The New York Times | https://nyti.ms/2pPXdOp

DealBook WITH FOUNDER ANDREW ROSS SORKIN

Puerto Rico: A Debt Problem That Kept Boiling Over

By MARY WILLIAMS WALSH MAY 5, 2017

It all goes back to 1917.

Congress passed a law that year making Puerto Ricans United States citizens. That same law, still on the books today, empowered the island to raise money by issuing tax-exempt bonds.

And not just federally tax-exempt bonds: Congress went on at length to bar anyone from taxing Puerto Rico's bonds, presumably never dreaming how this would play out a century later — which, on Wednesday, led to the territory declaring a form of bankruptcy because it could not pay the $123 billion in bonds and unpaid pension debts it owes.

The 100-year-old law stipulates that no one — not any state, not any county or city, not the District of Columbia, not any other territories, not even Puerto Rico itself — can tax the interest that Puerto Rico pays its investors. This has spurred people with eyes on easy profits to dive in for decades.

And, until last year, the investors taking the plunge had an easy guarantee: States and territories are not allowed to declare bankruptcy.

7
ARTICLES REMAINING

Save 30% for one year on your choice of subscription.

territories that want to shield themselves from creditors. Puerto Rico did this on Wednesday.

Now the small Caribbean island — home to some 3.5 million people, many of whom still feel the sting of the annexation of their ancestors' lands in 1898 — owes approximately $34,000 in debt per man, woman and child. Their school budgets and other services are all being cut as part of the austerity planning.

How did things get this bad?

As some Americans have grown increasingly tax-averse and eager to shelter income, that 100-year-old provision helped successive Puerto Rican governments build up a debt big enough to crush the island.

As the problem swelled, so, too, did the exodus of the educated classes from the island. Many tipping points were reached and reached again.

On Friday, Chief Justice John G. Roberts assigned Puerto Rico's case to Judge Laura Taylor Swain, a federal judge in the Southern District of New York and a former bankruptcy judge. The logistics of the case, which was filed in federal court in San Juan, are not yet clear.

Judge Swain has shown extensive familiarity with bankruptcy law, but the case is still expected to be long and contentious, with hedge funds arguing that Puerto Rico is violating a sacred constitutional pledge, unions clamoring to preserve labor contracts and some of the island's advocates saying that certain bonds should be declared void.

Many creditors are targeting Puerto Rico's federal oversight board, which has limited the amount available for debt service to $800 million a year for the next five years. They say this amount is absurdly low, relative to the roughly $3.5 billion a year coming due.

The debt train moved slowly until the outbreak of the Cold War, when the United States saw value in building up Puerto Rico as a showcase of how democracy

7
ARTICLES REMAINING

Save 30% for one year on your choice of subscription.

Money began to pour in for public housing and better infrastructure, and in 1952 Puerto Rico got its own constitution, which contained an unusual provision meant to reassure prospective bond buyers. It said, in essence, that if there was not enough money to pay for everything in the budget, then "all available resources" would go first to pay what was due on Puerto Rico's general-obligation bonds.

Today this constitutional guarantee — and what it means under Promesa, the law approved by Congress to organize Puerto Rico's affairs — looms as one of the major issues Judge Swain will have to decide.

Angry investors say that they bought the bonds with the constitutional guarantee, and that Promesa does not give Puerto Rico the right to suspend its own constitution.

Governor Ricardo Rosselló and his predecessor, Alejandro García Padilla, have both taken the view that in light of the crisis, they had to put the essential needs of the Puerto Rican people first.

Back in the postwar development boom, the constitutional provision made Puerto Rico's bonds an easier sale, and an attractive business for banks that help governments bring their bonds to market. Those banks came to the island, eager to take advantage of growth opportunities and to build relationships with Puerto Rico's Government Development Bank.

For decades, the appetite for Puerto Rico's tax-exempt, constitutionally guaranteed debt seemed endless. Demand for debt was fueled by the upward creep of tax rates on the mainland and, in the 1970s, the advent of single-state tax-exempt bond mutual funds.

Such mutual funds were popular in higher-tax states like New York, but not all states issued enough debt to make the funds possible — at least until fund managers remembered that Puerto Rico's were tax-exempt everywhere. Those bonds could be tucked into a fund's portfolio to boost the overall yield without jeopardizing the tax exemption.

7
ARTICLES REMAINING

Save 30% for one year on your choice of subscription.

The yields were higher because Puerto Rico's debt carried more risk, but that did not faze investors who wanted tax-exempt income — especially considering the constitutional guarantee.

After bankruptcy scares in New York City and Cleveland in the 1970s, Congress set about making amendments to the part of the bankruptcy law that cities and counties use, Chapter 9.

In 1984, an unknown person added a provision to federal law explicitly barring Puerto Rico, as well as the District of Columbia, from taking shelter from creditors in Chapter 9.

Almost no one paid attention until 30 years later, when Puerto Rico began to sound the alarm about a possible need for bankruptcy access, resulting in a fight that ultimately went to the United States Supreme Court, which ruled that Puerto Rico could not seek Chapter 9 bankruptcy access.

Melba Acosta Febo, the head of the Government Development Bank until it closed, said the problems began in earnest when Puerto Rico started borrowing to balance its budget.

This might have gone unnoticed too, because Puerto Rico's government structure, as well as its debt, is complex. But Ms. Acosta said that during the time she served as budget director, from 2001 to 2004, her staff realized that the development bank had $4 billion of loans outstanding to various branches of government that it was propping up.

"We were like, '$4 billion? Oh my God!'" Ms. Acosta recalled.

Puerto Rico was soon borrowing every year just to balance its budget, and taking on new debt to keep up with the payments on its old debt.

After the crash of 2008, when the Federal Reserve ushered in a long period of low interest rates, Puerto Rico's bonds grew even more desirable: Savers were desperate for yield, and Puerto Rican debt, supposedly supersafe, was now paying a

7
ARTICLES REMAINING

Save 30% for one year on your choice of subscription.

Puerto Rico came close to hitting a constitutional limit on its capacity to issue general-obligation bonds, but it still needed more money. So in 2006 officials began to issue a new type of bonds, called Cofinas, which were backed by a dedicated sales tax.

Yet Puerto Rico still needed more cash. In 2014, it issued one last, big batch of general-obligation bonds, some of it to make payments on older bonds. Puerto Rico's credit had been downgraded to junk, and the mutual funds and other conventional bond-buyers were finally worried. The only takers were hedge funds.

About a year later, Governor García Padilla announced that Puerto Rico had more debt than it could repay and needed a moratorium.

Now, no one will lend to Puerto Rico and everyone with a stake in the island's future is feuding. Repealing that 1917 law that made it so easy for the island to borrow might seem like a solution, but no one has suggested doing so, at least no one in a position to make it happen.

The U.S. Virgin Islands, another territory whose bonds no one can tax, has also run into serious trouble. It is struggling to make its own government payroll and has lost normal access to the capital markets. It has only $2.3 billion of bond debt outstanding — a fraction of Puerto Rico's burden — but that is still $23,000 in debt for every person on the island.

Correction: May 6, 2017

An earlier version of this article misstated the breakdown of the U.S. Virgin Islands' outstanding bond debt in terms of the amount it would equal to for every person on the island. It is $23,000, not $100,000.

A version of this article appears in print on May 6, 2017, on Page B5 of the New York edition with the headline: Even as Puerto Rico Was Buckling Under Debt, Investors Hungered for More.

© 2017 The New York Times Company

7
ARTICLES REMAINING

Save 30% for one year on your choice of subscription.