

**PUERTO RICO'S DEBT CRISIS
AND ITS IMPACT ON
THE BOND MARKETS**

HEARING
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS
OF THE
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
ONE HUNDRED FOURTEENTH CONGRESS
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**PUERTO RICO'S DEBT CRISIS
AND ITS IMPACT ON
THE BOND MARKETS**

Thursday, February 25, 2016

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:11 a.m., in room 2128, Rayburn House Office Building, Hon. Sean Duffy [chairman of the subcommittee] presiding.

Members present: Representatives Duffy, Mulvaney, Tipton, Poliquin, Hill; Green, Cleaver, Ellison, Delaney, Heck, Sinema, and Vargas.

Ex officio present: Representative Waters.

Also present: Representatives Velazquez and Maloney.

Chairman DUFFY. The Subcommittee on Oversight and Investigations will come to order. Today's hearing is entitled, "Puerto Rico's Debt Crisis and Its Impact on the Bond Markets."

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Also, without objection, members of the full Financial Services Committee who are not members of this subcommittee may participate in today's hearing for the purposes of asking questions and giving an opening statement.

Before we begin, I want to take a brief moment as we start today's hearing to recognize the Speaker of the Puerto Rican Legislative Assembly, Jaime Perello, who is here with us today. We are grateful for his participation and all the insight he has given both sides of the aisle, as we try to navigate the issues on Puerto Rico. So thank you for being here, Jaime.

The Chair now recognizes himself for 5 minutes for an opening statement. According to the Government Accountability Office (GAO), individual investors account for 75 percent of America's nearly \$3.7 trillion in the municipal bond market.

Bonds are an important source of financing for State and local governments to pay for a variety of public projects, such as infrastructure and schools. They are also considered a relatively safe security for retail investors, many of whom depend on the income that bonds yield in their retirement.

Despite Puerto Rico's relatively small size, it is one of the Nation's largest issuers of municipal bonds, in part because the bonds are triple tax exempt, at the Federal, state, and local level.

For this reason, Forbes estimates that about 20 percent of U.S. bond funds hold Puerto Rican debt. However, Puerto Rico is now struggling with \$73 billion in bonded debt, spread across 18 different issuers, eclipsing the size of the GNP.

In the words of one of our witnesses here today, "Puerto Rico faces hard times. Structural problems, economic shocks, and weak public finances have yielded a decade of stagnation, out-migration, and debt. Financial markets once looked past these realities, but have since cut off the Commonwealth from normal market access of crisis loans."

But the crisis may already be here. At over 12 percent of the island's unemployment rate, it is nearly double the next State. Labor force participation is 20 points lower than on the mainland, and nearly half of the island's population now lives below the poverty line, which is absolutely unacceptable.

It is no wonder that 7 percent of the island has left in the last 2 years, many of whom have come to the mainland in search of opportunity, after the island's economy has shrunk by 13 percent since 2006.

This is further compounding the island's crisis, as its workforce flees, as its tax base erodes, and it becomes harder to service the island's massive debt, which now accounts for one out of every three dollars the Commonwealth now spends.

The 3.5 million Americans living in the U.S. territory deserve the attention and support of Congress, which is why we are here today. After decades of mismanagement, Puerto Rico's investors also deserve better. And borrowers all over the country, from Wisconsin to Texas to Puerto Rico should be given our careful consideration.

Speaker Ryan, a great Wisconsinite, has committed this House to developing a responsible solution to Puerto Rico's debt crisis by the end of next month. We owe it to all parties to ensure that our response does not have negative implications for the rest of the bond market.

The governors of Arizona and Iowa have both sent letters to leadership in the House and the Senate cautioning against unprecedented steps being pushed by the Obama Administration to address Puerto Rico's debt, which the governors warn could have a significant impact on the cost of borrowing for states, municipalities, and investors, not just in Puerto Rico, but across the country as a whole.

I appreciate our witnesses being here today, including those whom I know have traveled some distance to be part of today's hearing. I look forward to learning more from all of you about the causes of Puerto Rico's crisis, the health of the island's financial services sector, and the impact on investors.

Mostly, I hope to hear how Puerto Rico can return to growth and to the capital markets, how we can have a positive impact on the people and the citizens on the island. And that is what this is about. This is about people. This is about prosperity. This is about opportunity. This is about growth. This is about doing the right

thing by the Puerto Rican people, whom, as we all know, are Americans.

I am sure all of my colleagues on this committee agree with that assessment. And I know we are going to have a great bipartisan movement and effort to come up with a solution that works for the island.

So with that, I yield to the ranking member of the subcommittee, Mr. Green from Texas, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman, and I will claim the 47 seconds that you did not utilize, by unanimous consent. My consent. Thank you, again, and I thank the witnesses for being present today.

And I do concur with you, Mr. Chairman. We all agree that we should do the right thing with reference to Puerto Rico and the Americans who are in Puerto Rico. The question that we will confront today is very simply put: Will we, in the Congress, allow the Americans in Puerto Rico to do the very same things that we allow the Americans in the 50 States to do?

Will we allow them access to bankruptcy, as we currently do for the Americans in the 50 States? I am talking about under Chapter 9 of the Bankruptcy Code. And it is interesting to note that Chapter 9 applied to Puerto Rico from 1933 to 1984. And then mysteriously, for some reason, Puerto Rico was exempt from Chapter 9.

But what the Congress giveth, the Congress can taketh away. And the Congress can return it, if I may coin a phrase. And I think that we may be at a point where we need to do so. I would also add this, that Chapter 9 would not be enough.

There needs to be an opportunity to have something that allows us to look into the future and deal with the fiscal necessities of Puerto Rico. This restructuring process might be called some sort of independent counsel or board, if you will. But it has to have autonomy and independence.

I would also add that the Administration has made a comment that I find favor with, the EITC, as well as helping with Medicaid, because a good many of the persons there have only Medicaid as a means of healthcare.

This is an important issue for us. I believe that we can find a consensus. The mandate has been given by the Speaker. But it is up to us to have the will to follow through. Now, let me ask you this question quickly, because it will come up, the notion that it is unfair to change the rules in the middle of the game.

I concur. It is. But the truth is, you have look at all of the rules. The Supreme Court has promulgated a rule that we have to adhere to, as well. And the Supreme Court has said that, because Congress has this enormous power to exercise, with reference to bankruptcy, that when you make these investments, you have to consider the fact that Congress can change the rules. And Congress can do so retroactively.

So the argument that we shouldn't change the rules in the middle of the game is a good one. That is why we are going to consider all of the rules, which allows rules to be changed. I will say more about that, as we progress, I am sure.

With that said, I am honored now to yield time to the gentlelady from New York, New York's 7th Congressional District, who has

been a preeminent leader in this area, the Honorable Nydia Velazquez. My time, remainder in residue, plus the 47 seconds.

Mr. VELEZQUEZ. Thank you, Mr. Chairman, and Ranking Member Green. After today's hearing in this committee and the Committee on Natural Resources, I am hopeful that we will move from convening hearings to drafting legislation.

And I believe that two principles must be met. First and foremost, Puerto Rico needs tools to restructure its unsustainable debt. What is critical is that the island be given the authority to promptly address all of its various debt obligations. This means not just the \$20 billion in public corporation debt, but, also, the remaining \$50 billion in general obligation, Government Development Bank, and territorial tax revenue, or COFINA.

By itself, Chapter 9 will address only a small sliver of this debt and do little to remove the black cloud hovering over the island. That is why we need a broader, territorial-level restructuring mechanism.

Second, an oversight board must be structured in a manner that does not undermine Puerto Rico's autonomy. If a control board takes the people's power away, it would just be viewed as another imperialistic power grab by the U.S. Government.

It will be the height of hypocrisy for the Federal Government to take away decision-making authority, due, in part, to the policies enacted by this very same body. Don't forget that Congress created and then eliminated the preferential tax policies that have played a massive role in this crisis. And I am referring to 936.

The ranking member mentioned the fact that Puerto Rico was covered under bankruptcy law protection from 1933 to 1984. So when people talk about changing the rules of the game, let's look at what the United States Federal Government, U.S. Congress policies have produced and the implication that it has had in Puerto Rico.

What they need is not only bankruptcy protection, but, also, economic growth. And the only way to do that and to accomplish that is by enacting the types of tax incentives that will enable investors to come and invest in Puerto Rico.

Thank you, and I yield back.

Chairman DUFFY. The gentlelady yields back. I now want to welcome our witnesses. Dr. Anne Krueger is a senior research professor of institutional economics at the School for Advanced International Studies at John Hopkins University, and she is a graduate of the University of Wisconsin, I believe.

Mr. Juan Carlos Batlle is a senior managing director and co-head of CPG Island Servicing.

Mr. William Isaac is senior managing director and global head of financial institutions at FTI Consulting. He is a former Chair of the FDIC. I believe you were the youngest Chair of the FDIC, if I recall.

And finally, we have Dr. Mark Zandi. He is the chief economist at Moody's Analytics and is a frequent witness on the Hill.

So I thank you all for being here today. The witnesses will now be recognized for 5 minutes to give an oral presentation of your testimony. And without objection, the witnesses' written statements will be made a part of the record.

Once witnesses have finished presenting their testimony, each member of the subcommittee will have 5 minutes within which to ask questions of each of the witnesses.

As a reminder, please note you have three lights on your table. The green light, obviously, means go. The yellow light means that you have 1 minute left. And the red light means that your time is up.

So if you get asked a question in yellow and you are finishing it, a brief time span into red, that is okay. But if you are going over, we will try to move on to the next witness. The microphones are sensitive. Please make sure you are speaking directly into them.

With that, Dr. Krueger, you are now recognized for an oral presentation of your testimony for 5 minutes.

STATEMENT OF ANNE O. KRUEGER, SENIOR RESEARCH PROFESSOR OF INTERNATIONAL ECONOMICS, JOHNS HOPKINS UNIVERSITY SCHOOL FOR ADVANCED INTERNATIONAL STUDIES

Ms. KRUEGER. Thank you, Mr. Chairman, and members of the subcommittee. I am very pleased to be here. I have submitted written testimony, and I will try to keep my opening statement very short.

Puerto Rico is a beautiful island, and it should be the jewel of the Caribbean. It has all kinds of advantages, including, of course, English and Spanish, including, of course, the U.S. dollar, U.S. law and order.

It also has some disadvantages coming from the United States Federal Government, as well. Unfortunately, over the past 10 or 15 years, the disadvantages that it has done to itself, plus those done by the Federal Government, plus those inflicted by the world economy have led Puerto Rico into a very long period of stagnation.

As the chairman already mentioned, Puerto Rican income per capita is down, population is down, labor force participation is less than 40 percent, contrasted with 62 percent on the mainland, and we are worried that is too low. And there are other problems.

Many of these problems have causes that can be, at least partially corrected. And there are three things that have to happen in order to get things sorted out. Puerto Rico has to resume growth. Without growth, there is no hope over the longer term for any solution.

To resume growth, however, its fiscal policies have to be amended in such a way as to become sustainable, which they are not currently. That is the second thing. And the third thing is that there has to be some kind of debt restructuring.

Debt, in the short run, is not sustainable, consistent with Puerto Rican growth. I will take my time, briefly, on each of these. No matter what happens, there is no way that today Puerto Rico could cut expenditures enough and raise taxes enough, quickly, to make a difference, in terms of the sustainability of its debt over the next several years.

Tax receipts don't come in sharply after you change taxes. And, indeed, in Puerto Rico's case, the likelihood is that, if taxes rose very much (except for reforms in the tax structure) what would

happen is that, first, Puerto Ricans would leave the island. More would go on welfare and there would be a lower participation rate and more in the informal sector.

Restructuring debt has to happen, because the government just can't pay everything, especially going forward, where there are pension liabilities and other things. But the thing I will focus a minute on is growth.

Growth has to resume. Without it, nobody can borrow, because future receipts will not be enough to cover it. And they are not going to be able to borrow, given the current state. Puerto Rico has lost market access. So that is critical.

What else is needed for growth? The fiscal situation must be addressed, but, also, there are a number of things, both Federal and Commonwealth, that have impeded growth measures and need to be changed. Some of these are things where something can be done and should be done, by the Commonwealth.

They include things to make a more level playing field for business. Right now Puerto Rico, by the World Bank, is ranked 49th in ease of doing business, in the world economy. The United States mainland is ranked seventh, which gives you some idea.

Some things take years in Puerto Rico. Registering property is a good example. There has not been property revaluation since 1954. There are a number of things that could be done. The Puerto Rican government itself could become much more efficient.

The number of school teachers has increased about 30 percent over the past several decades, while the number of students has dropped about the same amount. Some things need correcting within the public sector, but, also, in a way that Puerto Rico treats business.

There are other things to be done that would help a great deal. The Treasury's proposal for the Earned Income Tax Credit would certainly make a difference. Finding a fairer formula for Medicaid and block grants would be important in all of this.

There are a number of other things that can be done, at both the Federal and the State level. But, above all, we can't get very far without debt restructuring. And debt restructuring would be a long, drawn out process without some kind of legal framework for it, which now does not exist.

As you know, the Commonwealth tried to do it, itself. That was thrown out. It is a Federal responsibility. But, at the Federal level, right now, as someone mentioned, there are 18 different issuers of debt in Puerto Rico. And without somehow cleaning that up, there is going to be enough uncertainty hanging over markets and hanging over potential investors in Puerto Rico, that it will forestall growth.

So simply addressing the debt is a first prerequisite, along with, then, doing things to restore growth and getting the fiscal situation, going forward, straightened out.

Thank you very much.

[The prepared statement of Dr. Krueger can be found on page 82 of the appendix.]

Chairman DUFFY. Thank you.

Mr. Batlle, you are recognized for 5 minutes.

**STATEMENT OF JUAN CARLOS BATLLE, SENIOR MANAGING
DIRECTOR, CPG ISLAND SERVICING, LLC**

Mr. BATLLE. Thank you, Chairman Duffy, and distinguished members of the subcommittee. From 2011 to 2012, I served as president of the Government Development Bank for Puerto Rico and previously held senior positions with Banco Santander's investment banking arm on the island, working primarily in public finance matters of the municipal market for 15 years.

Focusing concurrently on the root causes of our problems, our banking sector, and the impact of the crisis on the municipal market makes it evident that we are faced with a dynamic situation, whose eventual resolution will rest on the actions or inaction of Congress and Puerto Rico.

In my view, the root causes for our problems are many. A lack of execution and follow through, as our leaders have put forth economic development plans that all shared similar principles, but all failed, not because they were flawed, but because we were unable to implement them.

An unwillingness to change and adapt, during and after the State filed a Section 936. Petty political parties infighting prevailed, and we failed to compromise and to execute. Decades of fiscal mismanagement, insatiable public sector crowded out the private sector. And the lack of adequate regulation over the Government Development Bank.

A fragmented government-wide technological structure, exemplified by the recent dismantling of the Office of the Chief Information Officer, after significant progress that included a pilot project to produce real-time financial data and financial statements. Ironically, our best talent from this office now works for the United States Digital Service here in Washington.

A completely dysfunctional Internal Revenue Service that facilitates tax evasion. Unfair and discriminatory funding of Federal health programs that aggravate budget deficits. The enactment of tax laws that encourage over-concentration of local wealth in Puerto Rico-only assets, resulting in unimaginable loss of wealth.

And lack of trustworthy and timely financial data and budgetary forecasts that eventually led to a complete loss of market confidence and market access. Our failure to execute on politically unpopular matters, given excessive partisan politics and a self-centered private sector are the main reasons that a fiscal oversight and control board is necessary.

Since 2006, our banking sector has lost 43 percent and 31 percent of its assets and deposits, respectively, and gone through four FDIC-assisted consolidations. Last year, over 4,000 homes were foreclosed, 27,000 since 2008, and over 20,000 are currently in the foreclosure process.

Today, this sector, the banking sector, has achieved healthy capital ratios and stabled delinquency ratios, after a costly transformation. But a banking sector can't really be healthy when a government and economy are not. And it is the subject of excessive regulatory examinations and stifling reporting requirements.

Under a fiscal oversight and control board, regulators could provide relief and additional technical assistance, without abandoning

their obligations, allowing banks to direct resources towards more agile lending and fueling economic activity.

Puerto Rico's bonded debt represents approximately 1.8 percent of the \$3.7 trillion bond market. Roughly 80 percent of this debt is held directly, or indirectly, by individuals in their own accounts, or through pension and mutual funds.

A restructuring of public debt through any mechanism other than good faith, consensual negotiations, or existing tools, like Chapter 9, could further delay Puerto Rico's ability to recover its credibility and market access, with additional and collateral damage spreading to the banking sector, credit unions on the island, retirees nationwide and locally, and other individuals.

The overall municipal bond market also stands to lose. An unfamiliar or disorderly debt restructuring process would have negative effects on the entire municipal bond market, given its reliance on the rule of law and certainty.

A fiscal oversight and control board, with a trusted and familiar tool, like Chapter 9, preceded by mediated, consensual negotiations, would mitigate the impact on investors and the municipal bond market.

Mr. Chairman, upon reviewing testimony from prior Congressional hearings, it dawned on me that we seem to forget we all are, and have been, responsible parties to our problems. Everyone blames politicians. Politicians blame each other. And all the ones who do the blaming forget, we were part of the problem, too, the 3.5 million citizens in Puerto Rico, this U.S. Congress, the White House, bond holders, and all stakeholders alike.

But crisis is the mother of opportunity. The situation we face today gives us a unique chance to shape our future. Our failure to execute, compromise, and live within our means, and the lack of action by Congress in the past, have left no other choice—an independent fiscal oversight and control board with a debt-restructuring mechanism that incentivizes consensual negotiations with access to Chapter 9, as a last resort, complemented by meaningful economic stimulus, are necessary.

However, bear in mind that you don't fix someone's mistake by fixing it for them, but rather by fixing it with them.

Thank you very much.

[The prepared statement of Mr. Batlle can be found on page 40 of the appendix.]

Chairman DUFFY. Thank you.

Mr. Isaac, you are recognized for 5 minutes.

STATEMENT OF WILLIAM M. ISAAC, SENIOR MANAGING DIRECTOR AND GLOBAL HEAD OF FINANCIAL INSTITUTIONS, FTI CONSULTING

Mr. ISAAC. Thank you. It is a pleasure to be here today, talking about Puerto Rico. Toward the end of my career, which has now spanned some 50 years, nearly 50 years, and, believe me, I hope it goes on another 50 years, or at least a lot longer. I am not ready to retire.

The situation in Puerto Rico takes me back to the beginning of my time at the FDIC, in March of 1978, when I was appointed by

President Carter and confirmed by the Senate to be one of three Directors of the FDIC.

My then current employer, which, at the time, was the largest bank in Kentucky, had a going away dinner for me one evening, shortly before I left. The Executive Secretary of the FDIC flew to Louisville that evening, on the evening of my dinner. And the next morning, I met with him in the lobby of the hotel where he was staying, and he swore me in.

We then drove straight to the airport to fly to Puerto Rico to handle the failure of one of the island's largest banks, Banco Credito. That was my first day in office. There was no Chairman of the FDIC at that time. The position was vacant, as was the Comptroller of the Currency position, the other Board Member of the FDIC.

So the 34-year-old, newly minted Board Member of the FDIC was about to be tested under fire. I remember saying that day to the professional FDIC staff, "I hope somebody in this room knows what they are doing, because I don't."

Banco Credito was a very large bank, by the standards of those years, and there were few potential buyers in Puerto Rico. So we broke the bank into two pieces, sold two-thirds of the bank to Banco Popular, the largest bank in Puerto Rico. And we sold the other one-third to the Spanish bank, Santander.

That was my first several days at the FDIC. My tenure as the Director of the Board lasted 2 years. And then, when President Reagan was elected, he appointed me as Chairman of the FDIC in 1981.

It was an extremely tumultuous time. We dealt with some 3,000 bank and thrift failures, including Continental Illinois, 9 of the 10 largest banks in Texas, and many other large banks throughout the country, and thrifts.

The problems we are addressing today are largely due to some of the unique features of Puerto Rico's relationship with the United States. While the challenges faced by the Commonwealth are substantial, I believe there is a way to assist the Commonwealth in organizing its finances and restructuring a portion of its debt within existing legal frameworks.

Successfully doing so will help position the Commonwealth for much-needed economic growth and restore confidence. But we need to go about it the right way. Specifically, I am very concerned about proposals coming from the Treasury, which propose so-called Super Chapter 9 bankruptcy, or a super control board, that would provide for the restructuring of all of Puerto Rico's debt, even its constitutional debt.

Granting this authority would be unprecedented and would have far-reaching implications, including, most certainly, raising the cost of borrowing for the 50 States. Moreover, long-term financial stability for Puerto Rico's government will require continued access to financial markets, which will be difficult and more expensive, if the Treasury plan should be enacted.

I believe the best approach to address Puerto Rico's challenges would be comprised of two parts. First, Congress should treat Puerto Rico like any U.S. State, by allowing the Commonwealth's municipalities to access Chapter 9 for bankruptcy.

This would allow Puerto Rico to legally restructure 75 percent of its debt, including debt incurred by COFINA, a public corporation created by the Commonwealth to circumvent its constitutional debt limit.

That said, because of Puerto Rico's track record in managing its finances, and its failure to produce reliable financial data, the idea of granting it Chapter 9 has been controversial. That brings me to the second part of my recommendation. Congress should create a Federal control board to oversee Puerto Rico's finances.

The control board should not have the ability to negotiate with creditors or to restructure debt. But it could be empowered with the ability to recommend normal Chapter 9 bankruptcy for specific instrumentalities of the Commonwealth, subject to appropriate financial tests.

I close by thanking you, Chairman Duffy, Ranking Member Green, and the members of the subcommittee. I understand you received a copy of my testimony, and I would be happy to respond to any questions you might have.

[The statement of Mr. Isaac can be found on page 75 of the appendix.]

Chairman DUFFY. Thank you.

And Dr. Zandi, you are recognized for 5 minutes.

STATEMENT OF MARK ZANDI, CHIEF ECONOMIST, MOODY'S ANALYTICS

Mr. ZANDI. Thank you, Chairman Duffy, and members of the subcommittee, for the opportunity to be here today. The views that I am going to express are my own, and not those of Moody's Analytics or the Moody's Corporation.

I will make three points in my remarks. Point number one, which is now the obvious, the Puerto Rican economic and financial crisis is very severe. You provided a long list of statistics to demonstrate that.

For me, the most telling is the fact that the job base of the island has declined by 10 percent over the past 10 years. Just for context, in the financial crisis that we went through a few years ago, peak-to-trough employment nationally fell by 6 percent. And, of course, the island's recession continues on. It is unabated.

The fiscal situation is very dark, \$70 billion in debt, another \$45 billion or so in unfunded pension liabilities. You add it up, divide by GNP, which is the Gross National Product of the island, the resources that the island has to pay on the debt, it is 160 percent.

Just for context, Illinois, which is the State under the most significant financial stress, has a debt plus unfunded pension liability to GDP ratio of closer to 20 percent; New Jersey, 15 percent; and in my own home State of Pennsylvania, which has had its own fiscal issues, it is 5 percent. So the situation is very dark.

Point number two, the legislation you sponsored, H.R. 4199, is a very positive step in the right direction. I think the two key aspects of that are very good steps. The first, obviously, is Chapter 9 bankruptcy for Puerto Rican municipalities and public corporations.

Obviously, that is a necessary condition for putting the fiscal situation on sounder ground. The quid pro quo for that is the opting in by Puerto Rican lawmakers to a financial stability council, a

board that has—I think it has a nice balance of authority to get what needs to get done, done, but, also, respect the sovereignty of the island. I think you did a nice job of accomplishing that balance.

