was declared unsustainable. The new regime established by PROMESA, including a stay of legal proceedings, provided the mechanism needed at the time, to deal with an extremely difficult financial situation, which was exacerbated after the devastation wreaked by two hurricanes in 2017, several earthquakes during 2019 and 2020, and finally the COVID-19 pandemic in 2020, events that shattered our economy.

On December 13, 2012, Puerto Rico received the first of several downgrades to its credit rating by *Moody's Investor Services,* about $38 billion in debt was downgraded with a negative outlook. The agency explained the reasons for its action as follows:

> The downgrade to Baa3 and the assignment of a negative outlook reflect four primary rating drivers:
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> Economic growth prospects remain weak after six years of recession and could be further dampened by the commonwealth's efforts to control spending and reform its retirement system, both of which are needed to stabilize the commonwealth's financial results. The lack of significant economic growth drivers and the commonwealth's declining population have also reduced prospects for a strong economic recovery.
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> Debt levels are very high and continue to grow.
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> Financial performance has been weak, including lackluster revenue growth and large structural budget gaps that have led to a persistent

[1] Puerto Rico Oversight, Management, and Economic Stability Act, Pub. L. No. 114-187, 130 Stat. 549 (2016).

> reliance on deficit financings and serial debt restructurings to support operations in recent years.
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> Lack of meaningful pension reform and no clear timetable to do so. Reform of the commonwealth's severely underfunded retirement systems is needed to avoid asset depletion and future budget pressure.

In summary, weak economy, high levels of debt, recurring budget deficits and high pension liability in the different pension systems of the Government were the factors for the downgrade. Many factors contributed to the deterioration of the Government's finances, among some of them:

- Repeal of Section 936 of the U.S. Internal Revenue Code - Year 2006 was the last year of the 10-year phase-out of Section 936, the federal tax incentive that attracted pharmaceuticals, medical device makers and other US manufacturers to the island. Since 1976, Section 936 provided significant tax advantages to US corporations that established manufacturing subsidiaries on the island. The Government of Puerto Rico also offered tax grants to reduce their Puerto Rico tax liability. In addition, if the earnings from Puerto Rico sources were deposited in local banks, no Puerto Rico withholding taxes would be imposed on dividends paid afterwards. This treatment, known as the 2(j) Income, provided vast liquidity to the Puerto Rico banking sector. As a result of Section 936, Puerto Rico developed a substantial manufacturing sector, with a sizeable number of manufacturing jobs as well as jobs in other sectors that provided goods and services to the manufacturing companies. The federal exemption from corporate taxes was one of the main drivers of industrialization and growth of Puerto Rico's economy, formerly based on agricultural production, mainly sugar cane. The elimination of Section 936 resulted in the loss of more than half of the manufacturing jobs, from around 160,000 to some 78,000. After 2006, Puerto Rico's economy shrunk nearly every year, and unemployment rates climbed as high as 12%.

- Continued Use of Deficit Financing to Cover Budget Deficits – For example, during fiscal years 2008-09 to 2012-13, approximately $9.1 billion of COFINA bonds, a long-term debt, was issued to maintain the operating expenses of the Government. Given the economic situation, Governments revenues continue decreasing and the Government used debt to fill in the gaps and continue running the Government.

- Debt Refinancing - The lack of sufficient resources to pay operating expenses and its debt service as contracted led the government to use debt refinancing to reduce the annual debt service. This practice consists of reducing the debt service by

> refinancing part of the debt with new bonds, by replacing the old debt with new debt, and lengthening the maturity of the bonds. This practice can be beneficial, for example, if debt with higher interest rates is replaced by debt with lower rates. The problem arises when the practice becomes necessary every year to configure and "balance" the budget in accordance with our Constitution. So, for several years, budgets did not include the total annual debt service payment as contracted, but rather a smaller amount was budgeted based on the expectation of a refinancing.

With this background, the Government faced a difficult fiscal situation where it was not able anymore to pay the debt service of its public debt while at the same time, run government operations to provide basic services, this while revenues were constantly falling. Before the approval of PROMESA, the government explored what options Puerto Rico had to file bankruptcy and restructure its debt. Chapter 9 of the Federal Bankruptcy Code, the regime that allows municipalities and public corporations to file bankruptcy, used to be applicable to Puerto Rico, but an obscure 1984 amendment eliminated its applicability to the island, removing its sole legal mechanism to file for bankruptcy. Curiously, the motive for this amendment has not been discovered in Congressional records.

