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A Puerto Rico Bailout Could Impact Virginians

By Michael Thompson

Following in the tradition of sovereign entities that spend too much, grow government too large, and do not bring in enough revenue to balance it all out, Puerto Rico finds itself facing a grave and escalating debt crisis.

This American territory followed a familiar playbook to reach its day of financial reckoning. It failed to balance its budget for more than a decade and, over that time, it routinely increased government expenditure and regularly fell far short of its revenue projections. This is made even worse by an abysmal tax collection record, heavy out-migration to the US mainland, and a labor participation rate just over 40 percent. And it continued to borrow heavily to cover its deficit and avoid laying off government workers, who make up nearly a quarter of the work force.

Unlike other municipal debt catastrophes, however, Puerto Rico's debt crisis will have huge and important implications for the municipal lending market – and all of its stakeholders – across the United States and even right here in Virginia. Unlike Detroit, Puerto Rico is not a municipality but a territory – far more akin to a state than a city – and there are no existing rules for how Puerto Rico can resolve its debts. Unlike sovereign debt crises abroad, the island falls directly under the purview of the federal government, and the precedents set by Congress in addressing the crisis will have far reaching effects throughout Virginia and the broader United States.

What makes it all the more perplexing is that Virginia Congressman Rob Wittman helped to draft a bill that will unequivocally rattle the municipal market and leave Virginians, in part, footing the bill for Puerto Rico's financial mismanagement.

Wittman sits on the House Committee on Natural Resources, which has jurisdiction over US territories and recently released a "discussion draft" aimed at addressing this crisis. The bill allows a federally-appointed "Oversight Board" to authorize an ex post facto application of bankruptcy law to Puerto Rico, despite the fact that the island has been explicitly excluded from the bankruptcy code since 1984. This Oversight Board can exert much broader bankruptcy power over the island than is available to states: it not only can authorize Puerto Rico's municipalities to file for bankruptcy (as Michigan did for Detroit in 2013) but can also authorize the restructuring of Puerto Rico's own General Obligation debt, essentially allowing the island itself to declare bankruptcy.

This is a very significant precedent to set, because nearly every state, Virginia included, issues the same kind of low-interest General Obligation debt, backed by the "full faith and credit" of the state government. These bonds are a cheap financing tool for states because there is very little risk for investors – states cannot declare bankruptcy. Thus states cannot restructure under bankruptcy protection.

Allowing Puerto Rico the unprecedented power of abridging such debt will come at a direct cost to Virginia and all the other states that rely on the bond market for financing. Once the market sees that "full faith and credit" protections are faulty, borrowing costs will go up for states in accordance with the increased risk. In fact, several state governors have already registered their alarm to Congress on this point. Likewise, the value of funds holding this debt, which are found in 401Ks and other retirement nest eggs across Virginia and the rest of the country, will be severely shaken.

The draft bill could well have other unintended consequences for Virginians. It includes a legal "stay" mechanism, which blocks certain creditors from pursuing legal recourse against the Puerto Rican Government for missed payments for a period of 18 months.

Similar measures are often enacted by bankruptcy courts under Chapter 9, but the Puerto Rico version is unique in that it applies only to bondholders and there are no corresponding rules governing how this island territory will pay off other creditors. So over the course of the 18 month stay, the island can use its cash to pay off contractors, advisers, pension liabilities, and other creditors while withholding all payment from bondholders. Under this draft bill, Puerto Rico can use money that otherwise would have gone to Virginia retirees who invested in these "safe" bonds to pay off other obligations. Then when the 18 month period of the stay is over, it could turn around and tell the bondholders that their payments can't be made.

Now, it's worth noting that none of this is set in stone. The "discussion draft," by definition, is meant to be reworked as needed until the bill is marked-up later this month. Hopefully, by then, Congressman Wittman and the Natural Resources Committee will come to a solution that holds responsible parties accountable their financial mismanagement and does not come at a cost to blameless Virginians.

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