Point number three, I think lawmakers should do more. I don't think your legislation is enough. The Chapter 9 bankruptcy for municipalities and corporations covers, for sure, about 30 percent of the island's debt. There is some debate, reasonable debate, as to does it cover other liabilities.

And that will have to be adjudicated, go through some court process. And judging by what Detroit has gone through, that could take a long time. And I don't think we have time.

So I would recommend that you shift from Chapter 9 bankruptcy to a broader restructuring framework that would maintain the board, as you have described it, an opt-in for the lawmakers of Puerto Rico, but they have broader authority around all of the liabilities that the island is struggling with, beyond just the debt of the corporations and the municipalities, including the GO debt and the unfunded pension liabilities.

This authority, this restructuring framework, should also allow for a timeout to, against litigation, let everyone sort this thing through and kind of nail things down. There needs to be a voting mechanism to ensure that a handful of creditors can't stop the way. And, as Mr. Isaac pointed out, I believe, there are 20 different creditor groups. It clearly suggests a very messy process.

Ultimately, if they can't come to an agreement, there is some kind of court process to work through the problems. So I would counsel that what you propose is great. I just don't think it is going to put the island on a sustainable path.

Then the other thing I say that I would recommend that you address is, and this goes to Dr. Krueger's comment. She is absolutely right, nothing works unless the economy's growing. And I, in my written testimony, talk and lay out a number of different economic policy proposals that I would consider to help the island.

But most importantly, most critically, you have to get Medicaid on sound ground here. Under current law, Medicaid funding is going to decline beginning mid-2017, 2018. And half of the residents of Puerto Rico rely on Medicaid and hundreds of thousands of people will be affected by this. And I think it is very important to put that on sounder ground.

Thank you, again, for the opportunity, and I look forward to your questions.

[The prepared statement of Dr. Zandi can be found on page 92 of the appendix.]

Chairman DUFFY. I appreciate the panel's opening statements. The Chair now recognizes himself for 5 minutes for questions.

Dr. Zandi, I will probably come back to you, if I have time, at the end. But you mentioned we deal with 30 percent of our debt, but I know there is some debate. Mr. Isaac brought this up, but depending on where COFINA falls, it looks like we could actually deal with 75 percent of Puerto Rican debt, excluding the GO bonds, which would probably be a lot closer to where you would like to be. But that is a conversation, I think, that we have to continue to have.

I will move on, though. Mr. Battle, I mentioned in my opening that Terry Branstad, the Governor of Iowa, recently wrote Congressional leaders, in both the House and the Senate, and expressed some concern about Treasury's plan, which is probably consistent with Mr. Zandi's testimony, about a restructuring that would violate the constitution of Puerto Rico, offering broad restructuring, including general obligation bonds.

And you kind of mentioned this, but could you go a little further? Does that set a dangerous precedence? And would it, likely, raise the borrowing cost, not just in Puerto Rico, but would it raise the costs in other parts of the country, have an impact on other states and municipalities?

Mr. BATTLE. Yes. Thank you for that question, Mr. Chairman. And I do think going down the path of a more broad restructuring regime would definitely have an impact on the overall municipal market.

I think the best way I would describe the municipal market, not to be disrespectful to it, but it is a very boring market, I would say. It likes predictability, stability, and it doesn't like surprises. It is a market used by a lot of both individuals, retirees, and this investment vehicle is looking for a stable, fixed income into their accounts.

And, I think, introducing an alien or new mechanism, that is completely unfamiliar and unknown, to an otherwise stable and very large market, on which the 50 States and the territories depend, or, say, subdivisions of the states and the territories rely on to raise necessary capital for infrastructure development and many other needs, would set a very dangerous precedent.

I think it would be highly speculative to go into any discussions as to what type of financial impact it would have, but, at the least, it would definitely create volatility, uncertainty, which would translate, naturally, into higher costs or higher losses, depending on which side of the aisle you sit.

Chairman DUFFY. And you live on the island, right? You live in Puerto Rico?

Mr. BATTLE. Yes.

Chairman DUFFY. And, so, going to the fiscal stability board and opportunity growth board, some will say a control board. I meet with a lot of the elected officials on the island and I get some pushback. And, as Ms. Velazquez mentioned, there is concern about sovereignty and perceptions.

And I am very sensitive to that. I think we want to have complete buy-in to a plan that comes from Congress. I hear from politicians, with maybe one perspective, but do you know where the people in Puerto Rico fall on this issue? Do they support some form of board that can help get the finances and the budgeting in order? Can you speak for them, by chance?

Mr. BATTLE. If I were to speak for them, and I will say this is my personal opinion on what I hear from the people I talk to, I do think, and I actually do strongly believe, that there would be strong support for a fiscal oversight and control board.

And on, if I expand just 1 minute, the proposal or the type of structure that I propose in my written testimony, it is actually

something that I think would get in the buy-in necessary from the politicians, also, on the island, from leaders.

That is why I call it an oversight and control, where you would have an initial phase, during which Puerto Rico would get the chance to deliver on the compromises and promises that we need to make to get things moving forward on the fiscal and economic side, and also on the debt restructuring side.

But there has to be very specific metrics, very specific milestones to be accomplished. And any non-compliance under this would automatically convert this oversight board into a control board that would have a lot more teeth into the decision-making process in Puerto Rico.

But I do think there will be acceptance within the population for that type of structure.

Chairman DUFFY. And the 5 minutes is just not enough time, but I want to go to you, Dr. Krueger. Quickly, you talk about growth, and I think growth is so important. You just can't have one component of some form of bankruptcy and oversight. We have to have growth on the island.

If you are thinking outside the box, and I don't have a lot of time left, can you give me some ideas on what we could do, in Congress, that could stimulate or incentivize growth and investment on the island?

Ms. KRUEGER. I think there are a number of things. There are Federal laws that really impede Puerto Rico. For example, the Jones Act on shipping, which I know is a political hot potato, but Puerto Rico lies right next to some other Caribbean islands. All of them are dependent on oil for their fuel, for electricity generation.

Puerto Rico pays 40 percent more than the other islands and there are other factors. Puerto Rico is not eligible for the Earned Income Tax Credit. Getting that through, which Treasury has proposed, would, indeed, very likely increase the formal participation rate, which would help.

Puerto Rico is subject to the mainland minimum wage law, and Puerto Rico per capita income is well below that of the poorest U.S. mainland State. Doing something to amend that so there could be, for example, a period of apprenticeship or a period for young people, youth employment, to learn skills on the island would make a difference.

It would not do it all overnight, however. All of these things would take some period of time. I know I have to stop here.

Chairman DUFFY. Thank you. And I would have asked you—going into the red zone. But thank you. My time has expired.

The Chair now recognizes Mr. Delaney for 5 minutes.

Mr. DELANEY. Thank you, Mr. Chairman. I just have a quick question, and it is related, but not directly on point to the bankruptcy.

Maybe for Dr. Zandi, Puerto Rico is unique in terms of their ability to offer tax incentives to U.S. citizens who domicile in Puerto Rico for 183 days. And they maintain their status as citizens of the United States.

And I have no issue with people who have done that, because it is perfectly permissible and perfectly legal under the laws, as they are now. But have you thought about the potential drain that has

on the U.S. income tax base? And should we be thinking about that, as part of other aid we provide Puerto Rico? You mentioned Medicaid, which I do agree with you. I think should be funded, so that we can stabilize that situation.

And, I guess, set the most efficient way to get Federal dollars into the Puerto Rican economy and would we be better off doing things more directly and not allowing them to put in place a scheme that would continue to drain or reduce the U.S. tax base?

Mr. ZANDI. Yes, I am sympathetic to what you are saying. I think that there are many other more effective ways of helping the island's economy. And the most obvious to me is the Earned Income Tax Credit, the EITC, which has a lot of bipartisan support.

We have a lot of evidence of it working, and it is particularly critical to Puerto Rico, because it will bring people out of the underground economy, the shadow economy. Someone made the point that labor force participation in Puerto Rico is 40, 45 percent, the lowest anywhere in the country.

Bring them back into the taxable base and establish a broader culture of paying your taxes. So if I were king for the day, I would take the tax benefit you described and use that to pay for, or help pay for, the EITC. I think that would be the best step to help the island, long run.

Mr. DELANEY. I yield back my time. Thank you.

Chairman DUFFY. The gentleman yields back. The Chair now recognizes the gentleman from South Carolina, Mr. Mulvaney, for 5 minutes.

Mr. MULVANEY. I thank the chairman. I want to talk about what both the chairman and the ranking member mentioned in their opening statements, which is their concern, and my concern, our concern, that this is about people, because it is about people, but not about maybe the people they were mentioning.

There is a New York Times article out this morning, and I will quote from it. It says that, "Most Puerto Rican debt is held by individuals. They are mostly over 65. They mostly have incomes of less than \$100,000 a year. They are not vulture funds, they are your friends and neighbors."

I understand that the Treasury's plan would change the prioritization of payments in Puerto Rico to prioritize payments to Puerto Rican pensioners, before bond holders get paid. So the Treasury plan would pay pensioners in Puerto Rico, before we pay the pensioners who lent Puerto Rico money in the first place.

And I want to know how that is fair, because it strikes me as not being fair. In fact, it reminds me, Mr. Chairman, of something that many of us in the Class of 2010 ran against when, during the Chrysler bankruptcy, we changed the laws in this body to give priority to unions over the pensioners from the Indiana Teachers and Firemen's Fund. It wasn't fair then, and it wouldn't be fair now.

I also understand, in doing some research, that some of the debt revolves around the state or the government-owned electric company, which has not raised its rates on its people since 1989.

So, again, I ask, is it fair for us to ask pensioners and retirees, some of whom may live in South Carolina, to incur greater debts on their own debt, in the future, or to lose prioritization here, so that the Puerto Rican government can continue to provide below-

market, subsidized electricity to their residents? That doesn't strike me as fair.

And I know I don't have many questions, because, honestly, I don't know who to ask the question of, but this—

Mr. DELANEY. If the gentleman would yield, I would—

Mr. MULVANEY. I would be happy to. Yes, sir.

Mr. DELANEY. Thank you. With reference to the power plant, when you are in Chapter 9 bankruptcy, you have to demonstrate that you have made a good faith effort. That would be part of the evidence that would be presented to the court. And if it concludes that the good faith effort has been made—

Mr. MULVANEY. Reclaiming my time. And I appreciate that, and that is fine. But, I guess, doesn't solve my original question, which is we would be asking pensioners in this country to help make up for the fact that, for the last 25 years, there have been no raises. And I will come back to you at the end, I promise, but let me finish my thought on this.

Look, I am sympathetic to what the island is going through. It strikes me that most of the ills are self-inflicted. Dr. Krueger made, perhaps, what I thought were the most positive comments so far, which is ways that we have actually made things worse.

We could fix the Jones Act. We could provide exemptions from the minimum wage laws, and those are positive things that don't really cost my folks any money. And maybe that is where I think we should be focusing our attention.

But everything else that we have talked about today smacks, to me, of a bailout, which I thought my party was supposed to be against. So I am curious to see how we proceed, Mr. Chairman. Again, I apologize for not having any specific questions, but, really, I am not really sure how to ask.

I tell you what, let's just wrap up with this point. And if anybody wants to respond to any of that, I would be more than happy to give you what little time I have left. Or not.

Chairman DUFFY. I believe Dr. Krueger wanted to—

Mr. MULVANEY. Dr. Krueger, okay, sure.

Ms. KRUEGER. I am afraid the situation is so dire that the question is not whether some of the bond holders will, but whether they will lose a lot or lose less. If there is no legal framework, all the lawyers I know, and I am not a lawyer, say that it will be a messy, long, drawn-out process.

I am an economist, and, as long as that is going on, the likelihood that there will be new investors and there will be others in Puerto Rico—or, sorry, and other growth in Puerto Rico will be very limited.

As to the PREPA, the electric company, it has been high cost. It has lost money most of those years, unfortunately, despite what you call socialization. It is very high cost, \$0.27 a kilowatt hour, remember, after the oil price decrease. So that is well above U.S. levels.

Mr. MULVANEY. As an economist, let me ask, in my last few seconds, don't you think we set a dangerous precedent by changing the law so that, after the fact, pensioners and retirees in Puerto Rico would be paid before pensioners and retirees in the States, who have loaned them money? That is to you, Dr. Krueger.

Ms. KRUEGER. Very quickly, the problem is that, somehow or other, Puerto Rico can't make all those payments. If it were required to do so—I don't know how you would require it, but if you did, the lights would go out. There would be no fire or police. The very basic things of government have to continue.

And I think they would choose that at a critical point. It hasn't happened yet, and I hope it won't happen. I hope we can address the issue sooner, as the chairman suggested that Speaker Ryan has wanted to do, and I think is the appropriate thing to do. But the alternative is really awful.

Mr. MULVANEY. Thank you, Doctor. Thank you, everyone.

Chairman DUFFY. Before you yield back, I would ask for unanimous consent for 15 extra seconds. I just want to be clear—I think the gentleman from South Carolina made a really good point, but I just want to be clear—when you talk about a bailout, are we talking about a bailout of pensions over creditors, or are we saying that bankruptcy is a bailout? I just wasn't sure what the point was.

Mr. MULVANEY. No, it is just, I guess, my objection is to using the term "creditors," because in here we are always saying that the creditors are bad people. Creditors are big banks. They are vulture funds. And the municipal bond market, more so than perhaps any financial security, the overwhelming group of investors are these same retirees and same pensioners.

Chairman DUFFY. Okay.

Mr. MULVANEY. It is just in a different place.

Chairman DUFFY. Thank you. The gentleman yields back. The Chair now recognizes the gentleman from Missouri, Mr. Cleaver, for 5 minutes.

Mr. CLEAVER. Thank you. Thank you, Mr. Chairman. This is, I think, heartwarming to see that, for the most part, we are all trying to figure out a way to solve a major crisis.

And, Dr. Zandi, in your simulations, it was a little chilling to assume that, by 2020, if nothing happens, we end up with a population in Puerto Rico of about 3.3 million, which means that the migration would increase significantly to this country.

So the truth of the matter is, we are going to pay, one way or another. Am I going down the right road?

Mr. ZANDI. I think that is entirely correct, yes. If you just kind of connect the dots, it is pretty dire for Puerto Rico and that, obviously, is going to be a cost to all of the mainland, as well.

Mr. CLEAVER. Yes. I think we are weird in the English language. We make some terms toxic, and then we can't use them. So we don't need to call it, but I would call it, let's say, "sweet juice." If we "sweet juice" Puerto Rico, we are going to have to do it one way or another.

And I am concerned. Would you have any response to the gentleman from South Carolina?

Mr. ZANDI. Yes. To the initial point you made about prioritization of the liabilities, putting the pensioners ahead of the creditors, the GO bonds, I would say two things. First, I think that should be left up to the restructuring framework.

Empower an entity, like the Financial Stability Council, to go through and figure that out. What is in the best interest of the island's residents and for everyone, all the stakeholders involved, in-

cluding the creditors and the pensioners. So I think that is something that should be left to that entity.

The second thing I would say, just as a point of something to consider in the prioritization process, is that, of course, the pensioners, and we are talking about, at least the data I have seen, 330,000 current and future pensioners, they are residents of the island, for the most part.

And if they don't get their pension payment, then that is just going to exacerbate, severely exacerbate, the economic effect on the island. The creditors, the folks who own the bonds, they are distributed around the world. And you are right, they are me, they are you, in the funds that we own. But the pain of that would be distributed much more widely across the globe.

But the pensioners are sitting on the island, and obviously, it just complicates the matters for the island's economy.

Mr. CLEAVER. Thank you. So, if we do nothing, unemployment is going to fall, because people are going to leave. And if the unemployment begins to drop, the tax base, is even further eroded.

So there should be little doubt that we have to do something. The question, I think, is what exactly we are going to do. And, frankly, Newt Gingrich was probably the most articulate person who proposed that we allow States to enter into bankruptcy. Now, Puerto Rico is a territory, but we do municipalities.

I know the municipal bond markets would tremble at the thought of any kind of bankruptcy, because it might damage the, I think, \$3 trillion municipal bond market. And all of you gave, I think, fabulous responses in your opening statements.

So if the four of you were able to sit in a room together, being as brilliant and smart as you are, and probably all of you are members of MENSA, what do you think you could work on, just off the bat, assuming that we would agree with what you presented?

Mr. ZANDI. Just very quickly, I think, listening to the testimony, there is significant agreement. The only point of contention that I could hear was around how broad the restructuring framework should be. Should it be solely Chapter 9, or should it be something broader than that?

And there is a lot of debate, reasonable debate and discussion, around that issue. And that is where we would probably have the conversation. And I think it would be important to have here, as well.

Mr. CLEAVER. Mr. Battle, you were trying to say something?

Mr. BATTLE. I just wanted to add that I think you touched upon the most important point here. I don't know what would come out of that meeting between the four of us, but that is what needs to happen.

I think what we have missed so far is a genuine good faith sit down, face-to-face, between creditors, the government, not their advisors, the government, and a truthful discussion with real numbers that both sides can agree on, because right now the relationship between the two sides, from where I stand, outside—I am not part of any of the discussions—it seems to me that discussion is not happening.

And I think that is the first step for any type of resolution going forward.

Mr. CLEAVER. Thank you, Mr. Chairman.

Mr. ISAAC. If I could just get one word in there—

Chairman DUFFY. Very quickly.

Mr. ISAAC. —I disagree a little bit with Dr. Zandi. I believe that, from my experience trying to run the FDIC during a banking crisis, the most important thing to do right now is don't let this thing spread more broadly than it already is.

And right now there is a problem that is small enough and isolated enough that it can be identified, and it can be fixed. If we start changing bankruptcy rules, I don't know where that goes, but nothing good is going to happen from that.

If you say, we are going to go ahead and use bankruptcy rules on State debts and allow them to reorganize, Illinois or whatever the State is, and I think that is taking us down a road we don't want to go down. And it will be very, very costly and extremely disruptive of the markets.

Chairman DUFFY. The gentleman's time has expired. The Chair now recognizes the gentleman from Colorado, Mr. Tipton, for 5 minutes.

Mr. TIPTON. Thank you, Mr. Chairman. Just by way of preamble, when Dr. Krueger's point that she had made that the situation is so dire, Mr. Zandi's point saying that we need to be able to spread the pain, and then Mr. Isaac's comment that right now we have a somewhat isolated problem and we need to be able to address it before it spreads.

I truly think that there is a broader lesson for government, not just in Puerto Rico, at the Commonwealth level, but for our States, for our Federal Government, as well, when we look over to Greece.

When governments over-promise and under-perform, simply by ability and through mismanagement, you create real problems that ultimately spread the pain far further than I think any of us want.

And I think that we need to be addressing some of those root causes, as well, rather than being reactive, be proactive. And Washington would be a great starting point for a lot of that.

Mr. Isaac, I would like to first go to you. You commented a little bit on the super committee that is being proposed by Treasury. Would you, perhaps, like to expand a little bit on why this might be a mistake, in regards to allowing Puerto Rico to be able to restructure all of its debt, including its general obligation funds, and how this plan could hurt other State and municipal debt owners or issuers in the United States?

Mr. ISAAC. I would be happy to. First of all, it is hard for me to comment on what the Treasury is proposing, because it seems to change with regularity. So and I am not sure what their current proposal is. I guess they are testifying this afternoon or sometime today, and maybe we will learn more about where they are right now.

I believe that it would be a serious mistake to restructure the general obligation bonds. The government of Puerto Rico, when it created COFINA, knew that it was violating the law. It said so, publicly. It was violating its own constitution. They called these extra constitutional bonds.

So everybody knew what the game was, and they were heading down the path they should not have headed down. And they

shouldn't take this period right now as an opportunity to go ahead and make these bonds superior, or even pro gratis or Pari Passu with the general obligation bonds.

If they do that, and if Congress allows them to do that, I don't know where it stops throughout the United States. Every State will be tempted to do it, or, at least, a lot of the States will be tempted to do it.

And the credit markets, I believe, would be in a state of chaos and it will affect a lot of banks, because banks are big holders of municipal debt. And, in terms of our own banking system, I shudder at the thought of that.

Mr. TIPTON. Following that line of thought, we would probably see rates increase, causing more pain, and ultimately, more cost.

Mr. ISAAC. Certainly, the borrowing costs on municipal debt and State debt would go up a lot.

Mr. TIPTON. In order to try and be a little bit solutions-oriented, the District of Columbia obviously had some challenges. Chairman Duffy actually has a piece of legislation that is going to allow for a limited duration council, only if the island's elected leaders are willing to be able to accept the council, somewhat a little bit similarly to what happened to challenges that were right here in the District of Columbia.

Is a financial stability council important to the rehabilitation in Puerto Rico's finances?

Mr. ISAAC. I believe it is critical, and I believe that D.C. is a good example, and we should emulate that. It was very, very successful what was done in the district. And something along those lines, I think, would work very well in Puerto Rico.

Mr. TIPTON. Great. Just to broaden this net a little bit, we have a piece of legislation that Senator Hatch has put forward, in regards to the Puerto Rico Systems Act. And the bill addresses Puerto Rico's financial crisis, but it also includes provisions intended to be able to reform the public retirement systems outside of Puerto Rico.

Specifically, this bill does include provisions that it would impose new disclosure obligations on the State and local government plans, as well as creations of a new type of plan designed for State and local governments that would not impose future liability on plan sponsor.

And, one of the reasons for that inclusion into the Puerto Rico debt crisis has been exacerbated by severely underfunded plans, obviously, in Puerto Rico's public employee plans. With the aggregate under being that we are seeing at the State and local defined benefit pension plans in the United States exceeding about \$4 four trillion right now, how important, Dr. Isaac, is it for us to be able to move forward with mandatory necessary reforms?

Mr. ISAAC. I am not an expert on Senator Hatch's plans. I have reviewed it, but not in any depth. I would tell you that I know him and have for a long time. And I think he is brilliant. He is a very public-spirited representative of our government, and I would think anything he proposed is certainly worth merit, has a lot of merit and is worth considering seriously.

But I am not an expert on his particular provisions, and so I would hate to go much further than that.

Mr. TIPTON. Okay. Thank you. My time has expired, Mr. Chairman.

Mr. MULVANEY [presiding]. The gentleman's time has expired. We now recognize the gentlewoman from New York, Ms. Velazquez, for 5 minutes.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Mr. Zandi, we have heard how so many people are concerned about the U.S. municipal bond market. Given that the island has already defaulted on some issues, has the U.S. bond market been impacted?

Mr. ZANDI. No. There is no evidence of that.

Ms. VELAZQUEZ. Many of the island's bonds are covered by bonds insurance. How does this help insulate the market from the impact of defaults?

Mr. ZANDI. The insurance will pay out under conditions, certain conditions of default and help cushion the blow to the bond holder. So it reduces the cost to the bond holders. Of course, the insurance companies have to pay it out.

Ms. VELAZQUEZ. Right. When it comes to providing Puerto Rico with debt restructuring authority, some are suggesting that this, by itself, could undermine the U.S. municipal bond market. Several municipalities have declared bankruptcy, however, including Detroit. Did this situation impact the U.S. municipal bond market over the long term?

Mr. ZANDI. No, there is no evidence of that. If you look at yield spreads in the bond market, municipal bond yield relative to risk-free Treasury rates, they have shown no impact. And, of course, Puerto Rico has been under severe financial stress for more than 2 years, and this thing has been gathering steam.

