Case Study

How a government struggling with debt navigated towards a brighter future

(PART 1)

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EY professionals helped Puerto Rico exit bankruptcy and created a solid foundation for future economic growth and opportunity.

1. BETTER QUESTION

☐ The better the question

How can a government bounce back from insolvency?

Struggling with debt, Puerto Rico's government needed a comprehensive plan to reduce its liabilities and restore economic prosperity.

"It was clear that Puerto Rico was in deep financial distress," says David Skeel, Chairman of the Oversight Board appointed to help the Commonwealth get back on track. "It wasn't just one area... It had too much debt. The government was too big. The government was inefficient, and it was just clear that everybody, across the board, had to sacrifice to get things back on track."

By the time the Commonwealth of Puerto Rico filed for bankruptcy in 2017, the island was struggling under a complex web of US$70 billion in debt issued by more than a dozen government entities and had virtually no money set aside to fund its US$55 billion pension liability.

A combination of complex factors over many decades – changes to the federal tax code, international trade agreements, the global financial crisis, and the loss of Puerto Rico's financial competitiveness in critical sectors – diminished the island's prospects for economic growth and led to structural shortfalls that evolved into a fiscal and economic crisis.

Persistent deficits and unsustainable borrowing left Puerto Rico's government without sufficient funds to pay its debts, honor its pension obligations to public workers, and adequately fund crucial public services. By 2017, government cash holdings declined to as little as US$15 million for an island with a US$28 billion consolidated budget and 3.3 million residents.

The limited cash on hand also created a crisis that caused the government to freeze public employee wages, raise taxes, underfund the retirement systems, cut supplies and other provisions to schools and hospitals, and defer maintenance on energy and water systems.

The fiscal distress also sparked the largest wave of outmigration in Puerto Rico's history, as residents fled the island in search of better opportunities. By 2016, Puerto Rico's population had declined by more than 10%, one of the largest population declines from a US state, territory, or municipality in the last 100 years.

Further complicating matters, Puerto Rico lacked a comprehensive legal framework to restructure its debts and bind dissenting parties if a payment default occurred. Without federal action, the outcome was expected to be complex, disorderly, contentious and protracted – both among competing creditor classes and against the Commonwealth.

As a result, in the Summer of 2016, the US Congress negotiated and passed federal legislation: the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA). This legislation established a Financial Oversight and Management Board, a comprehensive process for restructuring Puerto Rico's debt and expedited procedures for approving critical infrastructure projects. Puerto Rico filed for bankruptcy protection under Title III of the new law shortly after that, in May 2017.

"A sovereign debt restructuring is much less regulated," says Natalie Jaresko, the Oversight Board's Executive Director. "It's not in a courtroom. And so here we were facing what became this enormous task with so many different issuers, with so many different elements of claims within the plan."

The long road to restructuring

From the outset, any successful financial restructuring plan would require balancing legal obligations to the island's many creditors against the health, safety, and financial well-being of the families living and working in Puerto Rico.

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> **Gaurav Malhotra**
> EY Americas Reshaping Results & EY US Restructuring Leader

It would take thoughtful and lengthy negotiations, as well as considerable restructuring, labor, pension, and fiscal policy expertise, to design a workable restructuring plan that would receive the support from a majority of stakeholders and be considered as feasible by the US Federal judge overseeing the bankruptcy process.

"It's not just a group of creditors or two groups of creditors or three groups of creditors," says Jaresko. "It's also the discussions that we had with other stakeholders, including public unions, retirees, unsecured creditors, as we needed them to be a part of it."

Starting in 2017, the Oversight Board led negotiations for one of the largest restructurings in the history of the municipal bond market. The seven-member board, appointed by the President of the United States, worked alongside federal and local government officials and skilled advisors, including EY, to design a comprehensive restructuring plan that would create the necessary foundation for economic growth and restore opportunity to the people of Puerto Rico.

Despite the monumental challenge, the EY team helped its client, the Oversight Board, and the Oversight Board's other advisors navigate the unprecedented, complicated and at times heated restructuring negotiations. These included multiple financial creditors that held competing interests, including labor organizations, retirees, unsecured creditors, dozens of government agencies and instrumentalities, and federal and local government officials.

"This is something that goes beyond restructuring a balance sheet," says Gaurav Malhotra, EY Americas Reshaping Results & EY US Restructuring Leader. "What Puerto Rico needed was a plan to reduce debts to a sustainable level, ensure adequate investment in the people and resources the economy needs, and create a viable path forward for economic growth, opportunity, and hope. It was really about creating a balanced approach the Puerto Rican people could depend on and a future they could look forward to." ■

(CONTINUED IN NEXT EDITION)

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