



**ISAAC SARPONG:** Isaac is the Partner in charge of Tax Services. He has over 26 years' experience in the provision of multi-faceted advice to both local and international clients in taxation, accountancy, audit & assurance, and corporate law, among others. Isaac is a Chartered Accountant, a Chartered Tax Practitioner and a Lawyer.



## 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.

“It was really about creating a balanced approach the Puerto Rican people could depend on and a future they could look forward to.”

**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)

### RESTRUCTURING AND TURNAROUND STRATEGY

The COVID-19 pandemic will require many governments to significantly reshape their finances and economies. Strategic change focusing on financial and economic restructuring or turnaround must be implemented with speed and certainty. We provide trusted leadership in critical and complex situations to transform, create, preserve and recover value.

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#### About EY

EY is a global leader in assurance, tax, strategy and transaction and consultancy services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, clients and for our communities.

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(CONTINUED FROM PREVIOUS EDITION)

### 2. BETTER ANSWER

□ The better the answer

## Multidisciplinary, multilingual teams helped build a holistic plan

A team of specialists helped guide the island's massive public debt restructuring through complex, interconnected challenges.

Starting in 2017, the EY-Parthenon Government & Public Sector Turnaround and Restructuring Strategy Services team, led by Malhotra, Adam Chepenik and Juan Santambrogio, worked with the Oversight Board and the Oversight Board's other advisors at the earliest stages of the negotiations and planning to resolve the most complex public debt restructuring in the history of the US municipal bond market.

Several strategic priorities governed how the Oversight Board approached the restructuring process, including:

- ▶ The creation of a long-term plan, feasible over 30 years
- ▶ The importance of the human impact of a public sector restructuring
- ▶ The creation of an environment for long-term economic growth
- ▶ Investment in the health, safety and education of residents
- ▶ Safeguards to make the government and its finances more resilient to absorb future shocks

Given the multifaceted expertise required to address those priorities, the EY team quickly marshalled a broad, multidisciplinary and multilingual team of professionals from across the firm, and the globe to advise the Oversight Board on the best strategy to handle the many challenges ahead for the island. The team included EY professionals in pensions, actuarial analysis, economic forecasting, education policy, governmental budgeting, forensic accounting, international tax, public policy, disaster management, infrastructure and human resources.

**The Oversight Board, working with its advisors, including EY, started by developing and certifying a multi-year financial plan. Among other things, this plan established an ambitious set of fiscal and structural reforms, adequately funded pensions, and forecasted surplus levels available for creditor negotiations.**

After completing a draft of the financial plan, the team worked to enhance transparency in a historically opaque annual budgeting process and identified the government's cash resources accumulating in more than 2,000 bank accounts. Those efforts equipped the Oversight Board with adequate data to target spending and investment in the areas that needed it the most and to understand the magnitude of cash resources available to the government. The data also informed subsequent debt negotiations.

The devastating effects of the twin hurricanes Irma and Maria, which struck the island in September 2017, the 2019-2020 earthquakes, and the outbreak of the COVID-19 pandemic required multiple revisions to the original forecasts. Working collaboratively, the Oversight Board and its advisors, including EY and Puerto Rico's fiscal entities – the Department of Treasury, Office of Management and Budget, and the Fiscal Agency and Financial Advisory Authority – as well as many other stakeholders, refreshed the multi-year financial plans to better reflect reality and new information.

### Targeting investments on long-term value

The success of the plan hinged on having transparency into the financials of all government functions and agencies, so facts were clear and a deal could be successfully reached. EY teams advised the Oversight Board on the development of many critical building blocks to the restructuring plan. They offered recommendations for a multitude of reforms to enhance fiscal transparency, improve Environmental Social and Governance (ESG) management, and maintain a sustainable outcome for the government and people of Puerto Rico.

"Restoring structural balance and growth required the Oversight Board to integrate all elements of the proposed reform plan, including the financial and cash forecasts, the fiscal and structural reform impacts, the debt restructuring terms, and most importantly, identifying and minimizing any harm to the future of Puerto Rico's residents," says Adam Chepenik, Principal for EY-Parthenon Government & Public Sector Turnaround and Restructuring Strategy Services, Ernst & Young LLP.

Many operational reforms at the agency level were also required to establish transparency and trust that the changes proposed would be enacted. For instance, before the restructuring plan, budgetary spending included widespread use of prior year appropriations to fund new expenditures, even when cash to fund those expenditures was not available. The Oversight Board worked closely with its staff and advisors, including EY, to improve transparency in the budgetary process and solidify budgetary controls.

EY teams also helped advise the Oversight Board and several government agencies on ways to improve the strategic delivery of their services. For instance, the Oversight Board and EY teams worked collaboratively with the Puerto Rico Department of Education leadership team to develop a strategic transformation plan that would improve learning outcomes, streamline purchasing and procurement, increase capital spending investments, and improve pay for the system's educators.