And it is pretty obvious that there are going to be defaults and restructuring. And there has been no impact on any of the rest of the municipal bond market. There has been, obviously, an impact on the Puerto Rican debt. It is trading, depending on what you are looking at, at less than 50 cents on the dollar, but the rest of the bond market has been unaffected.

The other thing to point out is, there is no effect on flows into mutual funds, municipal bond funds.

Ms. VELAZQUEZ. So, what you are saying is that—

Mr. ZANDI. None.

Mr. VELEZQUEZ. —establishment of a debt restructuring—

Mr. ZANDI. Investors have said, quite clearly, in their voting with their money, that Puerto Rico's situation is Puerto Rico's situation. It is no one else's problem.

Ms. VELAZQUEZ. Right. In the next 6 months, there is nearly \$3 billion due in bond payments, of which half is for GDB, GO, and COFINA debt. Do you believe the island will be able to make this payment?

Mr. ZANDI. I think it would be incredibly difficult, and the governor has pretty much said no. The bond market investors, the guys who put the money on the line, are saying, no, this isn't going to happen. They are not going to be able to make those payments.

Ms. VELAZQUEZ. If Chapter 9, alone, was enacted, would it allow Puerto Rico to restructure all of these pending debt payments?

Mr. ZANDI. No. Chapter 9 for municipals and public corporations, again, is a very positive, big step in the right direction, but it

doesn't put Puerto Rico on a sustainable path. And I think, if we are going to empower an entity, like the financial stability council, to get this on a sustainable path, we have to give that council all the tools that it needs to be able to do that. And that means broader restructuring authority.

Limiting it to Chapter 9 for municipalities, and for—now, it could be I am wrong. It is possible, rare, but possible. But we should give the tools to this entity just in case, because there is no room for error, here.

Ms. VELAZQUEZ. So, Mr. Zandi, Puerto Rico already does not have access to the credit market. In that sense, it is not Greece. Greece has access to the credit markets. What this means for Puerto Rico is that the islands only children's hospital, large CT, and MRI machines, and has 70 vacant nursing positions, that therapy sessions for special education students are at risk, that supplies of gasoline for ambulances, police cars, and fire engines, were nearly cut off, that towns have gone without water, due to the lack of vendor payment, that food supply for inmates were almost cut because suppliers were not paid, that contractors, now, wait on average 4 months or more for the government to pay their bills.

The reality is that, after facing payment delays, some suppliers are threatening, or have shut off the provision of important public—there is a lot of blame to go around, mismanagement of the Puerto Rican government.

Mr. Battle, you worked for the Government Bank, and, while you were in office, the debt doubled. So there is a lot of blame to go around, including this same body, because we lack public policy uniformity when it comes to the U.S. territories.

So look at how much reimbursement they get when it comes to Medicare and Medicaid. We subject Puerto Rico to the same standards that we subject hospitals here and any other institution, and, yet, they don't have the resources to abide or to comply with those standards.

When it comes to the Jones Act, when it comes to so many other issues, we give and we take away. We promote economic growth in Puerto Rico by providing Section 936 when we needed to showcase Puerto Rico, as Ms. Krueger said, as the jewel of the Caribbean, sending a message, what, to Cuba, Fidel Castro, this is what it takes to be a good partner?

But now that Puerto Rico is not needed to showcase what a good relationship with the United States means, no longer is an asterisk, Puerto Rico cannot be a nuance for the United States Government. And you know what? We will pay. We will provide the tools, or we will pay later.

One point two million Puerto Ricans, basically, have left the island. And they are living in Florida. So be prepared to provide for their legal education and healthcare in your own Congressional districts.

Thank you.

Chairman DUFFY. The gentlelady yields back. The Chair now recognizes the gentleman from Maine, Mr. Poliquin, for 5 minutes.

Mr. POLIQUIN. Thank you, Mr. Chairman. I appreciate it very much. My heart goes out to the families in Puerto Rico. I don't know how you got into this mess. Your economy is shrinking. Forty

percent of the adults on the island have jobs, working-age adults. Twenty-five percent of the total jobs are for the government. Half of the population lives below the poverty line. The young are leaving.

This is a mess. Now, the folks who run the government down there, I don't know what they have been doing. There is a constitutional mandate on the territory, unless I am mistaken, that limits debt to about 15 percent of the tax revenues on the island. But COFINA was created to circumvent that law, to add to the debt level.

So, now, you have \$73 billion of debt, GOs, and revenue bonds. Thirty-six percent of the tax revenues generated on the island goes to pay the interest and principal payments on the debt. And you have a \$2 billion interest payment in a couple of months. Who in the heck is responsible? And where are those people now?

Now, I represent Maine's second district. The real Maine, not Northern Massachusetts, the real Maine. We are hardworking people, and we are honest people. We struggle for every buck we can make, struggling through the worst economy in 70 years. And a lot of these retirees own Puerto Rican bonds. They have lent money to the territory.

And so, now, you folks come to us, wanting what? So I will tell you Mr. Chairman, I am all about solving this problem. For me, and for the people I represent in Maine, any solution has to include a structural fit for the government structure on this island, who got us into this mess, so it doesn't happen again, because it is just not fair.

Now, Detroit has gone through some really tough times. And they were able to solve their problems and hold people accountable. So I don't know which of you individuals up here today can answer the question.

But I am going to ask you, Mr. Battle, are the people who were responsible for this mess still running the government down in Puerto Rico?

Mr. BATTLE. I would say that, as I mentioned in my oral testimony, everybody here is accountable for what happened. So, no, some of them are and some of them aren't, but all—

Mr. POLIQUIN. Okay. Let me ask you another question. I am the former State Treasurer in Maine, so we deal with the muni market all the time, and we deal with incentives all the time. Were there any incentives in place then, or now, in the folks who are running the government, to increase their debt levels, beyond levels that are clearly unsustainable?

Mr. BATTLE. Incentives for—

Mr. POLIQUIN. Yes, are there any electoral or governance incentives, right now, in the territory, that would incent people who run the government to increase their debt levels?

Mr. BATTLE. Not to my knowledge.

Mr. POLIQUIN. Then how did you get in this mess? Ms. Krueger?

Ms. KRUEGER. If I may, and there are problems within the government, in terms of the inefficiency of tax collection, and administration in general that have accounted for it. It is no individual, but it is the system, which you are quite correct.

Mr. POLIQUIN. All right. Let's dig into that a little bit. My understanding is that only 56 percent of the taxes owed in the territory are actually collected. Is that right? Why?

Ms. KRUEGER. It is hard to know a number, because there is a large informal sector—

Mr. POLIQUIN. Okay, fine. That is the report I have. It is about 56 percent. Why?

Ms. KRUEGER. There is a large informal sector, because, indeed—

Mr. POLIQUIN. What does an informal sector mean, people don't want to pay their taxes?

Ms. KRUEGER. People who are working and not paying taxes, yes, outside—

Mr. POLIQUIN. Well, no one wants to pay their taxes, but if you owe your taxes, you pay them, right? So why aren't these taxes collected? Mr. Battle?

Mr. BATTLE. Sir, the taxing authority in Puerto Rico is a very dysfunctional entity.

Mr. POLIQUIN. It is a cultural thing? Did I hear that right?

Mr. BATTLE. Dysfunctional. The taxing authority.

Mr. POLIQUIN. It is dysfunctional. What makes it dysfunctional? It is dysfunctional in Greece, too.

Mr. BATTLE. I will tell you that the—

Mr. POLIQUIN. People don't want to pay their taxes there, and then you complain because you can't run the government. And you have to borrow more, and it puts everybody at risk. I know it is dysfunctional. How do you fix it?

Mr. BATTLE. There has to be consequences to people who don't pay taxes.

Mr. POLIQUIN. What kind of consequences?

Mr. BATTLE. Whatever consequences could be incorporated into the system.

Mr. POLIQUIN. Okay.

Mr. BATTLE. I am not an expert on that in my area, but—

Mr. POLIQUIN. Mr. Chairman—

Mr. BATTLE. —there have to be consequences.

Mr. POLIQUIN. Thank you, sir. And I am not trying to badger anybody, it is just that I represent people who are coming to us to ask to be on the hook to bail out people who weren't responsible. There has been reckless behavior down in this territory, and in other parts of this country. It is not just the territory. Other parts of this country, including, here, in Washington.

They are looking for bailouts. So I will tell you, Mr. Chairman, I am out of time. I am all for a solution, as long as there are structural changes to fix this problem, so that we don't go down this path again. Thank you.

Chairman DUFFY. The gentlemen yields back. The Chair now recognizes Mrs. Maloney from New York for 5 minutes.

Mrs. MALONEY. All right. I want to thank you, Mr. Chairman and Mr. Ranking Member, for allowing me to participate in this hearing and, really, for having this very important hearing. Puerto Rico is home to 3.5 million American citizens, and they face a severe financial crisis. I believe we have an obligation to help our fellow citizens.

And New York City has a long history with Puerto Rico. The very first, a Puerto Rican veteran, was from El Barrio in East Harlem of New York. The very first elected party official, first elected official, many leadership and the arts came from what we call the cradle of Puerto Rican advancement in the United States, East Harlem or El Barrio.

Now, I would like to just note and put into historical reference what we are confronting today. New York City, the city that I am proud to represent, also faced a huge financial crisis back in the 1970s, and there was a reaction by some in Congress to do nothing. Let them die. Let's do nothing to help New York.

Gratefully, the Majority in Congress responded to the crisis in New York, and helped the City and its people rebuild. And that was to the benefit of our entire Nation, not just to the City and State, but our entire Nation. And the solution that Congress put forward involved a control board, a restructuring law, and a \$2.3 billion loan from the Federal Government.

We faced a similar crisis with the auto industry in New York, and again, not in New York, in our country, out in Michigan. And, again, our country responded by restructuring, offering loans, and we now have an auto industry that survived and is now exporting and creating American jobs.

So I feel we have a responsibility to get in there and help, and help them restructure it and help them rebuild. I would like to ask, and I would like to really comment on Dr. Zandi's testimony that what we should approach what is confronting us now is a territorial bankruptcy regime that would, when you said that it would not disrupt the broader municipal bond market, that seems that should be the way that we would go. And I think that is really important, your testimony that it would not disrupt the municipal bond market.

A territorial bankruptcy regime, by definition, would not be available to States. It would only be available to the five territories that we have, or it could be drafted specifically for Puerto Rico.

I want to compliment and applaud Chairman Duffy. He is the only Republican, that I am aware of, who has tried to confront this problem and come forward with constructive solutions. He has introduced a bill that grants Puerto Rico access to Chapter 9 bankruptcy, just like every other State has.

And there is absolutely no justification, in any way, shape, or form, for excluding Puerto Rico from Chapter 9. And I want to thank Chairman Duffy for his leadership in putting this forward.

But I think it is also important to remember that much of Puerto Rico's \$72 billion worth of debt is what is known as special revenue debt, which enjoys unique protections under Chapter 9.

So even if they had Chapter 9, there would be a whole area that would be protected from restructuring. I hear that, roughly, only 30 percent of the debt would be available for restructuring under Chapter 9. Is that correct, Dr. Zandi? If we had Chapter 9, how much of Puerto Rico's debt could be restructured?

Mr. ZANDI. For sure, 30 percent of the debt. There is a reasonable debate as to whether the other debt, parts of the debt, would fall under Chapter 9. But that would have to be adjudicated, and it would go through a court process.

And just looking, a similar kind of question came up in the Detroit bankruptcy about eligibility, and that just dragged on for 12, 18 months. And Puerto Rico doesn't have that time.

Mrs. MALONEY. So I think we have to consider a more comprehensive option, like a broader restructuring regime, that can bring in all of the creditors to the table, including the secured creditors.

And that is why I believe, Mr. Duffy, we have to look at expanding it to a territorial restructuring and put everybody at the table.

But my question is for Dr. Zandi: What difficulties would Puerto Rico face in negotiating a restructuring under a regime that coves only roughly 30 percent of their debt?

Mr. ZANDI. I think if you do the arithmetic, if they can only get 30 percent of the debt restructured, that wouldn't put Puerto Rico on a sustainable path. They would continue to have significant fiscal problems, economic problems, and you would not have solved the issue. It would be back here. We would be back here, again, discussing this and trying to figure out what to do.

So I don't believe that is sufficient to solve this problem in a sustainable way, as other Congressmen have said that we should.

Mrs. MALONEY. So we need to consider stronger tools than Chapter 9, you would say, Dr. Zandi, correct?

Mr. ZANDI. Yes, I do. And I don't say this lightly, because I do think we need to be cognizant of the cost, potential cost. I think Mr. Isaac brings up an important point that we need to think through.

But I think, at the end of the day, Puerto Rico is not a State. States, under the 10th Amendment of the Constitution, will never go down the path that was being proposed here for Puerto Rico.

And, again, the proof, or the basis, for this perspective that gives me confidence is in the marketplace. Investors who have money on the line are saying that this is not going to be an issue for the rest of the country.

Mrs. MALONEY. Okay. So do you think a territorial bankruptcy regime would be sufficient?

Mr. ZANDI. Yes. And just a restructuring framework. It doesn't necessarily have to be bankruptcy. That is perhaps the cleanest way. But there are other ways of doing it. But there has to be a framework to allow a restructuring of all of the liabilities that the island is struggling with, all of the debt, and all of the unfunded pension liabilities.

Mrs. MALONEY. And that would have the least impact on taxpayers, too.

Mr. ZANDI. I think, at the end of the day, that is the only way to put Puerto Rico on a sustainable path and limit the fallout on the rest of the municipal bond market economy and financial system.

Mrs. MALONEY. Thank you very much.

My time has expired. Thank you very much, Chairman Duffy and Ranking Member Green, for your work on this. And I thank all the panelists for your thoughtful presentations today.

Chairman DUFFY. And I appreciate your positive comments, Mrs. Maloney, but your time has expired. Thank you.

The Chair now recognizes the ranking member of the subcommittee, the gentleman from Texas, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you very much, Mr. Chairman.

Let's start with bankruptcy, in general. I must tell you, friends, I marvel at how bankruptcy has become a taboo for the committee, when, for many years now, there has been this clarion call, if you will, to eviscerate Dodd-Frank and replace it with some sort of super bankruptcy for the big banks.

It just seems to me that if bankruptcy is good enough for the big banks—and that is a bailout if you want to call it such—it seems like it ought to be good enough for Puerto Rico. It just seems to me that we can do for Puerto Rico what persons are proposing currently to do for the big banks.

Literally, eviscerate—well, if not eviscerate, emasculate Dodd-Frank, so that there will not be the opportunity to have the orderly liquidation of these huge mega banks. Now, with reference to someone indicating that it was unfair, or it would create some sort of—disrupt the balance, if we moved to change the bankruptcy rules, we did it in 1984.

And it seems to me that things are still functioning fairly well. And, immediately after 1984, there was not this great disruption in the markets. We changed it, 1984. The law allows for it to be done.

Investors who invest understand that it can be done when they make the investments. They understand this. These are very sophisticated investors, the people who actually make the investments. So they understand that Congress can change the rules retroactively, because we have changed the rules retroactively. Nothing new. It happens.

I don't advocate doing it on some sort of routine basis, but I do believe that, when we have a crisis of this magnitude, such that we will, with our inaction, allow Puerto Rico to become the Greece of the western hemisphere, I think we ought to act. We ought not just allow this to occur.

Now, with reference to the 30 percent, Mr. Zandi, this is the case, because of the specific revenue bonds. And for edification purposes, these are bonds that, in a Chapter 9 bankruptcy, when you get the automatic stay, you are still going to be paying the principal and interest on those, under the automatic stay.

The others, the 30 percent you are talking about, will be subject to the automatic stay, which is why you have to have some methodology by which you can bring everybody to the table at the same time, if you are going to get a long-term solution to a crisis of this magnitude.

I believe that Detroit has benefited greatly. I think that those who prefer D.C., I am not going to argue with you about it. But I think that a good argument can be made that, if we can do it for Detroit, we can do it for Puerto Rico, as well.

And, finally, before we go to another round, if there is going to be another round, Mr. Chairman, I would like to go to Mr. Zandi and ask him the following.

Sir, with reference to the broadening of this, beyond what Chapter 9 will afford, if we broaden, and we bring everybody to the table, would you juxtapose that to what happens if we only bring—

and I think you have done this, but I would like for you to do it again, to help provide additional clarity, if you only bring that 30 percent that we are talking about, that Chapter 9 might afford us, what will the difference be?

Mr. ZANDI. If we only get the 30 percent through the bankruptcy, Chapter 9 bankruptcy, and you do the arithmetic, it is very likely that we haven't solved Puerto Rico's problems. It is unsustainable.

So I think it is important. And, again, that is my arithmetic, but I think it is important to provide the tools necessary for other people to do this work in more detail and to figure it out. And give them the tools to be able to restructure the liabilities more broadly, if necessary, to put Puerto Rico on solid ground.

And I do think it is reasonable to treat Puerto Rico differently than a State. It is not a State. It is a territory. It has the same relationship to the Federal Government as does Detroit has to the State of Michigan. And that is why I think it is perfectly reasonable and ultimately vital that we allow for this broader restructuring framework to go forward.

Otherwise, my sense is, my view is this problem will not be solved, and we will be back here, again, trying to figure it out.

Mr. GREEN. I yield back, Mr. Chairman.

Chairman DUFFY. The gentleman yields back. For those who are willing to participate, and if the panel is okay with it, we would like to do a second round. We have lost a few Members, so it won't take as long. So, with no objection, the Chair recognizes himself for 5 minutes.

I have to say, Mr. Zandi, I would have to imagine that, if that statement was made to the residents of Puerto Rico, that the relationship of Puerto Rico to the United States is that of Detroit to Michigan, I would have to imagine you would probably get some pretty significant objections.

But with that said, I want to look at the debt that is out there. And, to your point, you have indicated that, well, if you offer Chapter 9, that might only be 30 percent, and 30 percent isn't enough to deal with the issues on the island. Is that a fair enough statement that you have made at today's hearing?

Mr. ZANDI. Yes, just to clarify, to your previous point, I said that in the context of the debt, not in the context of the broader frame that you put it in.

Chairman DUFFY. Okay. But you would also agree that we are having a conversation about what is the solution.

Mr. ZANDI. Yes.

Chairman DUFFY. What do we do, as Congress, so we have the power to decide whether it is 30 percent, whether it is 100 percent, or whether it is 75 percent. I am not advocating that COFINA be included, but I am not saying that it shouldn't be included.

But if COFINA is included, we are not at 30 percent. We are going to get up to 75 percent.

Mr. ZANDI. You are right.

Chairman DUFFY. And if we choose, as legislators, to do that, is the 75 percent of debt restructuring sufficient to address the issues on the island and still protect Wisconsin and Texas, States and municipalities, from increases in interest rates?

Mr. ZANDI. Yes, in theory. This is a matter of theory and practice. Are you going to actually accomplish what you want to accomplish with your legislation?

Chairman DUFFY. That is always a question for Congress, theories and—

Mr. ZANDI. Well, no. You are trying to solve a problem. So are we going to solve this problem or not?

Chairman DUFFY. That is why we are here today. We are trying to solve the problem, right? That is the point of the hearing. That is the point of the testimony. But I don't want people to be misled that our proposal can only hit 30 percent.

Mr. ZANDI. You are absolutely right. And I tried to say, every single time that this question has been asked, because it is a key question, and I say, "For sure, 30 percent."

Chairman DUFFY. And this will be a question for us, what—

Mr. ZANDI. Yes.

Chairman DUFFY. —how do we structure—

Mr. ZANDI. Right. Yes.

Chairman DUFFY. —bankruptcy and how much of the debt does it touch?

Mr. ZANDI. But you are absolutely—I don't want to mislead anybody.

Chairman DUFFY. Thank you. So, I know. I wanted to make sure we were clear on that.

Mr. ZANDI. Right.

Chairman DUFFY. Mr. Isaac, former Chair of the FDIC, I think you recently said, "Puerto Rico's debt situation has a potential of significantly rattling the financial markets, and banks need to take notice." What is at stake? Why? With regard to banks? If this question isn't properly handled?

Mr. ISAAC. Pardon?

Chairman DUFFY. If this question isn't properly handled, what do you mean by that?

Mr. ISAAC. I am concerned that the banks have made loans all over the country, in reliance on certain rules of bankruptcy. They understand the rules. They understand what general obligation bonds mean. And they understand the difference between a general obligation bond and a revenue bond.

And, if we say that, through our actions in Puerto Rico, that all those distinctions that you have been relying on don't work anymore, you are no longer in favored status when you have a general obligation bond—

Chairman DUFFY. That would create uncertainty, right?

Mr. ISAAC. Enormous uncertainty.

Chairman DUFFY. And is uncertainty bad for our markets?

Mr. ISAAC. As former Chairman of the FDIC, I used to hate uncertainty. I wanted to know what was going to happen each day when I woke up.

Chairman DUFFY. Thank you for that.

Dr. Krueger, as the former chief economist for the World Bank and the managing director of the IMF, it is my understanding that, when we have distressed countries, the benchmark for debt servicing has been 18 to 22 percent. I think that is—I read that somewhere.

The proposal from Puerto Rico has been that 15 percent of revenue would go to debt servicing. Does that make sense? Should it be 15 percent? Should we get up to 18 to 22? Where should that number be—or percent be, I should say?

Ms. KRUEGER. That number depends, in part, of course, on the country situation. And it varies a bit, of course, by country. I think more accurately what the Fund does is try to look at what needs to be done, structurally, to change growth prospects, at the same time as to get whatever tax and expenditure adjustments are necessary, and then look prospectively at what we call the primary surplus will be going forward.

It is defined as the amount of revenue, over and above other government expenditures, that will come in. And, in general, we look at the primary surplus, rather than an 18 or 22 percent number to ask what could be reasonable.

And those numbers vary all over the place. When I was there, I think we had one country where, indeed, something like 20 percent of GDP was primary surplus going to debt service for a year or two. Another country it was three. It makes a big difference what the inflation rate is and things like that.

I don't think there is any hard and fast rule on 15 or 18 percent. There are many other things to be taken into account.

Chairman DUFFY. Okay. I think everybody would understand and agree that this institution is very sensitive to taking taxpayer money and using it in the form of a bailout. If you haven't noticed that, you haven't been paying attention.

And, so, there is some conversation about bankruptcy being a bailout. Now, I would ask the panel, I would normally think of a bailout as this institution taking Federal taxpayer money and giving it to another institution to bail them out.

Do you all see bankruptcy as a bailout? Yes? Dr. Krueger?

Ms. KRUEGER. Do you want me to start? Bankruptcy comes about when there is no alternative, which is, I am afraid, the Puerto Rican case, or, more accurately, when the alternative is worse. And the alternative, in this case, for Puerto Rico, of not getting something now means probably no growth, which, as I said, also means some other things, and continuing fiscal unsustainability, which leads to uncertainty, which leads to more problems. The normal—

Chairman DUFFY. And could that lead to the call for this institution actually to bail them out? To actually send taxpayer money to the island?

Ms. KRUEGER. The normal procedure is, when things get to that shape in countries, what happens is that without some short-term money, things are grinding to a halt, and the downward spiral is making things even worse.

So that sometimes what happens is money comes with it, but that normally is repaid. Now the art of bankruptcy is to find a law which gives enough room so that when their things are really in dire, dire straits, so there is no alternative, there can be a mechanism so that you just don't go downhill forever.

But, at the same time, creditor rights are protected, as much as you possibly can, because otherwise creditors aren't going to lend. So finding that balance is what is really hard.