After several congressional hearings on Chapter 9 and on the Government's finances,[2] discussions about providing Puerto Rico with a broader tool took place. The mechanism was dubbed the *Big Chapter 9,* under which restructuring the Commonwealth's debt would be allowed. Although initially the idea was positively received, there was reluctance to approve something seen as an advantage for Puerto Rico over the states. Within this context a bankruptcy regime applicable to the territories was devised, different from that applicable to the states, giving rise to the concept of the *Territorial Chapter 9*, which later developed into PROMESA.

PROMESA provided a better option for Puerto Rico. Chapter 9 allows municipalities and public corporations to file for bankruptcy, such as Detroit and Jefferson County, but not to the states. Thus, Chapter 9 would not have solved Puerto Rico's problems because only public corporations such as the Puerto Rico Electricity and Power Authority (PREPA) could legally avail themselves of it to file for bankruptcy protection. Chapter 9 could not provide the relief that the Government's finances needed, which included the debt of the Commonwealth of Puerto Rico and other issuers.

The approval of PROMESA brought uncertainty as to how its implementation would affect governmental processes in Puerto Rico, particularly those related to managing the finances of the

[2] https://www.finance.senate.gov/imo/media/doc/Melba%20Acosta-Febo%20U.S.%20Senate%20Testimony%209-29-2015%20(Final%20with%20exhibits).pdf (last visited July 1, 2023).

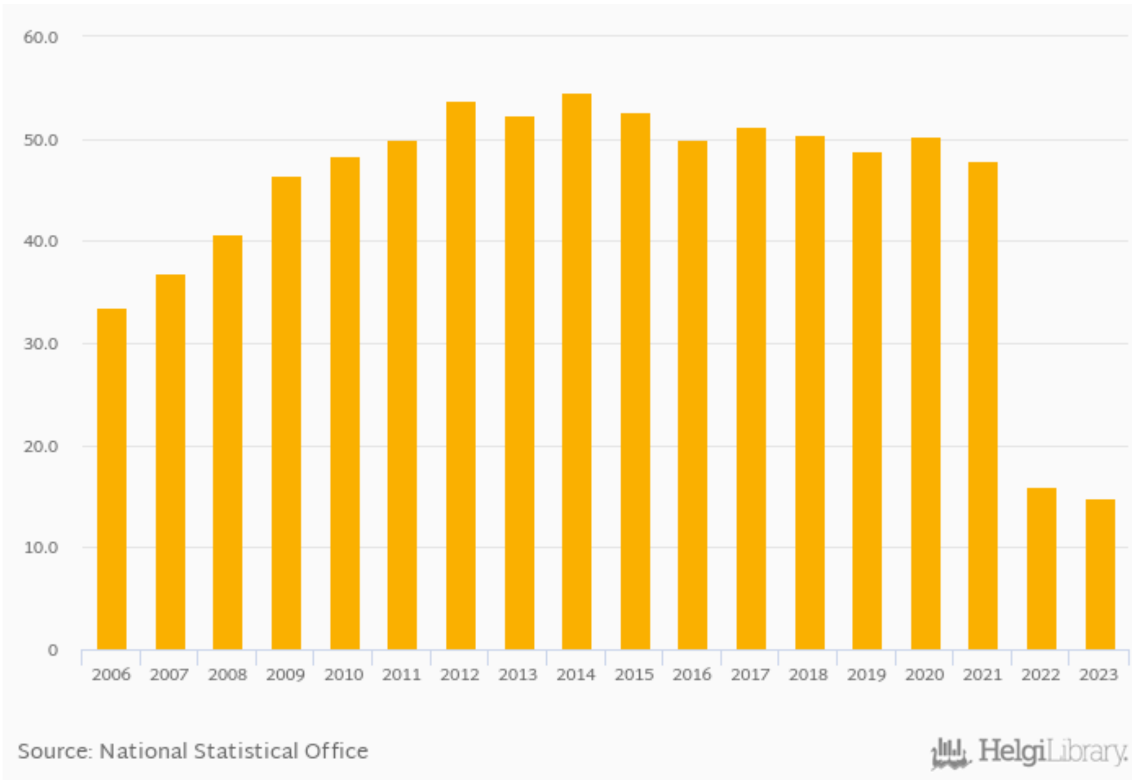
Commonwealth of Puerto Rico (Commonwealth). For one, the preparation of the budget would have to follow a certified fiscal plan for the first time, a step not considered in the Organic Law of the Office of Management and Budget, Act 147-1980, as amended. PROMESA became law after the US Supreme Court decisions in *Commonwealth of Puerto Rico v. Sanchez Valle* and *Commonwealth of Puerto Rico et al. v. Franklin Cal. Tax-Free Trust et al*., seminal cases that re-interpreted basic aspects of the relationship between Puerto Rico and the United States Congress in fiscal matters and criminal law, paving the way for PROMESA's approval and a new management regime of Puerto Rico's finances.