Similarly, the Oversight Board, supported by EY teams, worked closely with the leadership team in Puerto Rico's Department of Economic Development to recommend improvements to the administrative structure for the island's tax incentive regulations. The Oversight Board and EY teams also catalogued and inventoried thousands of real estate and landholdings for more than 20 government agencies. This provided a comprehensive view of critical assets the government could hold, develop and, if desired, divest. Previously, Puerto Rico's government lacked a strategic view of government real estate and land holdings. ■

(CONTINUED IN NEXT EDITION)

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# How a government struggling with debt navigated towards a brighter future

(PART 3)



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"The fiscal controls and enhanced budget process now contain a level of detail and transparency to clearly show taxpayers how their government spends their money, as well as the controls in place to avoid the financial instability and deficits that Puerto Rico previously confronted," says Chepenik. As the restructuring plan is operationalized, EY teams have continued to manage long-term expense forecasting and track spending and investment priorities to help keep the plan on track.

### Transforming the pension system

EY teams also advised the Oversight Board extensively on pension-related matters. These efforts included the provision of actuarial forecasting, pension reform proposals, and most importantly, the creation of an innovative pension reserve trust to enable adequate funding of pensions well into the future. The new pension reserve trust is projected to be funded with \$10.3 billion in government contributions over the next 10 years.

"The newly established pension trust transforms an insolvent pension system that promised to pay pension benefits in the future, even though no money was set aside to do so, into a viable, trustworthy government commitment," says Juan Santambrogio, EY-Parthenon Managing Director, Government & Public Sector Turnaround and Restructuring Strategy Services, Ernst & Young LLP. "Future retirees can now rest soundly knowing there is a path to pay the hard-earned benefits they accrued over time."

Additionally, EY teams assisted the Oversight Board in negotiations that resulted in nearly 100,000 public employees who contributed their own money to the pension plan to finally have access to up to US\$1.5 billion in segregated retirement accounts. The 2022 budget certified by the Board sets aside the first US\$1.4 billion pension reserve contribution for government retirees – serving as a financial cushion for any economic downturn ahead. "This is only possible because of the stability and predictability ensured by the Plan of Adjustment," says Jaresko.

### Working together from macro to micro

Throughout the process, EY teams worked closely with the Oversight Board and other advisors to provide detailed policy analysis and technical assistance to Puerto Rico's government on a variety of topics across the full range of governmental challenges. This included economic analysis, tax expenditure reporting, evaluations of intergovernmental fiscal issues, regulatory reform alternatives and fiscal and economic impact assessments. It also involved devising recommendations for the transformation of the property tax system to collect taxes more equitably – the first change to the system's base property values since 1957.

Efforts going forward are dictated by a comprehensive Financial Management Agenda, led by Puerto Rico's Office of the CFO, centralizing disparate fiscal operations and their oversight, tasks previously split between multiple different agencies and entities. "This is the culmination of Oversight Board efforts over the past five years, in collaboration with the government, and really gives Puerto Rico a strong chance of recovery," says Chepenik.

### 3. BETTER WORKING WORLD

#### □ The better the world works

## A viable path for sustainable growth in Puerto Rico

### The restructuring plan identifies a route to a more promising future for the Commonwealth and its people.

After nearly five years, on 18 January 2022, the US District Court for the District of Puerto Rico approved the amended plan: the largest public debt restructuring in American history. Among its key benefits, the plan successfully reduces Puerto Rico's annual debt

service by more than US\$2 billion a year, restructures US\$125 billion of liabilities, and reduces Puerto Rico's outstanding debt by nearly 80% – from US\$33 billion to US\$7.4 billion. This will save Puerto Rico more than US\$50 billion in debt service payments and create a more stable economic outlook for nearly 100,000 government employees.

"This plan benefits the people of Puerto Rico in many ways – concretely by having a predictable and sustainable level of debt, being able to now plan how to use the rest of the budget and having the maximum reasonably possible to spend on essential services," says Jaresko. After two decades of decline and uncertainty, the government can now refocus on recovery rather than crisis management.

Puerto Rico's recovery will be supported by a complementary 30-year framework for long-term growth and financial sustainability, giving the island's more than three million residents a brighter future of greater economic security and opportunity. "The debt service has been cut dramatically," says Malhotra. "That allows Puerto Rico to have the resources to invest for a vibrant economy going forward." The Oversight Board, in collaboration with EY teams and its other advisors, is assisting with the implementation of the restructuring plan to minimize the risk that Puerto Rico finds itself back in an unsustainable financial situation.

With the plan successfully going into effect on 15 March 2022, Puerto Rico now has a financial and strategic framework for paying down its debts, delivering government services, funding civil service pension obligations, improving education outcomes, and investing in public services and the island's infrastructure. "The fiscal predictability provided by the exit from bankruptcy, together with the significant increase in federal funding, allows the government to increase public employee salaries and invest in more effective services for the people and businesses of Puerto Rico," Jaresko says.

Increased financial transparency and ongoing government reforms will also serve to prevent and discourage the errors of the past. As David Skeel, the Oversight Board's Chairman, put it: "Decades of deficit spending have ended, and Puerto Rico is far along on its path to a responsible fiscal future." ■

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