Chairman DUFFY. What is key. Thank you. Just quickly, and I am done, but does anyone disagree with that point that bankruptcy is a bailout? No one is raising their hand. I will take that as you don't agree that bankruptcy's a bailout.

With that, my time expired long ago. The Chair now recognizes the ranking member of the subcommittee, the gentleman from Texas, Mr. Green, for 5 minutes.

Mr. GREEN. I thank you, Mr. Chairman. Let's continue with the bailout proposition, because it is important to note that when you are in bankruptcy, the creditors come to the table, and it is all about trying to get some agreement as to how the creditors will go forward.

And if there is a loss, it is the creditors, not the citizens, who are not a party to the bankruptcy, who end up taking the loss. The creditors, not the citizens. Now, taxpayers can be involved in business, but it is not because they are citizen taxpayers that they are at the table. They are at the table, because there was some investment.

So it is those who have invested. And we have to make that clear, because there seems to be a belief, among some of us, that in bankruptcy the court orders money from the Treasury to be used to satisfy some need, which is absolutely, totally, and completely untrue. It is not the case.

Now, moving forward, let's see a show of hands of the persons who are here with us today as witnesses, and I thank you, of those who would favor bankruptcy. You may favor more, but see bankruptcy as a part of the solution. If you think bankruptcy is a part of the solution, I just want to get this on the record, would you kindly raise your hand?

All right. Let the record reflect that all of the members of the panel—you may lower your hands—see bankruptcy as a part of the solution.

Now, Mr. Isaac, you have been in the banking business for some time. And you are aware of bankruptcy laws, to a great extent. I am assuming this, okay? But when it comes to banks, when they have a problem, they usually close them on Friday. The FDIC comes in. then, they open them up on Monday, generally speaking. Is that a fair statement?

Mr. ISAAC. That is a fair statement.

Mr. GREEN. All right. And so, if in banking—and by the way, FDIC is sort of a fund that is developed from a premium paid by banks. Is that a fair statement?

Mr. ISAAC. That is correct.

Mr. GREEN. Okay. So you have the FDIC, you have the banks. Now, if banks made an investment in some aspect of the Puerto Rican economy, they did so understanding that they might make money or they may lose money. Even banks can lose money. Would you agree that they would have to do that with that understanding, that they would make or lose? It is not always a winning proposition. You can't arbitrage a bank.

Mr. ISAAC. That is correct. It is a risk business.

Mr. GREEN. Right. Although, I do confess that there is a way, sometimes, to arbitrage with the spread and something that we went through in 2008. But that is not a part of this hearing.

So if banks can lose money, then this may be one of those times when banks may have to take a haircut—haircut is another way of saying lose some money—just as other investors may have to take a haircut.

And, by the way, I am not in favor of having anybody lose money. But we have a crisis that we have to resolve. And we are not going to resolve the crisis by allowing it to continue without some intervention. So the question is, to what extent do we intervene?

I remember in 2008, Mr. Zandi, when—and I think you were around and a part of many of these discussions, trying to determine what the amount of the—what was it, the TARP?

Mr. ZANDI. TARP. TARP program.

Mr. GREEN. TARP. Yes, trying to determine the TARP was a big question. We had someone to come in and testify that we needed a certain amount of money, with about five sheets of paper.

Mr. ZANDI. Yes.

Mr. GREEN. And with those five sheets of paper, we started a process. But we had a big debate about how big it should be. So we are into that big debate now about how big this should be.

It is what we have done before. We do this. This is why we are here, to have these debates. And Mr. Duffy and I will, hopefully, try to come to a consensus so that we can resolve this and not have a measure that doesn't go far enough, because we have seen what happens when you don't go far enough.

You can actually exacerbate the problem. And that is not what we want to do. We want to resolve the problem.

With that said, Mr. Chairman, I yield back.

Chairman DUFFY. The gentleman yields back. The Chair now recognizes the ranking member of the full Financial Services Committee, the gentlelady from California, Ms. Waters.

Ms. WATERS. Thank you so very much, Mr. Duffy. Let me tell you how pleased I am that you are holding this hearing. I think this absolutely needed to be done, and I am very appreciative that you are doing this.

Let me direct a question to Dr. Zandi and, perhaps, Dr. Krueger, too. Throughout your testimony, you have spoken of the importance of expanding the Medicaid program to improve health outcomes and of introducing the Earned Income Tax Credit, as a strong incentive to find taxable employment.

Chairman DUFFY. If I could just briefly interrupt the ranking member, if you could speak a little bit louder, I think the panelists are having a hard time hearing you. I'm sorry.

Ms. WATERS. They can't hear me? Usually, that is not the case.

Chairman DUFFY. That is usually not the problem.

Ms. WATERS. What is wrong today? Okay. The questions that I have are for Dr. Zandi and, I believe, Dr. Krueger. Throughout your testimony, you have spoken of the importance of expanding the Medicaid program to improve health outcomes and of introducing the Earned Income Tax Credit, as a strong incentive to find taxable employment.

Specifically, I am told you mentioned that the cost of these proposals, when fully operational, would be roughly \$2 billion a year. Will you please explain how the cost of these programs would be

offset by the expected increase in labor force participation and tax revenues and anticipated decrease in healthcare expenditures?

Secondly, what would be the expected costs if these critical social welfare programs were not made available? Is it possible that the lost revenues and unemployment expenses could exceed \$2 billion per year? Starting with Dr. Zandi.

Mr. ZANDI. Okay. So just to be clear on Medicaid, all I am arguing is that the funding for Medicaid in Puerto Rico should be the same as the funding on the mainland. If you have that same threshold, then, I think, you have gone a long way to helping Puerto Rico, because under current law that is not the case. And the funding will decline in late 2017, 2018.

And this is key for Puerto Rico, because half of the population is on Medicaid. And without those benefits, this will be very serious. That, just to be precise there, my calculation of the cost is \$2 billion per annum on a present value basis.

So over the next 10 years. So \$20 billion, over the next 10 years, on a present value basis. If you do it by CBO accounting, it probably comes closer to \$30 billion. That is in nominal dollars.

You make an excellent point, and that is, if we don't take steps like funding Medicaid fully and adopting an EITC, and other steps, the economy of Puerto Rico will continue to shrink, which means the fiscal situation will continue to erode, which means we will be back here, again, talking about Puerto Rico's problems.

It means the tax base erodes. It means less tax revenue, and the costs will continue to mount. If we do these things, in addition to some other things I propose in the written testimony, get Puerto Rico moving in a positive direction, that gives you positive revenue growth.

And I haven't done the calculation, whether that pays fully for the Medicaid expansion and EITC, but it probably comes pretty close, yes. So I think it is a very reasonable thing to do. And, frankly, I don't see any other option, because if we don't get Puerto Rico moving north, as opposed to south, nothing works. Nothing works.

Ms. WATERS. Thank you very much.

Dr. Krueger, you have a minute or so to add to that.

Ms. KRUEGER. First, I agree with everything that Dr. Zandi said, but I would make the point even more strongly. If the formula for providing Medicaid to block grants were the same for Puerto Rico, that be a huge difference in Puerto Rican payments.

And the current payments are expected to expire in 2017, which, if something is not done, is going to be another big hole in the Puerto Rican budget, because they are mandated that they must do it.

And it is not that healthcare would improve. It is that the funding must be done by the Commonwealth, by Federal law. And any other State in the United States gets more funding for the same—if you use the same formula, Puerto Rico would get more, too.

As to EITC, obviously, if more people enter the formal labor force and start paying taxes, even though they get EITC, there is a huge offset there, but the big offset, I think, is in getting Puerto Rico turned around and on a proper growth path.

Costs of welfare, in general, will go up across Medicaid, everything, until such time as the Commonwealth turns around. And

they will come either on the island, or on the mainland, if people leave.

So it is not a U.S. choice to avoid. It is only a question of where the pain comes and how much there is, I think.

Mr. ZANDI. Just one quick point, Congresswoman? All of the budgeting that is being done now is under the assumption that this Medicaid fix will occur. If it does not take place, then all of these budget assumptions that are being—with the governors putting forward and what the bond holders are assuming, everything, it is just not going to work. It is going to be many times worse than what we expect right now.

So this is a working assumption of everyone out there, that this is going to happen.

Ms. WATERS. All right. Thank you very much, and I yield back.

Chairman DUFFY. The gentlelady yields back. The Chair now recognizes the gentleman from Minnesota, Mr. Ellison, for 5 minutes.

Mr. ELLISON. Thank you, Mr. Chairman, and thanks to the ranking member, as well. And, also, thank you to the panel.

Dr. Zandi, thanks for being here. I have read that some economists believe that Puerto Rico's current problems began with the winding down of Section 936. Section 936, for the record, provided American companies with incentives to invest and create jobs in Puerto Rico.

Would bringing back Section 936 generate economic activity and jobs? Would restoring it enable Puerto Rico to pay off its creditors in time?

Mr. ZANDI. I think the expiration of 936, and it was completely wound down by the year 2006. And that was the year that the economy peaked in Puerto Rico. Employment peaked, population peaked.

So, yes, I think the expiration of the tax benefit under 936 has contributed. There are many other factors, obviously, but it is one factor in the 10-year long recession in Puerto Rico. Would I bring it back? I think if—we were talking about this earlier—if I were king for the day, I would say no.

I would use that resource and that money, and I would use it to fund the EITC, a Child Tax Credit, which, by the way, also incents work. But we want to get a culture of people paying their taxes. It has been aptly demonstrated here that there is a big underground economy. People don't trust the system, and they are not paying.

And, so, we have to change that. And the EITC and the Child Tax Credit would go a long way to incenting people to get into the formal economy, start paying their taxes. It will make this whole thing work out a lot better. So, if I were doing this, that is where I would spend my attention and the resources.

Mr. ELLISON. Thank you. Also, do any of the other panelists have any comments on that? Yes, Dr. Krueger?

Ms. KRUEGER. Yes, I would agree with Dr. Zandi, but add that, indeed, even the 936, when it came, brought in the high-value added skill using things, and that is not Puerto Rico's comparative advantage, first.

But, secondly, we did it once. We took it back once. What would convince people that Congress, if they did it again, would not take

it back at some later date? And I would think the effects of it, the second time around, would be far smaller than they were the first time. And the first time, it helped the people who didn't need the help as much.

Mr. ELLISON. Yes. Thank you for your thoughts on that. And here is another question for the panel. What sectors of the Puerto Rican economy have the most potential to grow? You can start, Doctor.

Ms. KRUEGER. I can take a crack at it.

Mr. ELLISON. Okay.

Ms. KRUEGER. The first thing I ever taught in an international trade course was that you can never tell what will spring up when you change incentives. And that is true. The things that become big industries and big users of the labor force very often are things that nobody ever dreamt of ahead of time. So it is very hard to tell.

But tourism in Puerto Rico has not thrived, except at the high end, partly because of minimum wage. Dominican Republic's minimum wage is very low. Puerto Ricans are competing when their minimum wage is about 10 times as high. Not that it should be that low, but it should be somewhere in between, probably, for that purpose.

But tourism, there are very few more tourist spends now than there were in 1980, despite the boom of tourism all around the Caribbean. It doesn't make any sense. I think that there should be a booming corporate headquarters for companies, probably mostly European, that do business in both North and South America.

It hasn't happened. And I think a lot of this problem we have been discussing accounted for it. But Puerto Rico should be a major corporate headquarters sector, provide financial services for both North and South America, and other things that would take advantage of the U.S. dollar, U.S. law and order, U.S. protection of various kinds, and the advantage of the geographic location, and the Spanish and English connection.

Mr. ELLISON. Great. Others?

Mr. ZANDI. Yes, I would agree. The most obvious is the tourism industry, which has languished for lots of reasons. And the infrastructure of Puerto Rico is quickly eroding and making it more difficult for that to be a mass market for tourism.

But that is the most obvious comparative advantage. And I do think financial services is a place where there would be significant potential. There is a lot of capital flowing from South America, Central America, into the United States.

Now, right now, it is mostly going into Miami, in Florida. But I don't see any reason why Puerto Rico couldn't get its fair share of that capital flow. And I think that would be a significant boon to the economy.

Mr. ELLISON. Good.

I will yield back and say thank you, again, to the panel and to the chairman and the ranking member.

Chairman DUFFY. The gentleman yields back. The Chair now recognizes the gentleman from South Carolina, Mr. Mulvaney, for 5 minutes.

Mr. MULVANEY. Thank you, Mr. Chairman. I thank the panel for sticking around. Mostly, I want to talk to my colleagues, if I may,

because a couple of items have come up, from both Mr. Green and Mr. Duffy, regarding bankruptcy.

I think it was referred to as a taboo. Some question whether or not some of us thought it was a bailout. Certainly, no one here, gentlemen, is suggesting that a bankruptcy filing is somehow a transfer from the Treasury to the island government. That is not the point.

The point, to my friend Mr. Green, would be that the understanding of the lenders, which you talked about at some length, is critical here and central to the issue. And you used the word banks. I will use retirees. But when the retirees in my district invested in these bonds, they did so under a certain understanding.

Yes, part of the understanding was that they could lose money. But another part of the understanding was that the general obligation, the taxing authority of the island was pledged as security. And, in exchange for that promise, that legal promise, that contract, my retirees accepted a lower rate of interest.

If they had known that maybe the pensioners would go first on the island of Puerto Rico, that they might be made subordinate to that flow of funds, they may have demanded a higher rate of interest. But it was a legal contract.

And what we are talking about here is not allowing bankruptcy. I used to practice bankruptcy law a little bit. I know what it is. I know that it can be helpful at particular times. But what we are talking about here is allowing bankruptcy after the fact. My folks have lent to Puerto Rico—

Mr. GREEN. Will the gentleman yield, since he has invited me into the conversation by naming me?

Mr. MULVANEY. I will. And I think Mr. Duffy will be a little bit liberal with the time, since this is the end of the discussion. But my folks have lent money under the understanding that it be repaid in a certain fashion and that bankruptcy could not be used, as it is used in other States or as it is used in corporations, that it was different.

And, in exchange for that set of facts, they were willing to accept a lower rate of interest. We are not suggesting that bankruptcy, by itself, is a bailout. We are certainly not suggesting that bankruptcy is somehow a transfer from the Treasury.

What we are suggesting is that it is unfair to change the rules on the people who have lent money, in good faith and with a certain legal understanding as to how they might be repaid. Yes, there was a risk that they would not get repaid. But bankruptcy was not one of the risks they signed up for.

And, with that, I will yield to the gentleman, to my friend, and I will be happy to enter into a colloquy, if you would like to.

Mr. GREEN. Thank you very much. I concur with you, to a great extent, but I do have to acknowledge that the Supreme Court weighed in on this. And the Supreme Court indicated that, because Congress has this awesome authority to regulate bankruptcy, that Congress can change the rules.

And the Supreme Court has gone so far as to say the rules can be changed retroactively. And the people who make these deals, who make the deals, not some of the people that you may be addressing—and I don't want to see anybody hurt—but these are, by

definition, sophisticated investors, persons who understand what they are doing, and are in a position to sometimes lose.

That is unfortunate. I don't want to see anybody lose, but that is the case sometimes. And with reference specifically to Puerto Rico, we are talking about Americans there, Americans here, as well. It just seems to me that there should be some accommodation. There will have to be some compromise.

And I am willing to work out a compromise. And my trust and belief is that you are willing to do so, as well.

Mr. MULVANEY. I appreciate that, and I will reclaim my time. And I tend to agree with you. I have read the case that the governor sent us from the Supreme Court from the 1930s. It makes it clear that Congress does have the authority to do this.

Of course, we did this, again, in the Chrysler bankruptcy, during the auto bailout. But I would suggest to my friends, on both sides of the aisle, that just because we have the authority to do so does not mean that it is fair for us to do so, or that it is right for us to do so.

So I don't think anyone is arguing here whether or not we have the legal authority, the legislative authority, to do what the Treasury, specifically, is suggesting. My question is should we do it? Is it fair?

Is this one of those circumstances that is so extreme and so unfortunate? For example, when the case from the 1930s references the Great Depression in California, a national calamity. From what I have read so far, much of the ills that have befallen Puerto Rico are specific to Puerto Rico and specific to the management of the company.

I, specifically, referenced earlier the experience with the electric company choosing, of its own free will, not to raise rates, money that could have been used to help pay back the bond holders.

And I do look forward to continuing the conversation. I want to ask one or two more questions before we leave.

Specifically, Dr. Zandi. And I want to put you on the spot, because you weren't the only one who said this, but you were the most recent one, so it sort of stuck in mind. We have to do something to get Puerto Rico going. We have to do something to fix it. I think Dr. Krueger mentioned it. Everybody agrees that we have to have growth in Puerto Rico and have some restructuring and so forth.

Why do we think we are better at it than the Puerto Ricans?

Mr. ZANDI. I think that we aren't. They have their own views and perspectives, and I think they should be considered. But there are things that Congress can do and, I think, would be very helpful to the Puerto Rican economy, that the Puerto Ricans would welcome and that would be beneficial to U.S. taxpayers, in the long run.

If we don't address Puerto Rico now, and the Puerto Rican economy, I think, most of us would agree will continue to be in recession and sink, it is going to cost taxpayers, U.S. taxpayers, your constituents, me, money.

So we need to address this. And I think they will welcome proposals like EITC. But, at the end of the day, they are a sovereign entity. And they have to be involved in the decision-making process

and be involved, because they are going to have to solve the problem and get on a sustainable path by themselves.

Mr. MULVANEY. And if that is a basis for understanding going forward, if we talk about the Jones Act, talk about the EITC, we talk about tourism, we talk about the minimum wage exemptions, that may be a basis for a future understanding.

Last question—I appreciate the chairman’s liberalness, with a small L, with the time—which is I heard something at the very end and it struck me, which is that these assumptions, we are making assumptions about a change in, is it Medicaid reimbursements?

Mr. ZANDI. Yes.

Mr. MULVANEY. So my understanding, and it is just very basic, is that the current law of this country is that those payments will go down fairly dramatically in the next couple of years. What you are telling us is that the assumptions that everyone has made is that Congress will change the law, in order to fairly dramatically increase Medicaid reimbursements to Puerto Rico in, I think, it is 2018. Is that correct?

Mr. ZANDI. Yes. When I say everyone, I am saying market participants—

Mr. MULVANEY. Right.

Mr. ZANDI. —people who are looking at this, people who are doing the budgeting in Puerto Rico. You have to make assumptions when you do a projection.

Mr. MULVANEY. Absolutely.

Mr. ZANDI. And one of the key assumptions, is, yes, that is going to be patched.

Mr. MULVANEY. How much is that? Does anybody know?

Mr. ZANDI. By my calculation, I calculated on a CBO basis, over a 10-year period, it will probably cost \$25 to \$30 billion per annum.

Mr. MULVANEY. “Billion” with a “B?”

Mr. ZANDI. “Billion” with a “B.”

Mr. MULVANEY. So the assumption is that we will increase the Medicaid reimbursement to Puerto Rico, beginning in 2018—

Mr. ZANDI. Yes. And because you might have missed this, what this will do is ensure that the Medicaid reimbursement to Puerto Ricans is exactly the same as the reimbursement to you and I, here on the mainland.

Mr. MULVANEY. Right. But it is different in the law, now.

Mr. ZANDI. It is different in the law now.

Mr. MULVANEY. Okay. All right.

Mr. Chairman, thank you very much.

Chairman DUFFY. The gentleman yields back. I am going to ask unanimous consent to recognize the gentleman from Texas for 1 minute.

Mr. GREEN. Thank you, Mr. Chairman. I believe that Dr. King addressed this question of it is only Puerto Rico. And I would like to share his thoughts with you. He reminds us that life is an inescapable network of mutuality, tied to a single garment of destiny. What impacts one directly, impacts all indirectly.

What happened to Greece, we thought, was a problem for a given country. But we now understand that these problems can exacerbate other problems in the world. What happened with credit default swaps, we thought would impact just some, maybe in a cer-

tain market. But we found out that it could impact the entire economy.

So I think we have to step back and get a sense that this may not end at the water's edge in Puerto Rico. It has a potential to surf its way all the way to the USA. I yield back.

Chairman DUFFY. The gentleman yields back. I always appreciate that I get some of the best Dr. King quotes from the ranking member. He always puts them in so well, and I thank him for that. And I thank the panel for coming in today.

This has been a really great discussion, and I hope that you take away that we are all engaged in trying to find a solution that works for Puerto Rico, that works for our government, and that is fair, by way of everybody.

And I think it is a conversation that puts everything on the table and looks at Puerto Rico as a whole. And we have an eye towards the people of Puerto Rico and making sure their lives are better, their opportunities are better, and their future is better and brighter.

And, if they want to stay on the island, in their neighborhoods and in their communities, they will have that option. If they want to come to the mainland, they can make that choice, too. But a lack of opportunity should not be the reason why they can't stay.

So, again, I want to thank the panel for being here and for your time and for your insightful testimony.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And, with that, without objection, this hearing is adjourned.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

A P P E N D I X

February 25, 2016

Written Testimony of Juan Carlos Batlle
United States House of Representatives Subcommittee on Oversight and Investigations of
the Committee on Financial Services
February 25, 2016

Puerto Rico's Debt Crisis and Its Impact on the Bond Markets

Good morning Chairman Duffy, Ranking Member Green, Resident Commissioner Pierluisi and other distinguished members of this committee.

For the record, my name is Juan Carlos Batlle. I was President of the Government Development Bank for Puerto Rico from March 2011 to December 2012. Prior to holding this position, I held senior positions for Banco Santander's investment banking, asset management and retail brokerage operations in Puerto Rico for 15 years, working closely with public finance matters for the Government of Puerto Rico and the municipal bond markets, locally and stateside.

Focusing concurrently on the root causes of our problems, the health of our banking sector and the impact of the debt crisis on investors and the municipal bond market makes it evident that the subject matters are interrelated and that rather than static, they constitute a dynamic situation whose eventual resolution will rest on the action or inaction of this Congress and the Government of Puerto Rico. Failure to act will only add new problems, destabilizing again our banking sector, inflicting even more pain on the 3.5 million US citizens who call Puerto Rico home, investors and our economy while introducing unwarranted uncertainty and legal entanglements to the municipal bond market. There is no unique, perfect solution out there, but we need to act. This Congress needs to act. And time is of the essence.

In my view there are nine major root causes of our problems:

First, a lack of execution and follow through on economic development initiatives. Over the past 20 years and under five different administrations, Puerto Rico has put forth five different economic development and fiscal plans. Plans that shared the same underlying principles and objectives: Making Puerto Rico a better place, more competitive, with a better business environment, a more efficient and less bureaucratic government and allowing the private sector to spearhead job creation that would lead to better quality of life and social wellbeing¹.

The plans and ideas are not the problem. Our inability to execute has been the limitation to our progress and the culprit of our lack of economic development. Five plans have failed not because they were flawed or inadequate, but because we **failed to execute, we failed to compromise. We don't need new plans, we need the will to compromise and execute for the greater good.**

¹ Commonwealth of Puerto Rico Financial Information and Operating Data Reports
http://www.bgfpr.com/investors_resources/documents/2012-06-13-PRCommonwealthPubImpRef1998.pdf
http://www.bgfpr.com/pdfs/public_corp/commonwealth/OSGOREfundingApril2003.pdf
http://www.bgfpr.com/pdfs/public_corp/commonwealth/2007-09-17-OS-PRCommonwealthGOs408MM.pdf
http://www.gdb-pur.com/investors_resources/documents/2011-02-15-PRCommonwealth2011A356MM.pdf
<http://bgfpr.com/documents/CommonwealthReport11-06-15.pdf>

Second, our inability and unwillingness to change and adapt. In 1996 Congress eliminated Section 936 of the US Internal Revenue Code through a 10-year phase out. Section 936 provided tax incentives for manufacturers to locate its operations in Puerto Rico.