PROMESA brought the Financial Oversight and Management Board for Puerto Rico, (the Oversight Board), a new entity that is basically in charge of the finances of Puerto Rico, including the preparation of Fiscal Plans and the Budgets. The definitions of the powers and limits of the Board vs the Executive and the Legislative Branch were developed through judicial decisions in many lawsuits, with each party winning some and losing some. However, the main tool provided by PROMESA, the legal authority to restructure the public debt through a consensual process through its Chapter VI or a court administered process through its Chapter III, was crucial to restructure our debt to a sustainable amount.

As of March 2024, under PROMESA the Government has restructured the debt of most of its numerous debt issuers, among them, the Puerto Rico Sales Tax Financing Corporation (COFINA), the Government Development Bank for Puerto Rico (GDB or the Bank), the Commonwealth of Puerto Rico's General Obligation bonds (GOs), the Public Building Authority (PBA), the Employees of the Commonwealth Retirement System (ERS), and the Puerto Rico Highway and Transportation Authority (Highway Authority) as well as other debt guaranteed by the Commonwealth, and other issuers whose debt service was tied to the Government, including those whose revenues were "clawed-back" by the Government-- all in all, approximately 80% of its total debt. Still pending is the restructuring of the debt of the Puerto Rico Electric and Power Authority (PREPA, in the approximate amount of $8.3 billion). According to a report issued by the United States Government Accountability Office (GAO) to Congress dated June 2023 on the Public Debt Outlook for United States Territories, the restructuring of Puerto Rico's debt completed represents a 55% reduction, from $63.1 billion to $28.6 billion, and a reduction in debt service from 25% of revenue to 6.1 percent of revenues in 2022. The debt service is annually fixed on $1.15 billion through 2049.[3] Puerto Rico public debt, as a % of GDP, fell 7.27% to 14.8% in 2023.

[3] https://www.gao.gov/assets/gao-23-106045.pdf (last visited on July 1, 2023). The webpage of the Oversight Board reflects different amounts: a reduction of 57% from $71 billion to $31 billion (https://oversightboard.pr.gov/debt/, last visited on September 25, 2023).

Public Debt (As % of GDP) fell 7.27% to 14.8% in Puerto Rico in 2023
Public Debt (As % of GDP) (%), 2023[4]



In the immediate future, Puerto Rico will lack access to the municipal market to obtain financing, in part because of conditions imposed by PROMESA as well as certain conditions imposed by the Plan of Adjustment (PDA) that governs the restructured debt of the Commonwealth. Thus, during the next several years, the Government will have to rely on federal disaster recovery funds to develop and maintain its infrastructure. After Hurricane Maria, the Federal Emergency Management Agency (FEMA) estimated that it would invest approximately $50 billion in the reconstruction of Puerto Rico. In addition, the federal Department of Housing and Urban Development (HUD) allocated $20 billion for housing, infrastructure and other recovery and mitigation programs. The total of the two grants, over $70 billion, represents close to two and a half years of consolidated budgets of the Commonwealth and all its components. To this amount, we must add approximately $43 million that Puerto Rico received in financial aid due

[4] https://www.helgilibrary.com/charts/public-debt-as-of-gdp-fell-727-to-148-in-puerto-rico-in-2023

