

August, 2017

PUERTO RICO UPDATE

On May 30-2017, the US District Court for the District of Puerto Rico ordered that all future payments of principal and interest on debt be suspended. The Court ordered that all outstanding payments be held, where funds are available, in their existing accounts until a final order is made by the Court directing the time and manner (principal, interest and nature of likely haircuts) of final post default payments. It is yet to be determined whether these post default payments will be in the form of principal, interest, and or possible haircuts.

The Court appointed trustee has the responsibility to determine which category of investors should be paid first. However there is currently a dispute between the court appointed trustee and the bond holders regarding who should be paid in preference to others. Additionally, some investors are contending whether an event of default is applicable to the class of bonds they hold.

In order to apply a structured approach to the default process, the Court has stayed all claims/interest and principal payments pending a further court order. All parties claiming a right to disputed funds are required to assert their rights in court proceedings.

WHAT HAS HAPPENED TO THE LAW & OVERSIGHT BODY PUT IN PLACE BY PRESIDENT OBAMA?

Former US president Barack Obama signed into law, on June 30th, 2016, the Puerto Rico Oversight, Management and Economic Stability Act, or **PROMESA**. The legislation protects Puerto Rico from being sued by creditors, by allowing the country to seek bankruptcy protection from the Federal Courts. The act also forced Puerto Rico to accept strict oversight by a Financial Control Board (**FCB**), that had the power to place restrictions on Puerto Rico's day to day affairs and fiscal spending patterns. Puerto Rico, guided by the FCB, was to put forward a credible restructuring plan which would include any proposed principal and or interest haircut on the debt.

Despite the provisions under the act and the powers of the FCB, the FCB and the Puerto Rican Government failed to negotiate and restructure most of the debt via an out-of-court process.

As a result of this breakdown, the FCB has resorted to Title III of the PROMESA. Title III is a form of court supervised bankruptcy process used as a last resort to restructure the debt.

The bankruptcy proceedings began in mid-May with a US District Judge responsible for proceedings, to restructure at least US\$120 billion in debt and pension obligations. The judge is tasked with working with bondholders to reconcile their repayment issues. The judge will effectively decide the likely interest, and/or principal haircut bondholders will take and simultaneously the burden/sacrifice that the people of Puerto Rico will have to bear.

HOW LONG WILL THE PROCESS TAKE?

It is difficult to place a definitive timeline on the process at this stage. Recall that Puerto Rico has a massive debt burden spread across government, public sector and quasi-public sector bodies. Further challenges will emanate from the structure of the debt issued and the specific bond covenants. As noted earlier, some debt-holders are of the view that based on what they purchased, their bonds are technically not in default. There are also issues with regard to which bonds are to be held subordinated or in higher/lower rank of payment compared to other bonds.

A comparison may however be drawn with Detroit's bankruptcy in 2013. Both cases saw an unelected authority unsuccessfully attempt to negotiate a haircut, Detroit was sued by creditors and eventually declared bankruptcy. It has been noted however

that Puerto Rico's debt is larger in size and is more complex. **Detroit was able to receive a ruling in an "exceptionally quick" 17 months but it is projected that Puerto Rico should take longer.**

SOME IMPORTANT CONSIDERATIONS

(I) The judge will have to balance the need to repay investors with the capacity of Puerto Rico to pay. In 2015 when the pressure finally became unbearable and an assessment was made, **it was noted that the country would have to make US\$5.3 billion per annum in debt service payments over the next decade. This represents about 60% of the 2017 fiscal year budget.** For comparative purposes and simplicity, Jamaica's debt servicing represents approximately 40.0% of the budget.

(a) **The Puerto Rican economy has contracted by approximately 1.5% per year over the last decade.** In 2006, Section 936 of the U.S. tax code was eliminated; this effectively meant that U.S. firms could no longer relocate the income generated by subsidiaries in Puerto Rico as tax-free dividends. This led to US firms moving jobs overseas and effectively contracting the Puerto Rican economy. Hence Puerto Rico's capacity to pay is weak.

(II) Average income in Puerto Rico is only a third of that of the rest of the United States and more than 50% of the families are below the poverty level. Puerto Rico's total debt is

approximately US\$123 billion; with a population of 3.5 million. This represents a debt load of about US\$34,000 per person.

- (a) Consequently, placing an onerous or overly burdensome repayment package on the people of Puerto Rico will likely result in another default process in a few years which the judge will likely wish to avoid.
- (III) Some of the current creditors who are pushing their interest in litigation are not the original bondholders. **It has been posited that hedge funds, including so-called “vulture funds” own in excess of 50% of Puerto Rico’s outstanding debt.** This debt was purchased at significant discounts in the secondary market with the intention of realizing a significant profit on recovery.
- (IV) Other bondholders must admit that they knew the risk of investing in non-investment grade/“junk bonds”. Non-investment grade assets are by definition considered to be speculative in nature.

CONCLUSION

While a judge will undoubtedly bear in mind that Puerto Rico broke a contractual agreement when they defaulted, their capacity to pay will likely be the overarching issue. Placing an onerous repayment burden on the debtor could force the country back

into default in a few years. It should also be borne in mind that the economy has contracted by an average of 1.5% per year for the last decade. Hence there is not much wealth to distribute in the form of debt repayments.

President Trump and some Republicans have been adamant that there should be no bailout/relief for Puerto Rico. **Further, there are no plans to reenact Section 936 of the U.S. tax code which would effectively reignite business interest in Puerto Rico as a tax haven.** Recall also that Puerto Rico is a commonwealth of the US and consequently persons born in Puerto Rico are natural born citizens of the United States. This means that they could easily migrate to the mainland to seek jobs if the repayment terms are too burdensome; effectively abandoning Puerto Rico and leaving no tax revenues for government coffers and consequently no money to repay the debt.

At this time we see the possibility of a significant haircut; by this we mean in a worst case scenario—20 to 30 percent of principal, a cut in interest and a possible extension of maturities to give further breathing room. We will continue to provide updates as the situation develops.

THE NEXT STEPS

We are currently seeking legal advice to provide guidance on the next steps. We are committed to updating you, once information becomes available.

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