The elimination of Section 936 was certainly a tipping point after a 20-year window that allowed us to build the foundation for a robust manufacturing sector. However, it was our responsibility to adapt and to change to the new paradigm in a post-936 world. We did not. **We failed to adapt and execute, we failed to compromise, and chose to put the petty political fight before the well-being of future generations.**

Third, decades of fiscal and economic mismanagement resulted in recurrent budget deficits, ballooning public debt, an unchecked informal economy, legal and illegal, significant government corruption and a bloated public sector that crowded-out private sector growth.

Fourth, a lack of adequate, independent regulation over the Government Development Bank for Puerto Rico (GDB) and the Economic Development Bank for Puerto Rico (EDB). The GDB and EDB must be subject to heightened regulation by independent regulatory bodies. For decades and during times of economic prosperity, they each served very specific purposes – the GDB promoted economic development and acted as fiscal agent and financial advisor to the Government of Puerto Rico, its agencies and instrumentalities, while EDB focused on providing financing to small and medium size businesses and start-ups. Since the early 2000s as central government and municipal budget deficits widened, public sector payroll ballooned, and public corporations faced financial and operational challenges, GDB became the lender of last resort to these troubled public sector entities.

Fifth, a fragmented government-wide technological structure that has not focused on "delivery" to the end user. Most systems throughout government agencies work on sub-par levels and do not speak to each other. The Office of the Chief Information Officer (CIO), created by Executive Order in 2009 and enhanced during the first 30 months of the current administration, was dismantled after significant progress in development and delivery of new services, including a pilot project aimed at producing **"real time" financial statements for public corporations**². Former employees of this now defunct CIO Office are currently working for the US Digital Service (USDS) here in DC. The USDS' best practices and talent level can contribute immensely in improving local government efficiency and the ease of doing business in Puerto Rico. We should aggressively pursue a formal collaboration arrangement with USDS.

Sixth, a completely dysfunctional internal revenue service with an ill-trained and equipped workforce and aging and inefficient technological systems that facilitate out of control tax evasion.

² "How the Government of Puerto Rico Can Deliver Financial Statements in Real Time" by Giancarlo González, former Chief Information Officer of the Government of Puerto Rico (2013-2015) <http://www.giangonz.com/espanol/puerto-rico/how-the-government-of-puerto-rico-can-deliver-financial-statements-in-real-time/>

Seventh, employers and employees within the formal economy in Puerto Rico pay the same payroll taxes as in the mainland, yet the funding of federal health programs to Puerto Rico is unfairly rationed by federal discriminatory legislation and arbitrary administrative determinations.³ This unfair treatment is one of the principal drivers of recurring budget deficits, as it places an unjust and disproportionate burden on the central government to provide essential health services to its citizens.

Eighth, the enactment of tax laws and lax regulation by local and federal regulatory bodies that discouraged suitable wealth preservation strategies and encouraged the over concentration of local wealth in Puerto Rico assets.

For decades, Puerto Ricans have been incentivized to invest disproportionate amounts of local wealth in stocks of financial institutions with predominant presence in Puerto Rico, real estate in Puerto Rico and bonds issued by Puerto Rico Government issuers. These non-diversified strategies resulted in an unimaginable loss of wealth estimated by some to exceed of \$50 billion. The magnitude and nature of this problem can't be ignored and must be addressed as we move forward.

Ninth, a lack of accurate, independent and timely financial and economic data as well as trustworthy budgetary forecasts which eventually led to total loss of market confidence, credibility and access. The loss of market access is the culmination of decades of fiscal mismanagement and failure to execute and compromise for the greater good.

The lack of execution mainly due to our inability to compromise on politically unpopular decisions as a result of excessive partisan politics and a self-centered private sector are among the main reasons Congress needs to act swiftly and decisively by mandating the creation of a fiscal oversight and control board.

The tenth anniversary of Puerto Rico's economic depression has resulted in a 14% contraction of our real GNP⁴ and a 42% contraction of banking system assets.

The sector has gone through three FDIC-assisted bank consolidations in 2010 and another in 2015. During the last decade, total system assets decreased by 43% or \$43 billion and total deposits declined by 31% or \$20 billion. The number of branches declined by 194 or 34% and total net loans and leases were reduced by 37% or \$22 billion⁵. Moreover, residential mortgage originations experienced a dramatic reduction of 60% or \$5.4 billion while foreclosures in 2015 reached 4,123. Since 2008, there have been over 27,000 residential foreclosures and there are currently close to 20,000 homes in different stages of the foreclosure process⁶.

³ Puerto Rico: Information on How Statehood Would Potentially Affect Selected Federal Programs and Revenue Sources, GAO-14-31, (March 4, 2014). <http://www.gao.gov/products/GAO-14-31>

⁴ Economic Report to the Governor – Statistical Appendix 2014
<http://www.bcfpr.com/economy/documents/AppendiceEstadistico2014-BajadoJP25ago2015.pdf>

⁵ V2A – Vision to Action, "Puerto Rico Banking Industry Trends and Benchmarking with United States National Trends: 10-Year Review (2006-2015)

⁶ Office of the Commissioner of Financial Institutions. <http://www.ocif.gobierno.pr/>

In spite of this, the banking sector in Puerto Rico has undergone a major transformation and has been able to stabilize its capital and delinquency ratios. However, the sector can't be healthy while the government's fiscal challenges and a contracting economy continue to drag it down and federal regulators subject them to excessive regulatory examinations and stifling reporting requirements.

Through the creation of a fiscal oversight and control board, federal regulators could provide relief and technical assistance to the banking sector without abandoning their supervisory responsibilities, allowing banks to direct resources on smarter and more agile lending practices that can fuel economic activity.

Puerto Rico's public debt is roughly \$70 billion⁷, representing 1.9% of the \$3.7 trillion municipal bond market⁸.

Unconfirmed estimates indicate that roughly 80% of the Island's bonded debt is held by individuals, directly through their own investment accounts or indirectly through pension and mutual funds. An important portion, over \$11 billion by my estimates, is still held by individuals on the Island, although this number was more than \$20 billion prior to the current crisis. An attempt to indiscriminately restructure all of Puerto Rico's public debt, without regards to the rule of law, credit hierarchy and in direct violation of Constitutional and legal protections awarded to certain bondholders, would have a dramatic impact on Puerto Rico's ability to recover its credibility and eventually, market access. Furthermore, deferring or defaulting on hundreds of millions of annual interest payments that pay for the cost of food, health and other essential services debt service on mortgages and loans of thousands of US citizens would be catastrophic.

Moreover, the municipal bond market would also stand to lose. The municipal bond market is boring. It frowns on surprises and uncertainty as it is generally a stable and predictable market. In this case, boring is good. Risking a unilateral and unjustified debt restructuring as currently being pursued by the Commonwealth's financial and legal advisors will undoubtedly create uncertainty and volatility that will have an impact extending well beyond Puerto Rico.

A disorderly debt restructuring will not only have negative effects on Puerto Rico's economy and thousands of individual investors, but on the entire municipal bond market. A federally mandated fiscal oversight and control board alongside a proven and trusted legal framework, like Chapter 9, that provides for the reorganization of municipalities, utilities and instrumentalities of Puerto Rico, including restructuring of debt of non-Constitutional and insolvent issuers the only way to safeguard and protect Puerto Rico and the \$3.7 trillion municipal bond market. This mechanism should require good-faith and consensual negotiations as a pre-requisite for Chapter 9 eligibility.

⁷ Commonwealth of Puerto Rico Financial Information and Operating Data Report, November 6, 2015. <http://www.bgfpr.com/documents/CommonwealthReport11-06-15.pdf>

⁸ Federal Reserve Statistical Release, Z.1 Financial Accounts of the United States, Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, December 10, 2015

Mr. Chairman, crisis is the mother of opportunity. The situation we face today presents this Congress, the Government of Puerto Rico, and all stakeholders with a unique opportunity to shape a better and stronger Puerto Rico.

Puerto Rico needs a comprehensive fiscal and economic recovery strategy that includes three essential components: A fiscal oversight and control board, a proven and trusted debt restructuring mechanism and economic stimulus measures.

- i. **Fiscal oversight and control board.** The board could have 5 members with adequate expertise, a majority of whom must be truly independent from the Puerto Rican government. The board's guiding principles should be to guide Puerto Rico towards fiscal stability and sustainable economic growth. Its main objectives should be the following:
 - a. Produce credible and timely financial data
 - b. Eliminate budget deficits within a reasonable period while maintaining balance for at least four consecutive years
 - c. Oversee a wide ranging restructuring of government agencies, municipalities and public corporations
 - d. Promote economic growth and greater private sector participation, including the concession of public assets through the already proven Public Private Partnership mechanism
 - e. Mediate an orderly debt restructuring process, through good faith, consensual negotiations first, and Chapter 9 of the US Bankruptcy Code, if needed
 - f. Restore solvency to pension funds
 - g. Assist in restoring credibility and the rule of law, while improving the business environment
 - h. Ensure any new federal assistance is properly monitored

This board could be structured in two phases: "Oversight Phase" and "Control Phase."

Oversight Phase:

- a. Appointment of a Chief Financial and Restructuring Officer that will report directly to the board.
 - ✓ CFRO must have the necessary credentials, reputation and independence to promote credibility and lure investors back to Puerto Rico
- b. Assist in the preparation and publication of independently audited financial statements in a timely manner
- c. Serve as liaison between the Government of Puerto Rico and the US Digital Service in order to promote best practices and attract "best for the job" talent to develop and implement optimal technological systems and processes

- d. Review central government budgets establishing goals for expenditures and collections and monitor the use of federal financial assistance
- e. Mediate and facilitate, but not adjudicate, consensual agreements between creditors and Government of Puerto Rico issuers, and authorize the use of Chapter 9, when needed
- f. Facilitate restructuring efforts between the Government of Puerto and its non-debt stakeholders (i.e., vendors, contractors, collective labor agreements, others)
- g. Review and approve all borrowing by the Government of Puerto Rico and its instrumentalities
- h. Review and approve any sale or concession of government assets
- i. Review and approve a wide ranging restructuring of government apparatus, including regionalization or consolidation of municipalities (78), government agencies (>130) and public corporations
- j. Prepare and deliver quarterly reports to the Governor of Puerto Rico, US Congress and the Puerto Rico legislature on progress of financial position, reforms and deployment of new federal financial assistance
- k. Review quarterly reports by the Government of Puerto Rico on debt restructuring negotiations, proposals from creditors, collective bargaining units, vendors and other stakeholders

The board must have the power to examine and veto annual budgets that are not truly balanced and to monitor budgets vs actual results on real time. It also needs to have the ability to approve capital expenditures that exceed certain thresholds. Finally, all labor contracts for government employees must be subject to review and approval by the board.

If expenses, collections or financial goals are not met and/or reporting is not complied with, or restructuring plans are not executed on a timely basis, the board would automatically transition into a control period that would include all of the responsibilities under the Oversight Phase and the following additional responsibilities:

Control Phase:

- a. Direct and enforce budget cuts, financial standards and reporting requirements
- b. Reorganize and consolidate executive departments, municipalities and public corporations
- c. Eliminate or modify existing taxes that undermine economic development
- d. Levy new taxes and fees and impose reforms deemed necessary to promote economic growth and fiscal stability
- e. All orders during the control period must be legally binding; venue for legal challenges must be the US District Court

ii. A debt restructuring mechanism that would promote consensual negotiations and agreements as pre-conditions to authorize eligible municipalities and instrumentalities to reorganize under Chapter 9 of the US Bankruptcy Code

- a. Amend US Bankruptcy Code to allow Puerto Rico to be treated as a state for debt-related purposes, returning to pre-1984 US Bankruptcy Code treatment
- b. Encourage the negotiation of good faith concessions by creditors that are not eligible for restructuring under any existing legal framework (Constitutional debt or otherwise secured and solvent credits) in order to achieve near-term debt service relief and obtain short term gap financing and CAPEX financing
- c. Restrict the ability of eligible issuers to access Chapter 9 through a neutral mediator, using California Assembly Bill 506, Chapter 675 of October 9, 2011 as framework. A professional, independent, neutral mediator could facilitate negotiations among issuers and creditors, labor unions, vendors, suppliers and other stakeholders
- d. In the event mediation process is not successful, establish a proven and trusted legal framework for the restructuring of all non-Constitutional, insolvent issuers)

iii. Economic stimulus measures. In addition to strict fiscal discipline and cost cutting, a meaningful economic stimulus strategy must be put in place in order to steer our economy towards sustainable growth.

- a. Fair and just treatment under federal health programs (Medicare, Medicaid, ACA) would improve the government's fiscal situation by reducing recurring central government deficits
- b. Extend the federal Earned Income Tax Credit (EITC) to Puerto Rico
- c. Exempting Puerto Rico from the "US built" requirement of the Jones Act while maintaining the US flag and crew requirements to protect jobs and coastal borders
- d. Improve treatment of Puerto Rico in other assistance programs such as Supplemental Security Income (SSI), Temporary Assistance for Needy Families (TANF) and Child Tax Credit
- e. Temporary relief on excessive regulatory examinations and reporting requirements by regulatory authorities over Puerto Rico banks, including residential mortgage regulations
- f. Provide technical support to the government of Puerto Rico for the development and implementation of a modern and effective technological infrastructure through the US Digital Service that will improve the ease of doing business in Puerto Rico

Mr. Chairman, upon reviewing testimonies in prior congressional hearings on Puerto Rico, it dawned on me that we seem to forget we all are and have been responsible parties to the problems we face today. Everyone blames politicians, politicians blame each other, and those doing the blaming forget they were part of the problem too. We are all accountable for our actions and

inactions -- the 3.5 million US citizens who call Puerto Rico home, the US Congress, the White House, bondholders and all stakeholders -- and we should all take part in together moving forward.

Our failure to execute, compromise and live within our means has left no other choice - Puerto Rico needs a fiscal oversight and control board alongside a debt restructuring mechanism that incentivizes consensual negotiations and provides access to Chapter 9 of the US Bankruptcy Code for its municipalities and public corporations. However, the importance of allowing us, the US citizens who call Puerto Rico home, to be part of this process can't be overstated. You don't fix someone's mistake by fixing it for them, but rather by fixing it with them. We must work together to guide Puerto Rico into prosperity once again.

Thank you.

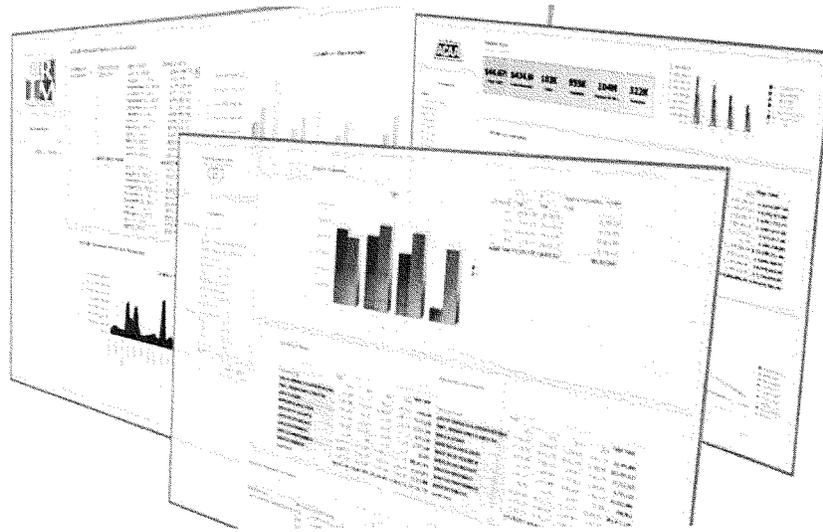
**Attachments to
Written Testimony of Juan Carlos Battle
United States House of Representatives Subcommittee on Oversight and Investigations of
the Committee on Financial Services
February 25, 2016**

Puerto Rico's Debt Crisis and Its Impact on the Bond Markets

1. "How the Government of Puerto Rico Can Deliver Financial Statements in Real Time"
by Giancarlo González, former Chief Information Officer of the Government of Puerto
Rico (2013-2015)
2. "Puerto Rico Banking Industry Trends and Benchmarking with United States National
Trends: 10-Year Review (2006-2015), prepared by Vision to Action

Giancarlo Gonzalez

Tales on tech, disruption, government, growth and endless possibilities...



How the Government of Puerto Rico can deliver financial statements in “real time”

There is a popular saying in Silicon Valley: there are developers whose work has an impact ten times (10x) greater than that of an ordinary programmer. If we want to fix the Puerto Rico Fiscal Crisis, we need a 10x quality technology team. Consider composition of a champion basketball team, the Golden State Warriors:

- 1 “alpha dog” – Stephen Curry
- 2-3 “all-stars” – Klay Thompson, Green Dreymond
- 3-5 “role players” – Andre Iguodala, Andrew Bogut, Shaun Livingston



Tim O'Reilly references how sports teach us the extraordinary impact that a superstar can have on the success of a team. To be successful in sports and in business requires a team of people who can work together to achieve extraordinary results.

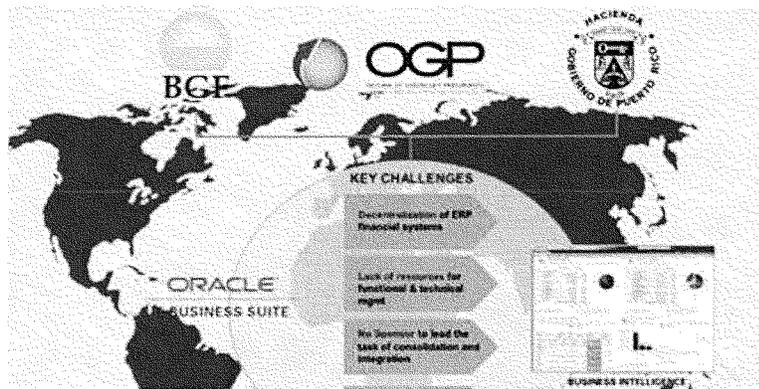
Such an effort demands a team of people who can work together, and who are superstars in technology and in application development. Just as Michael Jordan enables greatness in his team, a subject matter expert of superb skill provides an environment in which his/her people can produce their best work—be it someone who works in finance or someone in sales or operations. Success breeds success no matter the field.

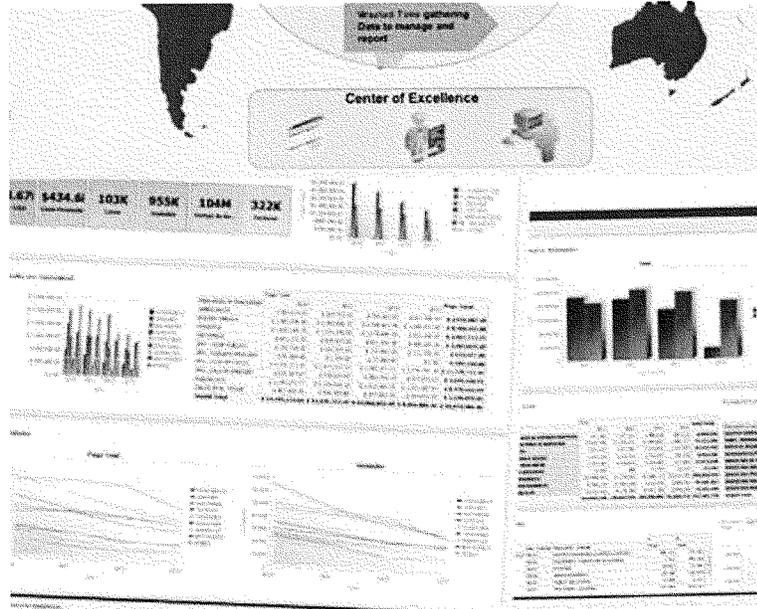
In this article, I will point out some of the challenges a PR fiscal control board would face.

Did you know that there is a pilot project via which one could see the financial statements for CRIM, ACAA, Public Works and UPR?

Although not finalized, if the internal processes of each corporation are working correctly and capturing the necessary data, the application does work. We were able to do it because there was a team of technical “all stars” who took on the problem.

This screenshot is based on the idea of creating a “center of excellence” for financial services. It uses images from the pilot application to give a idea of what a dashboard might look like.





How did the project come about?

In September 2013 the Office of the Chief of Information (OPEI) initiated a process to review all systems of Oracle E-Business Suite (EBS) that were installed in public corporations. Thanks to consulting time that had been included in 2013's contract renewal, for the first time we had the necessary resources to evaluate and understand the state of the agencies's then-present systems. As such we could finally visualize how help solve problems effectively and centrally.

The initial work took place from September 2013 to December 2013, and included visiting a total of 16 public corporations that use Oracle EBS. The team of software engineers assigned to the project were of the highest caliber that Oracle had to offer, with no margin allowed for failure—what I call “the best for the job, period.” This group worked with the agencies primarily to gather information, but in some cases were able to immediately stabilize existing problems their analysis had revealed.

Problems we encountered included:

- **Misunderstanding of the business task/problem/function**
- **Incorrectly implemented customizations**
- **Instances where the system did not perform as expected**

These issues existed in ALL the agencies. This table lists the issues faced by every single public corporation:

Hallazgos Funcionales	ADEA	ACAA	DTOP ACT	AEP	CTOUR	CPN	PRPA	CRIM	AT	UPR
Desconocimiento a nivel funcional de los módulos y sus procesos	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗
NO Todos los módulos implementados inicialmente funcionan en la implementada a hoy	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗
La configuración existente NO es correcta y no se puede usar el módulo	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗
Existen problemas funcionales por desconocimiento	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗
Existen problemas por situaciones técnicas	⊗		⊗			⊗				
Existen problemas porque funcionalmente no hace lo esperado	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗
Se requiere consultoría puntual por módulo y flujo de proceso	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗
Se requiere ajustar aplicación para requerimientos legales y tributarios	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗
Existen customizaciones en Oracle eBS NO correctamente construidas	⊗	⊗	⊗	⊗	⊗				⊗	
NO Hay documentación bajo metodología Oracle (OUM / AIM)	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗	⊗

In February 2014, shortly after completing this analysis, an article about the alleged waste of millions of dollars was published. The headline reads roughly: “Comptroller signals that millions were ill-spent at UPR on Oracle.”

Contralora señala malgasto millonario en la UPR con tecnología de Oracle (documento)

Por: CyberNews y NotiCel

Publicado: 18/02/2014 11:54 am

Una auditoría que señala inversión millonaria de fondos públicos para la adquisición y la implantación de la aplicación Oracle EBS sin haber logrado los objetivos y otros ocho hallazgos sobre incumplimiento de ley en la Administración Central de la Universidad de Puerto Rico (UPR), fue divulgada el miércoles por la contralora, Yesmín Valdivieso.



El ex presidente de la UPR, Antonio García Padilla, el actual presidente Unayón Walker, y el gobernador Alejandro García Padilla. Urosan Bruno/NotiCel

Here is what I thought when I saw the article in CyberNews/Noticel:

- It could equally apply to the other 15 entities in which we had recently done requirements gathering.
- The fault for the “ill-spent funds” was not 100% on Oracle (though Oracle does have other issues)

There must be a way to prevent something similar’s happening at the other 15 installations, to adopt better practices.

So how do we solve it?

