THE HILL

Puerto Rico: Is this any way to run an island?

By Arturo C. Porzecanski, May 29, 2014

As the Obama administration and leading figures in Congress weigh options to address the fiscal calamity in Puerto Rico, they are surely mindful of the need to avoid what could yet become a debt crisis that would make Detroit's fiscal woes look like mere child's play.

Indeed, recent events on the island suggest that the time has come for the president's Task Force on Puerto Rico to advise the Commonwealth on how to navigate the current difficulties without making matters worse.

The Commonwealth's direct liabilities are on the order of $70 billion, versus less than $10 billion in Detroit's case. Despite a much heavier debt burden, Puerto Rico's taxable base has eroded a great deal more: since 2006, the island has lost 275,000 jobs, or one-fifth of total, while the Detroit metro area has lost 100,000 jobs, or one-eighth of total. In Puerto Rico, the unemployment rate exceeds 14 percent, whereas in Detroit it has already subsided below 10 percent.

And whereas Detroit can avail itself of a Chapter 9 bankruptcy process, and obtain debt forgiveness from its creditors through an orderly procedure – as it is doing – Puerto Rico is a United States territory treated largely as a state, and thus the U.S. Bankruptcy Code is not applicable. This means that the Commonwealth has no established way to bind creditors to any sort of debt-reduction proposal that might address its heavy liabilities. It must keep raising taxes and cutting government spending to generate the cash needed to service its obligations – unless, of course, it were to do the unthinkable and disavow them.

Last February the authorities in San Juan were almost overwhelmed when all three of the leading credit-rating agencies decided to downgrade Puerto Rico's bonds to "junk" status. This move shut the Commonwealth's access to pension funds and other institutional investors, because they are limited to purchasing investment-grade bonds. Since that time, Puerto Rico has gained some breathing time by managing to place $3.5 billion of new debt mostly with risk-prone hedge funds, though at the cost of locking in a high coupon rate of 8 percent.

The new dark cloud on the island’s horizon is the potential for a banking crisis. Banks in Puerto Rico have been weighed down for several years now by bad loans, pressure on their margins, intense competition, excessive reliance on wholesale funding, and lately the economic consequences of the government’s austerity measures. In recognition of their vulnerabilities, most of the banks are graded very low by the credit-rating agencies.

Recently, the industry’s outlook took a turn for the worse by a surprise decision on the government’s part to disavow a major tax refund that was supposed to be paid to Doral Bank, one of the island’s largest lenders with assets of $8.5 billion and branches also in New York City and Florida. Doral and Puerto Rico’s Treasury Department had subscribed agreements on these tax receivables on six separate occasions during the past decade, with the latest binding commitment dated March 2012. Since the expected tax refund was part of Doral’s capital base, the news of its cancellation was followed by a swift reaction: Doral’s shares tanked, its ratings were slashed to near-default levels, and the FDIC and Federal Reserve imposed stringent operating restrictions on the bank.

Why would the island’s government default on a lawful obligation, thereby possibly pushing one of its leading banks into insolvency? The most likely explanation is that, given its own delicate financial position, the government does not wish to part with the $230 million long owed to Doral.

In recent weeks, the government has also introduced bills in the island’s legislature that would raid the insurance fund (COSSEC) set up by cooperative banks, in order to use that capital for fiscal purposes.

Governor Alejandro García Padilla is increasingly acting in a penny-wise, pound-foolish manner. The lesson of ample international experience is that when banks teeter and possibly fail, confidence often vanishes and economic conditions quickly get worse. Therefore, no measures should be taken to weaken the island’s already fragile financial system.

http://thehill.com/blogs/congress-blog/economy-budget/207436-puerto-rico-is-this-any-way-to-run-an-island#ixzz3383pDt2m