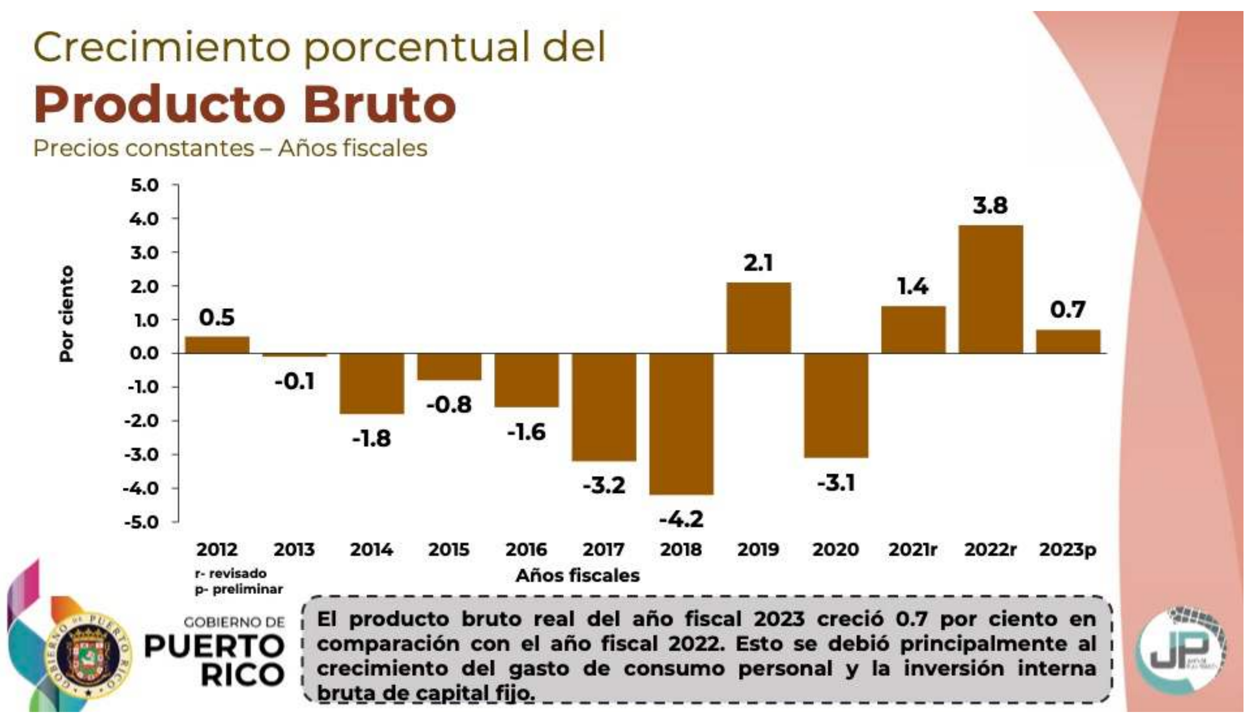
to the catastrophic effects of COVID 19 and additional disaster recovery funds that were received as a result of the damages caused by Hurricane Fiona during September of 2022.

Puerto Rico's financial and economic situation, with its new restructured debt, has been improving. Revenues have been increasing, according to a report issued by the Oversight Board:[5]

- General Fund revenue collections year-to-date (YTD) through the second quarter (Q2) of FY2024 were $540 million higher than the mid-year FY2024 forecast and $401 million higher than the same period in FY2023. This performance was driven primarily by strong collections of income taxes, sales and use taxes, and motor vehicle taxes.

- As of December 31, 2023, the Treasury Single Account (TSA), which is the Commonwealth's main operating account, had a balance mid-year of $8.9 billion.

The economy is also starting to show positive results, this after some difficult years with negative growth in our Gross National Product. Finally, the trend is reversing, as statistics of Puerto Rico's Planning Board for years 2021 to 2023 demonstrate: [6]



[5] https://drive.google.com/file/d/1pSFxOcb_gEq8xV1ga01v-wQZ-FbDbTrS/view

[6] https://jp.pr.gov/wp-content/uploads/2024/03/PRESENTACION-ECONOMIA-DE-PR-2023-2025.pdf

Puerto Rico has faced significant economic and fiscal challenges, including the severe recession that led the Government to file for bankruptcy under PROMESA in 2017. Puerto Rico's economy has been gradually recovering and the Government has recently emerged from bankruptcy. The economy is bouncing back, and as of mid-2022 private-sector employment was at a fifteen-year high. The medical manufacturing cluster remains a key part of the island's economy, although employment in this industry is still below its peak levels of 2005. Puerto Rico's tourism sector is still relatively small, but it has been one of the Commonwealth's strongest job creators in recent years. In addition, a fledgling aerospace industry has emerged around Aguadilla and Arecibo. We can consider that the Island is making progress in resolving and rebounding from its extensive fiscal crisis. Much still needs to be done.