To do so we have to understand first why it happens. I’ll explain what I mean in a simple chronological example:

- **2006:** Agency X buys Oracle E-Business Suite (EBS) and hires consulting Company A to handle the installation and to provide support. Things go well with the contractor. Customizations are made to the system to suit Agency X’s processes.
- **2008:** There is a change of political leadership. Agency X does not renew Consultant A’s contract. Instead, the new lawmakers and lobbyists take steps to ensure Company B receives the contract.
- **2009:** Without understanding the customizations made by Consultant A, Consultant B recommends upgrading to the new version of Oracle EBS. Only once the upgrade has happened—and cannot be reversed—does it become clear that the customizations made previously are not compatible with the upgraded version.
- **2010:** One year after the “upgrade” the system still does not work as needed. Consultant B is unable to resolve the problems, and so begins to use the government’s separately contracted Oracle support allotment. These “expert consultants” are literally being paid to call Oracle Support—again, paid for separately by the government—to see if Oracle can solve the problem. Eventually the consultants exhaust the prepaid Oracle support hours, as well as their own hours, and more have to be purchased.
- **2011:** The system does not function well. In light of that fact, employees resolve business issues another way. E.g., they fall back on Excel or other side-processes where Oracle EBS should be working.
- **2013:** Political administration changes again. New administration dismisses Company B. Company A wants back in the game. It takes a year to decide whether to go with Company A ... or perhaps Company C (which very well

be someone from Company B who has repositioned himself and so now appears as Company C).

Meanwhile, the truth of the matter is that the software isn't performing well, and what you're really paying for is to put out fires while trying to figure out what's actually wrong.

This is what happens in every public corporation in Government and it is the reason why fiscal information is not available in real time for Puerto Rico.

If the government identified and recruited "**the best for the job, period**" they could stabilize and correct the issues with minimal fuss. In the case of the financial reporting for the public corporations, the fastest and most efficient is an Oracle team—Oracle employees—working off a joint plan, on a centralized infrastructure for financial systems. This implies eliminating contracts to third-party "partners" unless it is absolutely necessary. Such a centralized infrastructure setup—Hacienda and DDEC have the resources—would significantly reduce equipment costs, energy, administration, support, training and development. Estimated savings by consolidating systems is between \$7-10 million over five years.

I urge all government leaders to pay attention to what the President Obama has done in recruiting technology talent in the United States Digital Service. You can see more detail about it [here](#). We need a public policy—supported in law—that will allow the unit head to hire the best person for the job, thus allowing for 'agile' development of products and services.

I never had the necessary legal powers to go to public corporations and force them to work with my office. I did have the power to go to each to help them solve a problem. When you have something positive to offer, people are willing to work closely. Our collaborations with specific public corporations (ACAA, CRIM, UPR and AEP) went very well. Even lacking a law that required cooperation, we could have kept going to all remaining public corps and solved the financial reporting problems, but we simply didn't have the resources to do so.

Bottom line: If you can identify and solve problems, and have good relationship with agency leadership, doors will open and things will get done. It's that simple.

I am sharing this story because, frankly, Puerto Rican citizens need to know why the financial systems (and other problems) are not resolved and should demand that those problems be addressed in the most effective manner while being as cost efficient as possible.

Our biggest weakness would be to surrender when facing a significant problem. The surest way to stand out is to try again one more time. We need our candidates for government to present initiatives and structures that encourage recruiting “the best for the job, period”. **That was the idea of PR Senate bill 614.** It is what President Obama did with the United States Digital Service, and we should follow the example.



📅 November 16, 2015 👤 giangonz 📁 CIO, Puerto Rico 📌 Debt, Fiscal Crisis, Gobierno, Puerto Rico



Puerto Rico Banking Industry Trends 10-Year Review (2006-2015)

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February 23, 2015

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- **General Banking Sector Indicators**
 - Number of Commercial Banking Institutions
 - Number of Deposits Branches
 - Total Employees (FTE)

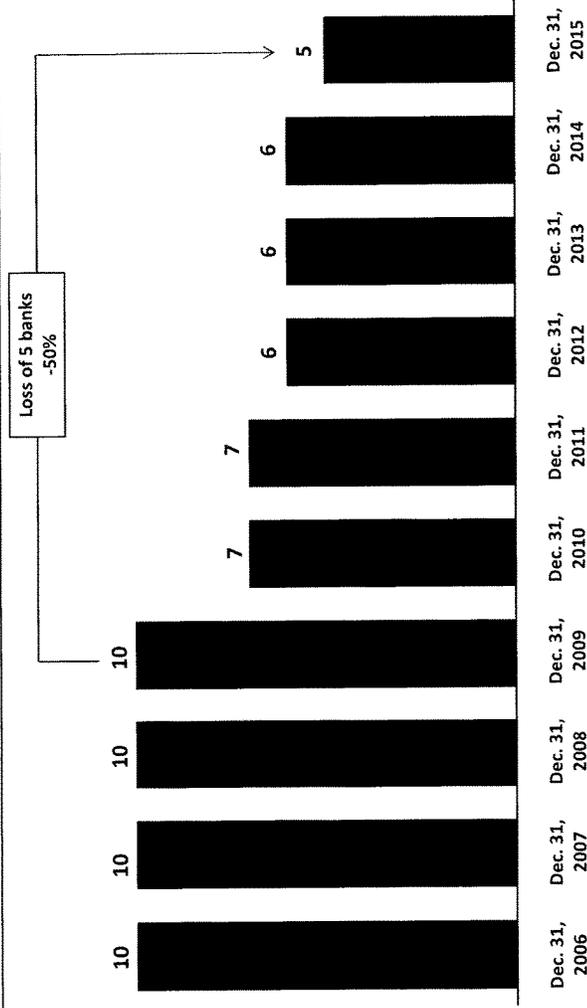
TABLE 1: General Banking Sector Indicators

Indicator	2019	2020	2021
Number of Commercial Banking Institutions	1,234	1,234	1,234
Number of Deposits Branches	5,678	5,678	5,678
Total Employees (FTE)	123,456	123,456	123,456



The economic and financial crisis of Puerto Rico has materially transformed its banking landscape, reducing the number of banks by 50%

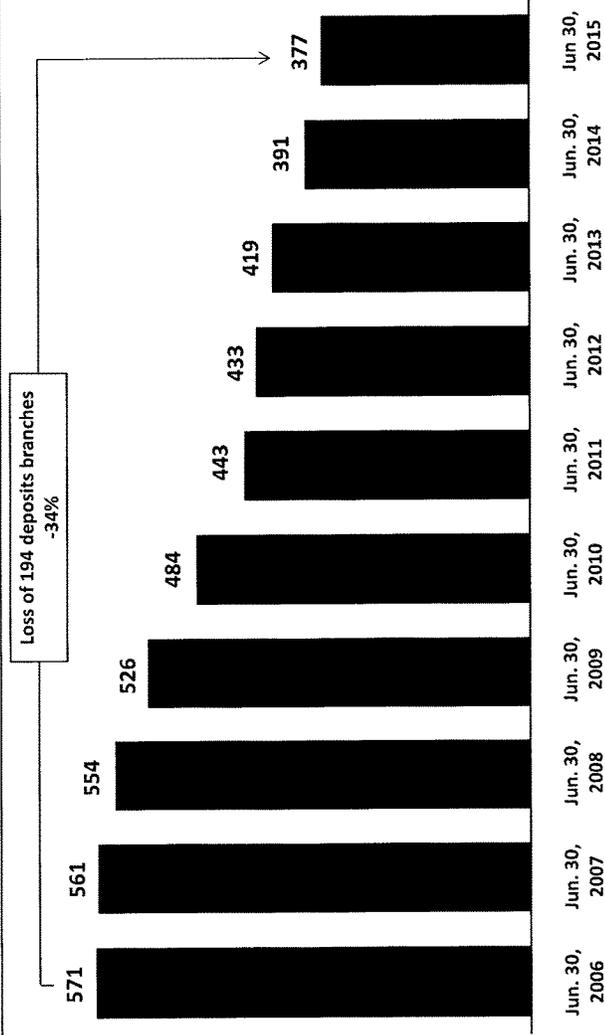
Number of Commercial Banking Institutions in Puerto Rico



Source: Federal Deposit Insurance Corporation (FDIC) - Statistics on Depository Institutions Report
Notes: "22 commercial banks were operating in Puerto Rico in 1995. By 2004, mergers and acquisitions had reduced the number to 14" (Collins and Bosworth, 2006).

The number of deposits branches has decreased by 194 (-34%) during the last 10 years

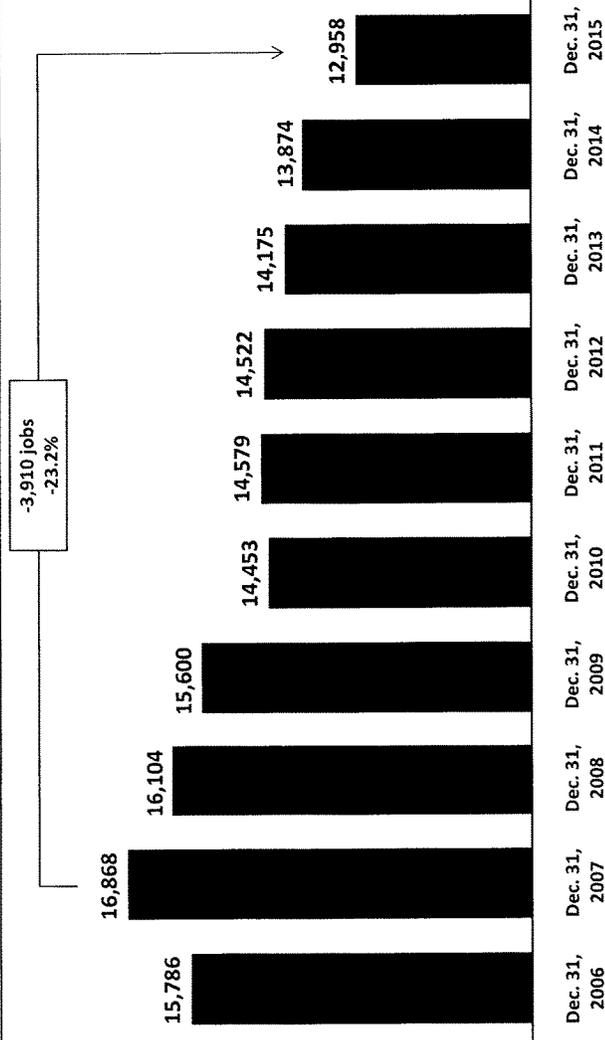
Number of Deposits Branches*



Source: FDIC – Summary of Deposits Report. Branch office data is provided as of June 30 of each year.
Note: *All service types included.

The labor force in the banking sector has decreased by 23.2% (-3,910 jobs) when compared to peak levels reached in 2007

Total Employees in Puerto Rico's Banking Sector (Full-Time Equivalent)



Source: 2006 - 2014: FDIC - Statistics on Depository Institutions Report; 2015: FDIC "Call Reports"
 Notes: From Dec. 2007 to Dec. 2015, a total of 187,000 jobs were lost (Total Employment - Household Survey).

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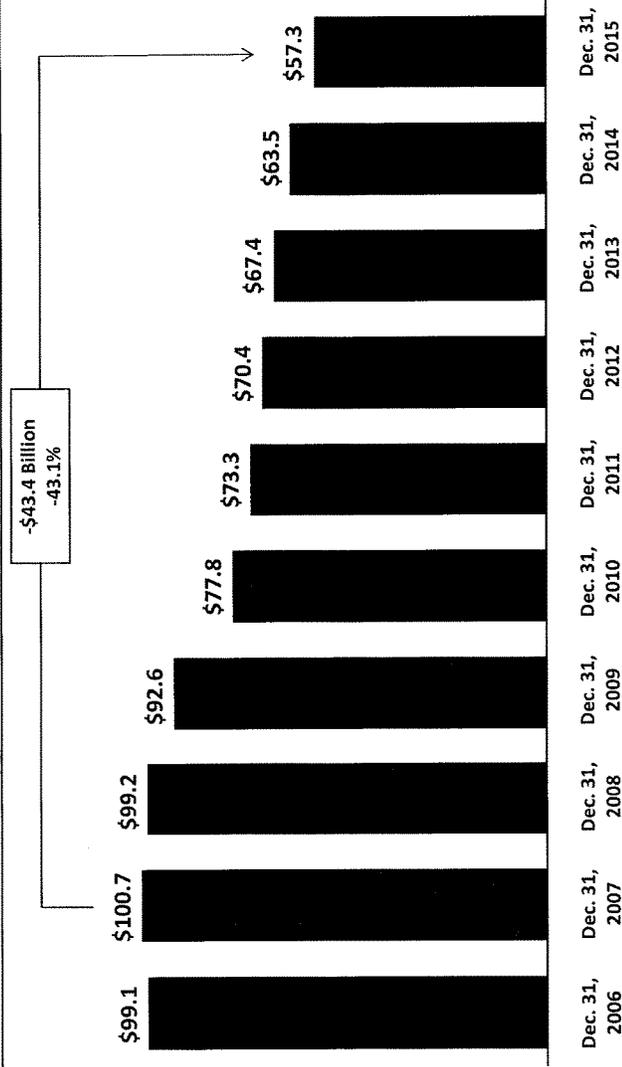
1. Introduction
 2. Board of Directors
 3. Management
 4. Financial Condition Indicators

➤ **Financial Condition Indicators**

- Total Assets
- Total Deposits
- Domestic Deposits to Total Assets
- Net Loans and Leases

The downward trend in total assets has continued unabated since 2007, reducing banking assets by \$43.4 billion (-43.1%)

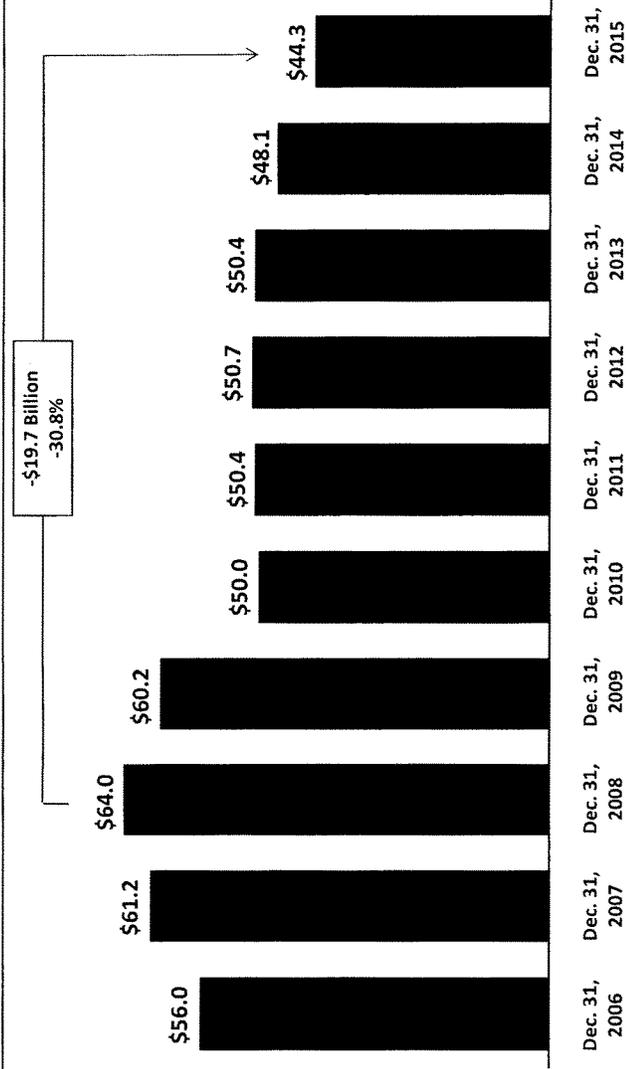
Total Assets (\$US Billions)



Source: 2006 - 2014: FDIC - Statistics on Depository Institutions Report; 2015: FDIC "Call Reports"

Total deposits have experienced a \$19.7 billion (-30.8%) drop since 2008

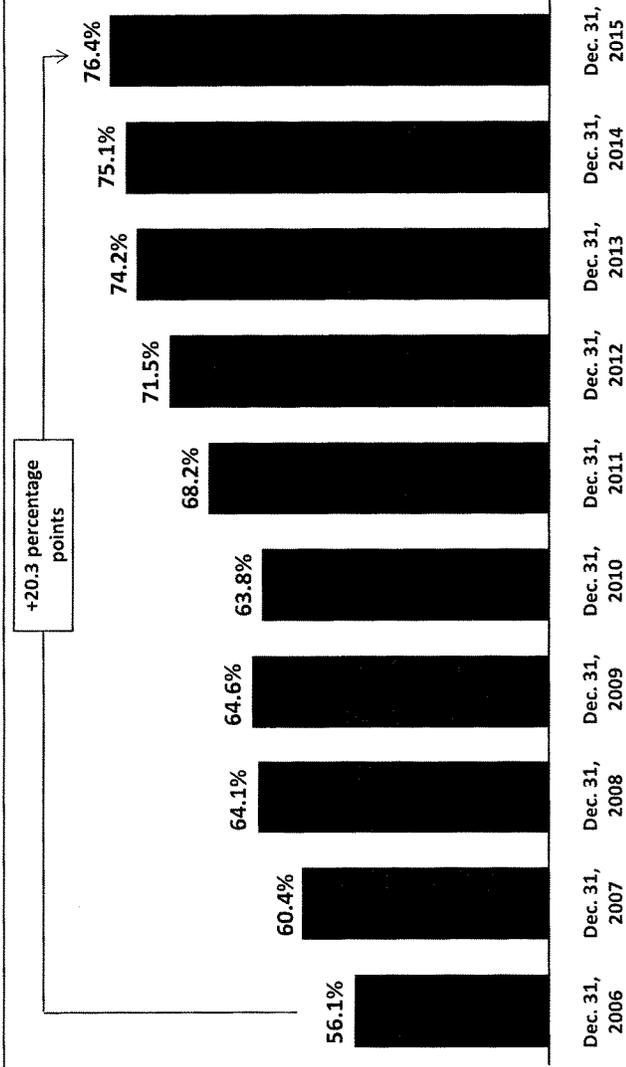
Total Deposits (\$US Billions)



Source: 2006 - 2014: FDIC - Statistics on Depository Institutions Report; 2015: FDIC "Call Reports"

Domestic deposits to total assets have increased by 20.3 percentage points during the time period under study

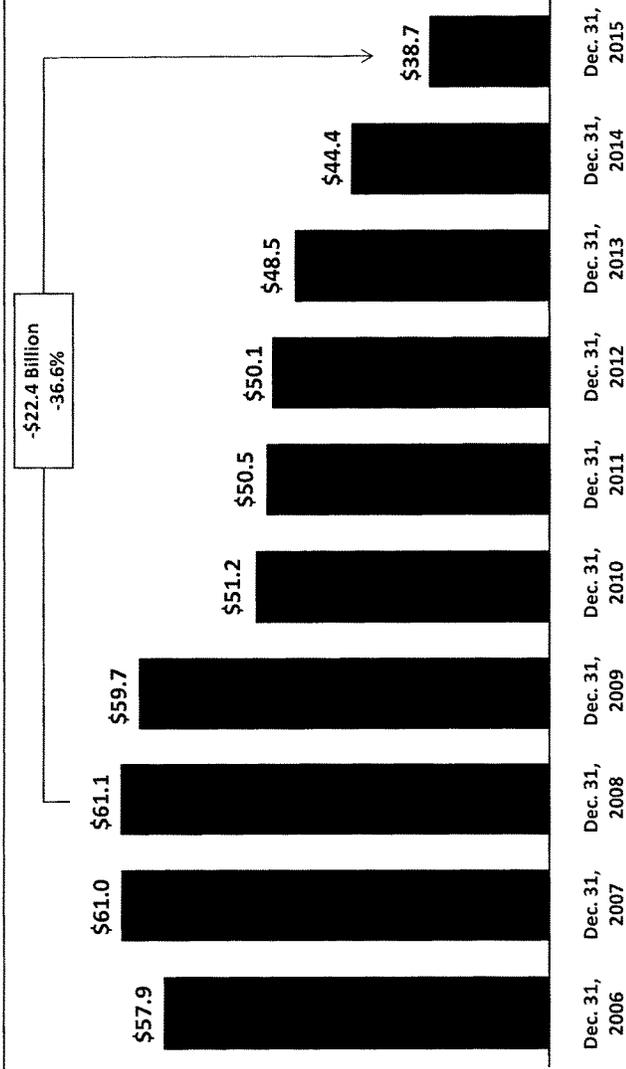
Domestic Deposits to Total Assets (%)



Source: 2006 - 2014: FDIC - Statistics on Depository Institutions Report; 2015: FDIC "Call Reports"

Total Net Loans and Leases have decreased by 37% or 22.4 billion

Total Net Loans and Leases (\$US Billions)



Source: 2006 - 2014: FDIC - Statistics on Depository Institutions Report; 2015: FDIC "Call Reports"

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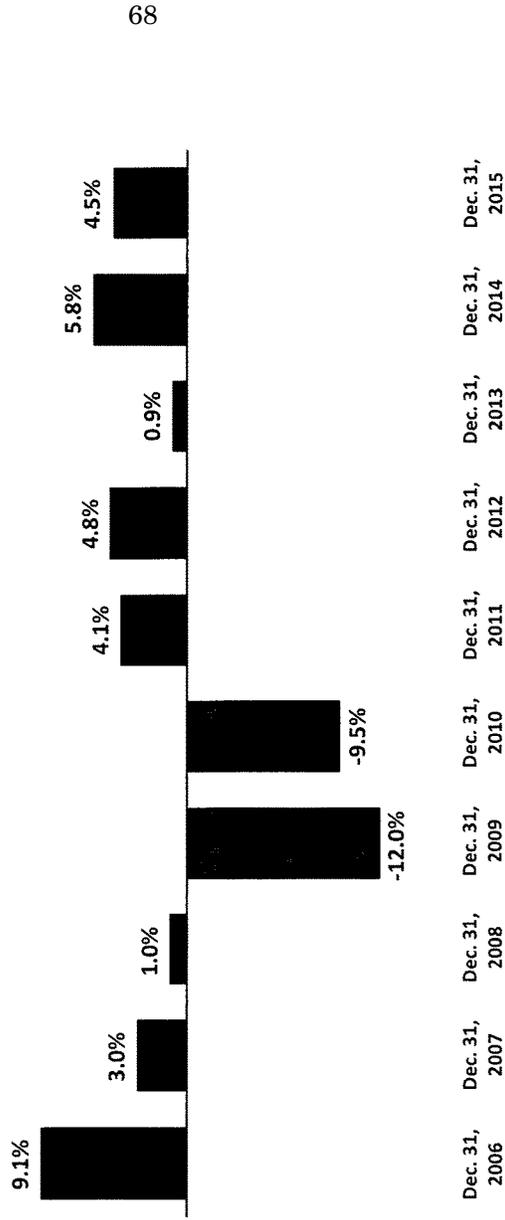
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- **Performance Indicators**
 - Return on Equity (ROE)
 - Net Charge Offs (NCO)
 - NCO to Loans and Leases: PR vs. US
 - Mortgage Originations

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**Profitability of the banking industry is out of the red, but remains well-
below the profitability levels reached prior to the economic downturn**

Return on Equity (ROE) (%)

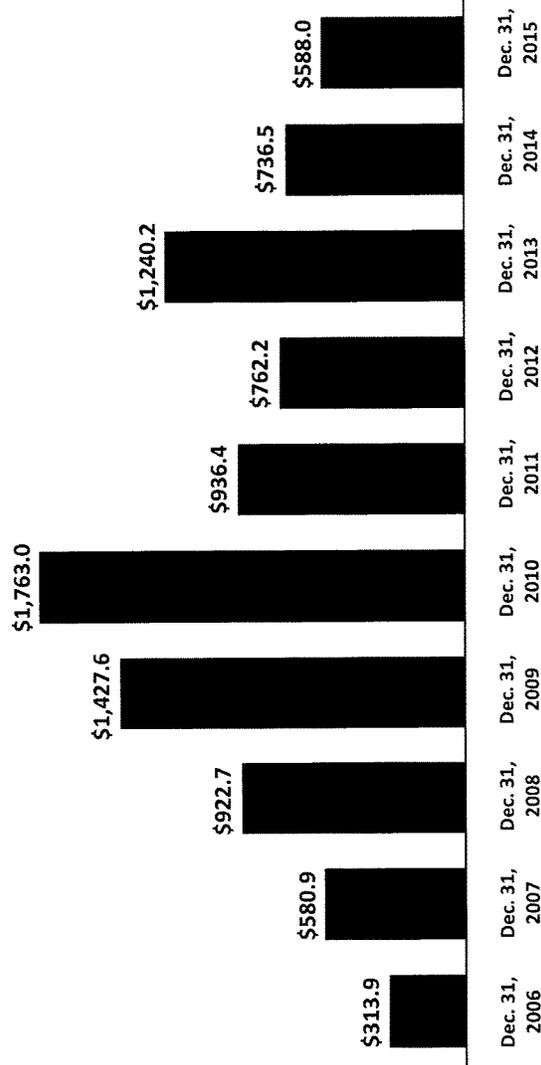


Source: 2006 - 2014: FDIC - Statistics on Depository Institutions Report; 2015: FDIC "Call Reports"



Banking Industry has charged-offs (net) over \$9.2 billion from loans & leases during this past decade

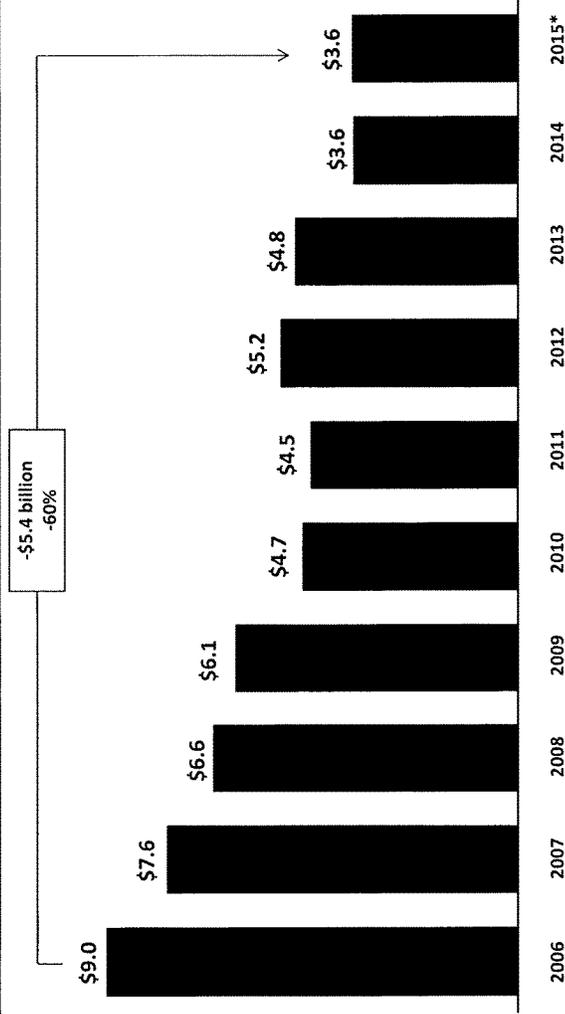
Net Charge-Offs (\$US Millions)



Source: 2006 - 2014: FDIC - Statistics on Depository Institutions Report; 2015: FDIC "Call Reports"

Mortgage originations experienced a dramatic reduction of 60% or \$5.4 billion

Mortgage Originations of Commercial Banks and Nondepository Institutions (\$US Billions)



Source: The Office of the Commissioner of Financial Institutions of Puerto Rico - in Spanish: Oficina del Comisionado de Instituciones Financieras (OCIF)
Notes: * Q1 2015 to Q3 2015 annualized.

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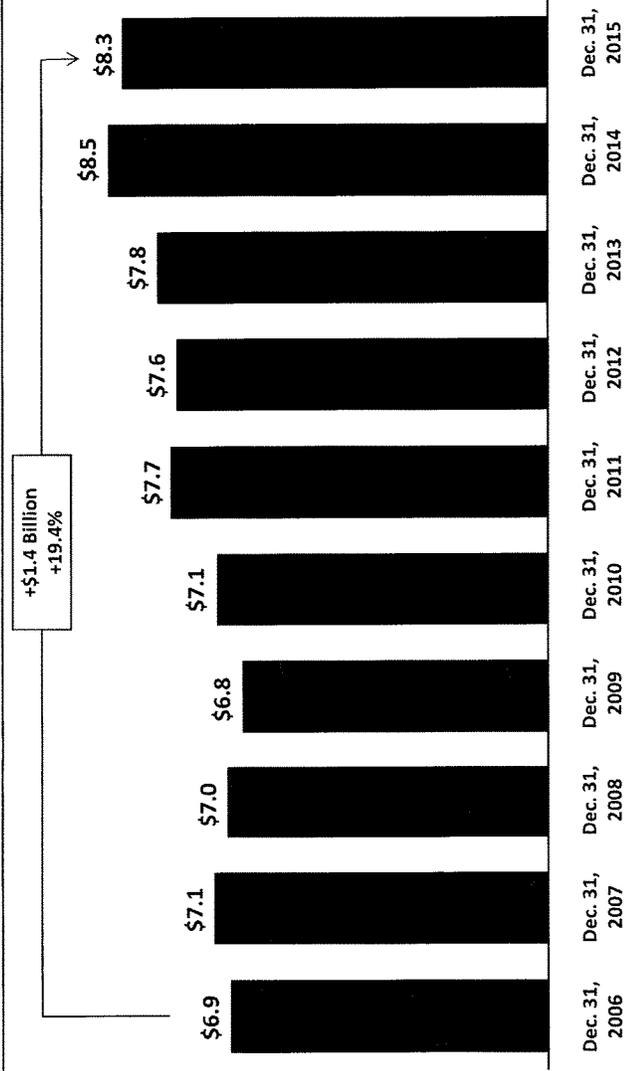
➤ **Capital Adequacy Indicators**

- Total Equity Capital
- Tier 1 Risk-Based Capital Ratio
- Tier 1 Risk-Based Capital Ratio: PR vs. US

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Capital levels have been steadily increasing, spurred by stricter capital requirements under Dodd-Frank regulatory changes

Total Equity Capital (\$US Billions)

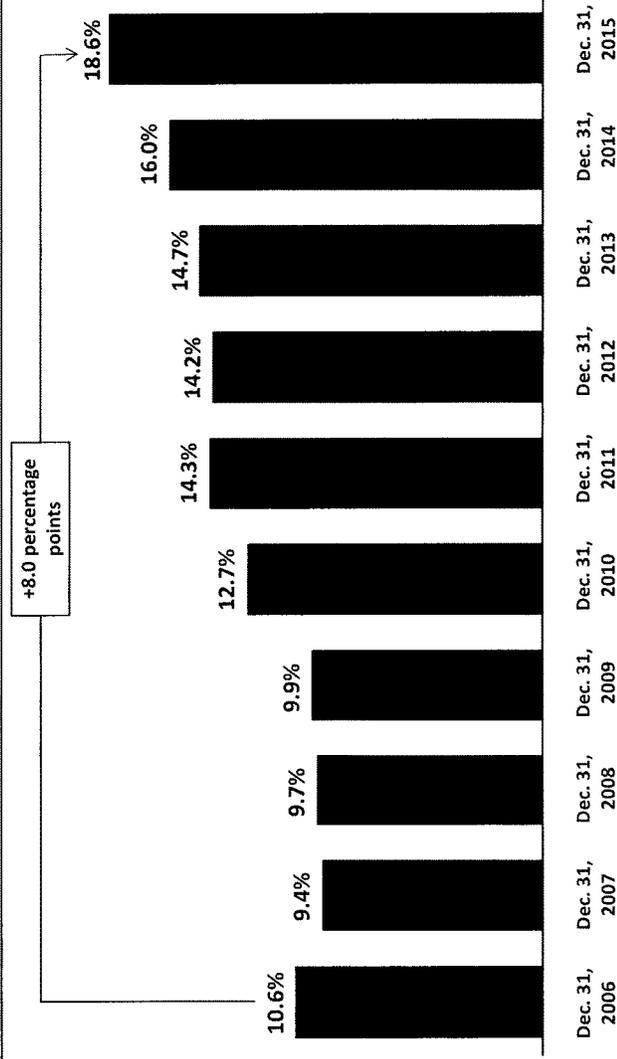


Source: 2006 - 2014: FDIC - Statistics on Depository Institutions Report; 2015: FDIC "Call Reports"

Robust capital base provides banks operating in Puerto Rico with the necessary capacity to absorb the potential materialization of downside risks in the economy and in the government's financial situation



Tier 1 Risk-Based Capital Ratio (%)



Source: 2006 - 2014: FDIC - Statistics on Depository Institutions Report; 2015: FDIC "Call Reports"

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TESTIMONY

of

WILLIAM M. ISAAC

**SENIOR MANAGING DIRECTOR & GLOBAL HEAD OF FINANCIAL INSTITUTIONS,
FTI CONSULTING
FORMER CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION**

before the

**SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES**

Washington, DC

February 25, 2016

Thank you Chairman Duffy, Ranking Member Green, and Members of the Subcommittee for conducting this very important hearing on the future of the Commonwealth of Puerto Rico, and the potential legislative proposals under consideration to help the Commonwealth address the fiscal crisis impacting the future health and welfare of the Puerto Rico.

Before I get to my specific recommendations on proposals to help address the fiscal issues surrounding the current crisis, I believe that it may be helpful to outline some of the pertinent factors that have contributed to the fiscal and economic situation in Puerto Rico in order to help address potential options for reform.

Problems/Challenges:

Territorial Status. One of the many problems in addressing the fiscal challenges in Puerto Rico is its status as a territory. Article IV, Section 3, clause 2 of the U.S. Constitution vests with Congress all authority for the promulgation of rules and regulations over territories. Even the action of creating the Puerto Rican Constitution had to be done pursuant to U.S. federal law and with the approval of the U.S. government.

Territories are not U.S. states, and the rights and obligations of Puerto Ricans are different from those U.S. citizens who reside in a state. Of course, Puerto Ricans are U.S. citizens. However, Puerto Ricans do not pay federal income tax although they pay social security and Medicare; they do not pay federal gas taxes but do receive federal funds for infrastructure.

Economic Stagnancy. It is well reported that the island of Puerto Rico has been economically stagnant for well over the past decade, and since 2005 its gross national product (GNP) is down 10%. Some of this reduction in growth is attributable to the phase out of IRS Section 936, which provided favorable tax treatment for U.S. manufacturers operating in Puerto Rico. That said, only 40% of the adult population is employed as compared to 63% on the mainland United States, and the island has lost 250,000 jobs since 2006. Moreover, a staggering 25% of the total job force is attributable to Commonwealth government employment.

The costs of doing business in the Commonwealth of Puerto Rico and the bureaucratic red tape to do business is ranked by the World Bank to be one of the highest in the world. These trends, and the absence of meaningful employment opportunities, have resulted in a substantial migration from Puerto Rico to the mainland United States, and it is estimated that the Commonwealth has lost 1% of its total population annually over the past decade – shrinking from a peak of 3.8 million residents to 3.5 million residents over that time frame. It will be critical to any potential economic recovery that a mechanism is set in place to adopt policies to encourage island job growth and increase labor participation for island residents.

Public Finances/Institutional Credibility. During the same period the Puerto Rican economy was stagnating, generating less tax revenue, and hemorrhaging population, the government of Puerto Rico was increasing public debt and running up budget deficits. Public sector debt in Puerto Rico rose every year from 2000 to the end of 2014, and now constitutes to 100% of the gross national product produced by the island of Puerto Rico. The total debt currently owed by the Commonwealth and its instrumentalities is estimated to be just under \$70 billion dollars.

Drilling down deeper into the debt, a Federal Reserve Bank of New York report indicates that Puerto Rico's total debt is:

1. General obligation/full faith and credit debt (\$17 billion/25% of total). This debt is guaranteed to be repaid by the terms of Article VI of Puerto Rico's Constitution, and issuance of this debt is subject to a first priority repayment. Limits on borrowing restrict the amounts that can be borrowed to no more than 15% of annual revenues.
2. Bonds issued by the Puerto Rico Sales Tax Financing Corporation (COFINA) (\$17 billion or 25% of total). COFINA was established by the Puerto Rican government in 2006 in order to escape the confines of the 15% borrowing limitation in Puerto Rico's Constitution. To put this even more clearly, COFINA was *expressly created* to circumvent Puerto Rico's Constitutional debt limit. This circumvention of Puerto Rico's Constitutional debt limit was accomplished by requiring COFINA bonds to be secured by increased sales tax revenues. Unfortunately, in issuing debt COFINA relied on overly rosy revenue projections, and failed, even

when made aware of revenue shortfall, to make adjustments to the issuance of debt based on actual revenues.

3. Public corporations and agencies, without COFINA (\$30.8 billion).
4. Municipalities and other (\$3.1 billion).

Believe it or not, Puerto Rico has a Constitutional debt limit. However, restrictions on the amount of debt that could be issued by the Commonwealth, as a result of Constitutional limits on borrowing, were avoided when Puerto Rico established COFINA as a municipal corporation in 2006, and authorized COFINA to issue debt based on revenue projections from sales taxes. Over the period from 2004 to 2014, government revenue forecasts exceeded actual collections by an average of \$1.5 billion each year, or 15% of the original budget. After 2006, continued reliance on flawed budget revenue estimates allowed COFINA to issue additional debt that was not covered by actual revenues, and increased the pace of the Commonwealth's indebtedness.

Essentially, at a time when economic reverses were reducing the amount of funds coming into government coffers, the Commonwealth government was aggressively expanding financing options to incur debt that could not be sustained. COFINA is certainly the most striking example of this.

Government Operations/Structural Reform. One of the other challenging features in addressing the fiscal crisis in Puerto Rico will/or should be the effort to reform governmental operations, and to reevaluate the structure of government. Any reform plan that does not include fundamental structural reforms to government fiscal programs will doom the plan to ultimate failure. Substantial thought should be given to the size and scope of services that should be provided by the Commonwealth government.

Establishment of an effective system of tax collection alone would strengthen the fiscal position of the Commonwealth government. KPMG, the government's consultant, estimated that Commonwealth could have collected an additional \$2.5 billion in revenue in 2014 by improving the tax collection system and simplifying the Commonwealth's tax structure. KPMG estimated that the Commonwealth collects only 56% of its sales and use taxes.

Institutional failings severely hamper the Commonwealth government's efforts to restructure, and wholesale revisions will need to be done in order to bring the Commonwealth's fiscal structure to the level that we would expect

of state and large municipal governments. Over-optimistic revenue projections, lack of expenditure control, and the absence of any real time deficit management hamper the ability to move forward in the immediate future. For instance, the Commonwealth under prodding from Senator Hatch, released an unaudited version of the Commonwealth's Comprehensive Annual Financial Report (CAFR) for 2014 on February 16th of this year – this means that the Commonwealth's annual audited financial report will be produced nearly two years after the end of the fiscal year. While there is expected to be a delay in any governmental organization's audited financial report, the magnitude of the delay on this document provides a glimpse of the challenges ahead in revising the system of fiscal accountability for the Commonwealth government.

Answers/Solutions:

While the challenges facing restructuring the Commonwealth government are very substantial, I believe that there is a way forward that would help assist the Commonwealth government in restructuring, restore confidence in the island's financial status, and pave the way forward to economic growth. Previous efforts by the Commonwealth government to reform have had only marginal impact, and it appears that the existing government does not have the expertise or the political will to institute what needs to be done in order to create fiscal balance and provide economic growth.

In view of this, I believe that the best legislative approach to address Puerto Rico's challenges would be comprised of two parts. First, Congress should treat Puerto Rico like any U.S. state by allowing the Commonwealth's municipalities access to Chapter 9 bankruptcy. This would allow Puerto Rico to legally restructure 75% of its total debt, including debt incurred by COFINA. That said, given Puerto Rico's track record in managing its finances and its failure to produce reliable financial data, the idea of granting it Chapter 9 has been controversial. This brings me to the second part of my recommendation: Congress should create a federal control board to oversee Puerto Rico's finances. The control board should not have the ability to negotiate with creditors or restructure debt, but it could be empowered with the ability to recommend normal Chapter 9 bankruptcy for specific instrumentalities of the Commonwealth *after* certain financial metrics have been met. This approach would be consistent with the legislation that you introduced Mr. Chairman,

H.R. 4199, the Puerto Rico Financial Stability and Debt Restructuring Choice Act. The approach is similar to legislation that Congress passed in 1995 to create a control board for the District of Columbia.

The D.C. control board legislation was the product of a bi-partisan solution crafted by a Democratic Administration and Republican controlled House and Senate, and was only required to be implemented for a limited time frame of six years, after which the District government assumed all control of government operation. The control board played a critical role in helping to oversee and improve the District's finances, but it did not have the authority to negotiate with creditors or restructure debt. Today, the District has a thriving economy, stronger system of governmental operations and fiscal control, and enjoys sterling access to credit markets – Standard & Poor's now rates District bonds at the AA level.

I am very concerned by proposals coming from the Treasury Department which propose so-called "Super Chapter 9 bankruptcy" or a "Super Control Board" that would provide for the restructuring of *all* of Puerto Rico's debt, even its Constitutional debt. Currently, no state has the ability to restructure its own general obligation or "full faith and credit" debt. Granting this power to Puerto Rico, or to a "Super Control Board" created by Congress, would be unprecedented and would have far-reaching implications, including raising the costs of borrowing for the fifty states. Moreover, long-term financial stability for Puerto Rico's government will require its continued access to financial markets. In this regard, I believe the costs of defaulting on Commonwealth issued Constitutional bonds will in the long-term cost the Commonwealth far more than any temporary respite from debt. In particular, I believe that the credibility of the Commonwealth government and its future access to private sector financial markets will suffer drastically should they attempt to default on or restructure the general obligation debt that is given priority under Puerto Rico's Constitution. The market reaction to a potential failure by the Commonwealth government to repay these obligations would in the long run increase its financing costs to much greater levels, assuming it were able to access the market at all.

Conclusion:

The challenges facing the Commonwealth of Puerto Rico are substantial. If Puerto Rico is to flourish, as we would all hope, it will require committed, independent leadership to help address fiscal and governmental structural issues. Thank you for the opportunity to address the Committee, and I am happy to respond to any questions.

Testimony of Anne O. Krueger before the House Subcommittee on Oversight and Investigations of the Committee on Financial Services. February 26, 2016.

Chairman Duffy, Members of the Committee, Ladies and Gentlemen:

I am pleased to be here and have a chance to discuss Puerto Rico's economic plight.

My name is Anne Krueger, and I am currently Senior Research Professor of International Economics at the School for Advanced International Studies at Johns Hopkins University. I was formerly Chief Economist of the World Bank from 1982 to 1986, Ritch Professor of Economics at Stanford University and First Deputy Managing Director at the International Monetary Fund from 2001 to 2006.

I am an economist, and not a lawyer. The issues being considered today have both economic and legal aspects. However, I shall confine my remarks to the economics of the situation and the implications for some of the legal questions.

In January 2015, I was approached by the Government Development Bank (GDB), (Roberto Sanchez Vilella Government Center, De Diego Avenue, San Juan, Puerto Rico) to lead a study into Puerto Rico's economic situation and prospects. I invited two former IMF officials to join me in this work, and we presented a report to the GDB at the end of June. We also made presentations of our findings, sponsored by the GDB, at that time, to the Governor and to the public. The report can be found on the GDB's website. There have been some minor revisions to the numbers since that time, but to the best of my knowledge, the outlook has not changed materially since.

Puerto Rico ought to be the jewel of the Caribbean. With its beautiful climate, scenery and beaches, the use of both English and Spanish, its location between the Spanish speaking Latin American countries and English speaking north, and the U.S. dollar and legal framework, it should be an attractive site for headquarters for companies doing business in both North and South America, as well as a major tourist attraction.

But it is not. It has had a stagnant economy for about 20 years. People, especially those of working age, can easily catch a plane and move to the mainland, and they do. In a recent article about the causes of Japan's slow growth, much blame was placed on the decline in population, which is falling at a rate of about one half percent a year. Puerto Rico's loss has been well over 1 percent a year for most of this decade and is thought to have reached 2 percent last year. Puerto Rico has only about the same number of tourist beds as it had in 1980, while tourism has boomed throughout the rest of the Caribbean.

But population loss and failure of tourism to boom are only symptoms of stagnation. They are the result of factors that have led to stagnation, rather than the cause.

The best way to address the needed policy changes that could reverse this decline is to look at what has gone wrong and resulted in such low growth.

The factors are numerous. Until 1996, the federal government extended tax exempt status to mainland companies that operated in Puerto Rico, and the pharmaceutical industry on the island had become a leading industry in response. It was then decided that the tax exempt status was to be phased out over the next ten years.

Some companies began leaving, and that was a negative for growth over the next decade. Successive Puerto Rican governments used traditional Keynesian remedies in an effort to

offset the decline, borrowing to finance not only planned budget deficits but unplanned expenditure and unanticipated shortfalls in revenues (due to the downturn in economic activity and overly optimistic forecasting).

At first, borrowing was easy, as Puerto Rico had little debt and bonds of the commonwealth held triple tax exempt status. But, over time as the economy failed to recover, debt accumulated. The diagnosis that Puerto Rico was in recession, and that Keynesian remedies would solve the problem, was wrong.

But as the economy shrank and borrowing continued, debt servicing and borrowing costs rose. Successive governments took measures that were intended to balance the budget. However, a lack of effective expenditure controls and the failure to anticipate the extent to which the downturn would persist, meant that net debt and borrowing increased every year over the past decade.

When the economy shrinks, tax revenues fall and expenditures (especially on social safety nets) rise. This was a major reason underlying the buildup of debt. By 2014, borrowing could take place only at very high costs and the market is now virtually closed for any new issues, while outstanding debt is selling at a sizeable discount.

While the absence of growth, and failure to find ways for its resumption, has been the main factor leading to continuing deficits and borrowing, an additional factor has handicapped policy makers as they have struggled with the issue. That is, the state of statistical reporting in Puerto Rico is unsatisfactory. Books are not closed until well after the end of reporting periods. The authorities, as a result, do not have good feedback as to the behavior of the economy. Moreover, the lack of effective and efficient expenditure controls resulted in the buildup of arrears by government agencies that were then cleared at the beginning of the next fiscal year.

The fiscal imbalances that resulted from efforts to reverse the economic decline were themselves a contributor to future difficulties, as debt servicing costs and uncertainty have increased.

But other factors have contributed to the economy's poor performance. These have included global events (the oil price increase of the last decade and the financial crisis of 2007-8), federal policy, and policies adopted by the Puerto Ricans themselves.

However, even when global events have been favorable (as during the years 2002 to 2007 and 2011 to 2014 with the upswing on the mainland and global economies); the Puerto Rican economy remained in stagnation.

At the federal level, there have been several contributing factors, including the funding formula for Medicaid, the Jones Act, which requires Puerto Rico's shipping (including especially oil, all of which is imported and which is the major energy source for electricity) to be on U.S. built and manned ships, minimum wage legislation, and a number of federally mandated environmental and other regulations. While all of these have been detrimental to Puerto Rico's fiscal and economic situation (especially because of competition with other Caribbean islands), Puerto Rico has been exempt from some mainland policies which could have helped. Chief among these are Puerto Rican ineligibility for the earned income tax credit and for Chapter 9 of the U.S. bankruptcy code. I will say more about these later as they, and especially Chapter 9, are the focus of this hearing.

Still at the federal level, there are a number of welfare measures which have effects on the island. Puerto Ricans are eligible for food stamps and other federal welfare programs including subsidies for housing, electricity, and more. One calculation that was made indicated that a wage earner in a household of three would have take home pay of about \$1100 a month if working at

the minimum wage (and it is estimated that a large percentage of Puerto Rican jobs are paid at rates close to it) and \$1700 if on welfare. A serious result has been that Puerto Rico's labor force participation rate is only 40 percent, compared to 62 percent in the United States. Of course, many Puerto Ricans go on welfare and work in the informal economy. This means that their earnings are not subject to tax as well as that their productivity is lower than it would be in the informal sector. That is detrimental to growth and to the fiscal situation.

At the level of the commonwealth, there is also much that needs to be done to improve growth prospects. In rankings of "ease of doing business", Puerto Rico ranks 47th of 189 (the U.S. ranking is 7th). There are many rules and regulations which require permits and other approvals, and they are slow in coming. Labor market regulations are in some ways more restrictive than those on the mainland. For example, employers are required to pay a 13th month bonus in December, each year. That makes the effective minimum wage on the island 8.3 percent above that on the mainland. Commonwealth employees have been entitled to 30 days annual leave, 18 days sick leave (which can be taken as leave if not used), and there are more holidays on the island than on the mainland. There are also significant obstacles to laying off workers.

There are many more practices that impede growth prospects and that need to be altered, but I will mention only two. First, the commonwealth faces large future pension and other liabilities that cannot be met under present policies and prospects. Second, there has been a tendency to deal with businesses on a one-off discretionary basis, with negative results for the economy as a whole (and there has been almost no credible research as to the effects or usefulness of many of these incentives. This has resulted in significant delays (especially in property registration and obtaining construction permits), as well as differential tax treatments of different firms.

The above considerations provide a broad overview of the factors underlying Puerto Rico's current crisis. Addressing unsustainable debt, correction of fiscal policies, and altering a set of policies inimical to growth are all essential if the island's prospects are to improve significantly. Experience of the International Monetary Fund in countries confronting extreme financial difficulties has shown that there needs to be "ownership" of reforms by the authorities. The authorities would surely need to buy in to these reforms if they are to succeed in laying the foundation for resumption of growth and higher living standards.

A first point I would make is that addressing any one or two of these issues can perhaps provide some relief and some breathing space for a year or two, but all three issues must be confronted meaningfully if Puerto Rico's prospects are to improve significantly.

In the remainder of my testimony, I will focus on why each of these issues must necessarily be addressed, but of course I will pay more attention to the debt issue, which is the subject of this hearing, than the other two.

Turning first to growth, it is obvious that a resumption of economic growth is desirable for its own sake. Most Puerto Ricans want to remain at home, and they move to the mainland for lack of economic opportunity on the island. But in addition to the inherent desirability of growth, establishing a set of policies that will offer greatly improved growth prospects is essential if there is to be any hope of achieving a debt burden that is sustainable going forward. If an economy is destined to shrink into the indefinite future, it cannot borrow for the longer term – investors would know that the tax base would be shrinking while expenditure demands would be increasing. The only sustainable fiscal policy would be one of reducing expenditures each year in line with reductions in tax revenues.

Measures needed for growth are many and most of them will take several years before their full beneficial effects are felt.

Addressing fiscal policy next, a first observation is that growth is necessary if fiscal balance is to be attained. As long as the economy is in decline, it is doubtful whether a long-term fiscal solution can be found. But, even if growth is resumed, fiscal balance is essential for continued growth for the obvious reason that without it, borrowing might start but would quickly be perceived as unsustainable. When growth prospects are good, governments can afford to borrow to finance productive public investments. But when growth prospects are dismal, there will not be many productive investments and there will be little prospect that debt servicing could be sustained.

Turning then to debt, the current level of debt is so high that Puerto Rico has virtually no market access. That, in turn, means that without addressing the debt problem, not only is Puerto Rico almost certainly unable to continue debt servicing indefinitely, but the commonwealth would have immediately to cut its public expenditures sharply in line with its dwindling tax revenues. While there are cuts that can and should be made, these would not have full effect instantaneously. There is a very good case, for example, for finding ways to reduce the number of teachers: there are about 30 percent more teachers than there were several decades ago while there are about 40 per cent FEWER students! But no one would advocate instantaneous reductions; clearly, this would need to be done over several years. Moreover, if the commonwealth had funding to offer reasonable retirement or retraining packages to teachers, the process would be less painful (and less depressive of economic activity). There are many other examples where some funds now could mean a better fiscal situation later. But in Puerto Rico's current situation, the debt overhang makes that infeasible.

If the commonwealth had to reduce its expenditures tomorrow to a level consistent with tax receipts, economic activity would surely be further depressed significantly (and that would continue as cuts had to be made in future liabilities such as pension payments). That, in turn, would induce more outmigration, and more job losses on the island. Tax revenues would fall while the need for expenditures on welfare would rise, thus worsening the fiscal situation still further. The vicious circle in which Puerto Rico finds itself would only be worsened.

However, it is almost unimaginable that the authorities would choose to maintain debt service given the order of magnitude that would have to be made immediately in public services in order to do so. Large and instantaneous cuts in payroll, and in expenditures such as those for lighting, policing and other public services would almost surely be largely avoided. In that case, the choice is between an orderly process for debt restructuring soon and a disorderly cessation of debt service payments spread out over the future.

Uncertainty about how the situation would be managed is already depressing economic activity. The longer the situation persists, the deeper will be the drop in economic activity, the longer the period of stagnation, and the greater will be the ultimate cost to creditors and Puerto Ricans alike.

For creditors, the choice is between accepting restructuring to enable growth to resume (as other policy measures are undertaken as well) or to resist now, fight restructuring, and be confronted with an even loss of net present value.

Hence, fiscal issues cannot be satisfactorily addressed and growth is highly unlikely to resume until the debt overhang issue is resolved. And Puerto Rico's debt is unusually complex. A number of government entities (the power company, the water and sewer company and the highway authority are the biggest

ones) have issued their own bonds. There are a variety of pledges, including of future revenue streams, and of assets.

With no protection under U.S. bankruptcy law, any group of creditors can take the case for their priority to courts. It seems inevitable that such a scenario, once started, would take years to resolve the issues. But, as I indicated above, the likelihood that growth could resume while the litigation process was underway is very small. As such, the period during which the court proceedings were continuing would be a further period of declining real incomes and continued outmigration. When the court battles were finally resolved, Puerto Rico's economic recovery would start from an even worse position than the one it is now in. Providing a legal framework which would enable a comprehensive restructuring of Puerto Rico's debt is therefore a crucial and desirable first step on the path to recovery.

A restructuring which provided creditors with reasonable certainty as to future payments while giving the commonwealth a bit of room for financing necessary investments in reforming the economy is therefore, in my judgment, highly desirable. By itself, it would not be enough. But without it, it is doubtful if Puerto Rico's downward spiral can be reversed without much more financial support and assistance from the federal government than seems possible.

With the parameters of debt service for the foreseeable future understood, the Commonwealth could address the fiscal challenge. The choice as to which expenditures to cut and what tax reforms to undertake should be the Commonwealth's, although the scope for raising tax rates is limited (as the attraction of outmigration or movement to the informal sector would increase). With needed economic reforms to spur economic growth also undertaken by the Commonwealth, and support by the federal government (including the EITC and other measures), it is likely that Puerto Rico's downward spiral could be quickly

arrested and that growth could resume and acquire some momentum over a 2-3 year period. The alternative, of a continued shrinkage of Puerto Rico's population and real income, is one too unpleasant to contemplate.

Written Testimony of Mark Zandi
Chief Economist Moody's Analytics

Before the:

House Financial Services Committee's Oversight and Investigations Subcommittee

"Puerto Rico's Debt Crisis and Its Impact on the Bond Market"

February 25, 2016

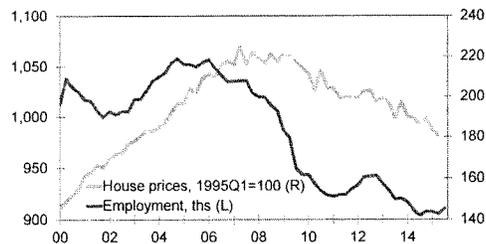
Mr. Chairman and members of the committee, thank you for the opportunity to provide this testimony regarding Puerto Rico's daunting economic and fiscal crisis. More specifically, I will document the extent of the crisis and identify its causes, consider what policymakers should do to address the crisis, and assess the implications of those policies on Puerto Rico's economy and the municipal bond market.

Never-ending recession

The Puerto Rican economy has been engulfed in a severe recession for the past decade. By most measures, the island economy peaked in the mid-2000s, slid sharply during the financial crisis of 2008-2009, and has continued to slump ever since.

Employment, which hit an all-time high of well more than 1 million in 2005, has steadily declined to near 900,000 (see Chart 1). Jobs have been lost in a range of industries, including in construction, manufacturing, financial services, and most notably in state and local government, where employment is down a stunning more than 25%.

Chart 1: Puerto Rico's Severe Recession



Sources: BLS, FHFA, Moody's Analytics

Unemployment remains extraordinarily high at more than 12%, but even this masks the economic suffering, as many of those losing their jobs are leaving the workforce and the island. Puerto Rico's labor force has contracted by 300,000 workers since peaking in the mid-2000s, a decline of 20%. The island's labor force is as small as it has been in more than a quarter century. Labor force participation is the lowest in the nation.

The depopulation of Puerto Rico has intensified. On net, each year more than 50,000 more people give up their Puerto Rican residence than take up residency. Those that are leaving are more highly skilled and educated. Only 24% of Puerto Ricans have earned at least a college degree, compared with more than 30% nationally.

Declining population is hitting the housing market hard. Approximately 6,000 new homes are being constructed each year, down from 16,000 before the recession. House prices also continue to slide, declining by almost 20% since the peak during the housing boom. Foreclosures remain among the highest in the country, with 6.5% of mortgage loans somewhere in the foreclosure process. This compares with only 2% nationally.

Puerto Rico's economy is far and away the weakest of any state in the country. By many measures, including the loss of output, GDP and wealth, it is already suffering a depression. Even more disconcerting, there is no prospect of the economic slide ending soon.

The island's important tourism industry is barely holding its own, as competition is intense and the strong U.S. dollar is not helping. The cost of doing business on the island is high, and since a lucrative tax break provided to American businesses operating on the island expired a decade ago, business investment has flagged. In the mid-2000s, businesses invested some \$9 billion a year; in 2014, investment had fallen to \$7 billion. Not surprisingly, public investment has declined even more sharply.

Fiscal crisis

The crushing economic downturn combined with poor fiscal management has resulted in a fiscal crisis. The territory's government, other public corporations it backstops, and municipalities collectively owe more than \$70 billion in debt (see Table 1).ⁱ This is equal to approximately 100% of the territory's gross national product—the island's financial resources to pay on that debt.ⁱⁱ

	Commonwealth	Municipalities	Public corporations	Total*
2009	9,939	2,997	40,044	52,980
2010	10,303	3,231	43,289	56,823
2011	10,363	3,537	45,284	59,184
2012	11,844	3,872	49,045	64,760
2013	12,329	3,882	48,746	64,957
2014	14,336	4,193	48,744	67,273
2015	14,077	4,126	47,980	66,183
2016**	13,771	3,907	47,305	64,983

*Ex \$2.9 bil in Senior Pension Funding Bonds issued by the Employees Retirement System, \$1.2 bil in Chil
**First 3 mo only of fiscal 2016

Sources: Government Development Bank, Moody's Analytics

The principal and interest payments on these debts require the government to devote a high and rising share of its tax and other revenues to meet them. In fiscal 2015, the debt service of the territory and agencies amounted to almost 40% of the revenues available to the government for these payments. For context, the average debt payment as a share of revenues across U.S. states is closer to 5%.

Puerto Rico struggled mightily to make its debt payments last year. It was able to raise some more money from investors in early 2014, at a high interest rate, and it stopped paying on many of its other bills. This will not work any longer. Creditors are no longer willing to extend any additional cash to the government, at any interest rate. Puerto Rico is locked out of capital markets.

The budget arithmetic is overwhelming. In the current fiscal year, which started in July, the government must make \$4.1 billion in debt payments to remain current on that debt. This amounts to 36% of expected available revenue. The debt payments over the next five years total \$18.1 billion, equal to a crushing nearly one-third of projected revenues.

Adding to the territory's fiscal woes are its troubled pension funds. Contributions to government pension funds have already been severely curtailed, and the funds are selling assets to meet their obligations to beneficiaries. They will run out of funds by the end of the decade unless the courts require the government to resume its pension contributions.

The government now has the grim choice of either slashing government services and jobs or making its debt payments on time. Odds are high that the government will not make its debt payments; the next significant payment is due by the Government Development Bank in May. The commonwealth has already warned that there may be a moratorium on the May payment if there is no consensual agreement with its creditors.ⁱⁱⁱ

The rating agencies concur, as Moody's Investors Service has put a Caa rating—consistent with a very high probability of default—on most of the island's debt (see Table 2). Bond investors also recognize this reality, with Puerto Rican debt trading on average at less than 50 cents on the dollar.

Table 2: Moody's Investors Service Ratings of Puerto Rican Bonds

Puerto Rican government bonds	Ratings	Outlook
General obligation and guaranteed	Caa3	Negative
Puerto Rico Industrial Development Co.	Caa3	Negative
Puerto Rico Aqueduct and Sewer Authority	Caa3	Negative
Sales Tax Financing Corp. (COFINA) Senior	Caa3	Negative
Puerto Rico Electric Power Authority	Caa3	Negative
Sales Tax Financing Corp. (COFINA) Junior	Ca	Negative
Government Development Bank for Puerto Rico	Ca	Negative
Municipal Finance Agency	Ca	Negative
University of Puerto Rico (system and facilities)	Ca	Negative
Highways and Transportation Authority	Ca	Negative
Infrastructure Financing Authority	Ca	No Outlook
Pension funding bonds	Ca	Negative
Convention Center District Authority	Ca	No Outlook
Appropriation debt of the commonwealth	C	Negative

Sources: MIS, Moody's Analytics

Adding to the fiscal mess are the numerous parties involved, including 18 different debt issuers and 20 creditor committees, and the government's opaque accounting and record-keeping. Simply getting the information needed to assess how bad Puerto Rico's fiscal situation is has been a significant challenge. However, even with the poor information, it is clear that the territory's finances are in tatters.

Puerto Rico thus threatens to descend into an economic abyss. Odds are high and rising that the territory will default on much of the debt it owes, and suffer an economic depression, if U.S. lawmakers do not act soon to address this problem.

Debt restructuring

Recently proposed legislation in the U.S. Congress to address Puerto Rico's fiscal crisis is encouraging. Subcommittee Chairman Duffy's legislation on this issue, [H.R. 4199](#), is important in that it provides Chapter 9 bankruptcy protection to the island's municipalities and public corporations. This would allow for an orderly restructuring of approximately 30% of the island's outstanding debt. Some of the island's other debt may also be impacted, although this would likely have to be adjudicated and would take a significant amount of time.

For this change in bankruptcy law to occur, Puerto Rico's government must choose to accept the establishment of a Financial Stability Council. This entity would have the authority to oversee the island's financial planning and annual budget. This is a reasonable step to ensure that Puerto Rico is managing its finances appropriately to meet the needs of the island's population and creditors. Other U.S. jurisdictions that have struggled with serious fiscal problems have had similar oversight boards, to good effect.

While H.R. 4199 is a positive step, lawmakers should consider shifting from Chapter 9 bankruptcy for the island's municipalities and public corporations to adopting a broader restructuring framework for all of the island's debts. The Financial Stability Council would be empowered to implement a temporary stay (say 12 to 18 months) of all debt payments, to use this time to fashion a sustainable restructuring.

Without this broader restructuring framework, it is likely that Chapter 9 will not be sufficient to put Puerto Rico on a sustainable fiscal path. With the broader framework in place, the council would have the tools it needs to restructure as much or as little of the island's debt as required. Moreover, this would create significant pressure on creditors, perhaps even leading to a voluntary agreement over the island's debts.

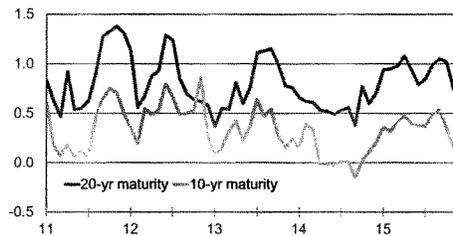
There are potential costs involved in allowing Puerto Rico to restructure its debts, most notable being it raises the possibility that other fiscally pressed states will want similar relief.^{iv} This would significantly disrupt the municipal bond market, increasing borrowing costs for all public entities.

However, it seems a stretch to argue that allowing Puerto Rico to restructure its debt will lead other states to demand the same authority. The 10th amendment of the U.S. Constitution, which explicitly sets forth our country's constitutional principle of federalism, precludes the ability of states to use federal bankruptcy court. Moreover, Puerto Rico is a territory, and not a state. The island should thus be treated like Detroit, which represents the nation's largest municipal bankruptcy, and not like the state of Michigan.

Worries that borrowing costs for all municipal borrowers will increase also appear overdone. Puerto Rico has been in severe financial distress for more than two years, but there has been no discernible impact on the municipal bond market. Yield spreads between munis and risk-free Treasuries have fluctuated in a narrow range, and flows into muni bond funds have not been affected (see Chart 2). It is also instructive that municipal bond insurers do not charge an explicit premium for their insurance for municipalities that have access to Chapter 9. If there is an impact, it will be modest, as academic research indicates that municipalities that have unfettered access to bankruptcy court pay no more than 7 basis points more in yield.^v

Chart 2: Puerto Rico Doesn't Impact Muni Spreads

Difference between muni yields and Treasury yields, %



Sources: MIS, Federal Reserve

Puerto Rican bondholders also argue that the rules on which they based their investment decisions are being changed. Future investors, fearful that the rules could change once more, will require a higher interest rate to compensate them for this risk. But although bankruptcy law should not be changed frequently, it should not be immutable, and it has been changed in times past. Even Puerto Rico had access to Chapter 9 bankruptcy prior to the 1980s, when the law was changed.

There is also the moral hazard concern: If Puerto Rico is given a break on its debts, it might then turn around and leverage back up again, thinking that another bailout will be forthcoming. These concerns should be allayed by the council, which will ensure that the island puts its finances in order and adopts sound fiscal management practices. The council will determine when it is appropriate to fully hand back fiscal management to the territory.

Economic policy

Of course, Puerto Rico's crisis will not be resolved until the island's economy is able to grow consistently. Lawmakers should help in this regard as well.

Stronger economic growth is possible only if additional policy steps are adopted to lower the territory's high business costs. Allowing Puerto Rico to freeze its minimum wage, which is high compared with the productivity of island workers, would be beneficial in the long run. Flexibility with the implementation of the Jones Act would help to reduce shipping costs.^{vi} And pension reform, the consolidation of municipalities, and reforms to public sector corporations, including privatization, would also be helpful.^{vii}

Lawmakers should also ensure that Puerto Rico is reimbursed for Medicaid at the same rate as governments on the mainland by ensuring that current federal funding under the Affordable Care Act is not scaled back beginning in 2018 as is currently legislated. Federal funding for Medicaid should be sufficient to allow Puerto Rico to provide benefits to its residents that are the

same as those received by other Americans on the mainland. This is critically important to the island since nearly one-half of its residents rely on Medicaid for their healthcare benefits.

The implementation of an earned income tax credit would also provide a meaningful boost to the Puerto Rican economy. The EITC is an effective way to provide income support to low-income workers. The credit is available only to those that work, which encourages labor force participation, something that is much needed to restart Puerto Rican economic growth. By requiring recipients to file a tax return, the EITC has the added benefit of drawing workers out of the island's large underground economy. Although the benefits of an EITC would not be felt until the next decade, Puerto Rico's economy will surely still need the help.

Of course, the expansion of the Medicaid program and introduction of the EITC are not free, and would need to be covered by U.S. taxpayers. I would expect the cost of these proposals when fully operational to be close to \$2 billion per annum in today's dollars.

Two scenarios^{viii}

Puerto Rico's crisis can unfold along many paths, but let us consider two scenarios that roughly bookend the possibilities. In the first scenario, U.S. lawmakers do nothing to address the crisis, and Puerto Rico defaults on its debt; the next payment is due in May. Since the territory, like the states, is not permitted to file for bankruptcy, bondholders haul the territory, the various public corporations it backstops, and the island's financially troubled municipalities to court. This results in a prolonged period of messy legal wrangling.

This pessimistic scenario is devastating for Puerto Rico's economy and residents. Based on simulations of the Moody's Analytics econometric model of the Puerto Rican economy, the downturn that began a decade ago rages on into the next decade.^{ix} By 2020, the end of the scenario, the island's employment declines by an additional 13% and the unemployment rate increases to more than 14% (see Table 3). Unemployment would be even higher if not for the mass out-migration of disenfranchised workers to the mainland. The island's population is expected to fall to 3.3 million by 2020, compared with its peak of well more than 3.8 million in 2004.

	2015	2016	2017	2018	2019	2020	Avg annual growth 2015-2020
Nonfarm employment, ths	910	906	885	851	817	788	-2.8
% change	0.1	-0.4	-2.3	-3.9	-4.0	-3.6	
Gross state product, 2009\$ bil	95.8	94.4	91.8	88.1	84.6	81.8	-3.1
% change	0.0	-1.5	-2.8	-4.1	-4.0	-3.3	
Unemployment rate, %	12.0	12.1	12.5	13.0	13.6	14.1	
Civilian labor force, ths	1,131	1,120	1,110	1,098	1,086	1,075	-1.0
% change	-1.2	-1.0	-0.9	-1.1	-1.1	-1.0	
Population, ths	3,511	3,483	3,448	3,410	3,372	3,335	-1.0
% change	-0.9	-0.8	-1.0	-1.1	-1.1	-1.1	
Net migration, ths	-38.4	-41.7	-47.2	-49.4	-48.6	-46.9	
Disposable personal income, 2009\$ mil	56,688	55,239	53,001	50,939	49,255	47,797	-3.4
% change	1.0	-2.6	-4.1	-3.9	-3.3	-3.0	
Wages and salaries, \$ mil	26,694	27,865	28,552	28,613	28,370	28,110	1.0
% change	3.9	4.4	2.5	0.2	-0.9	-0.9	

Sources: BLS, BEA, Census Bureau, FHFA, Moody's Analytics

Under an alternative, more optimistic scenario, U.S. lawmakers act quickly to address Puerto Rico's problems. Most important, Puerto Rico is given access to an orderly restructuring regime. The quid pro quo is the establishment of an oversight board, such as the Financial Stability Council, to improve government accounting, enhance transparency, and impose fiscal discipline. The council is independent and remains in place until it determines that the territory is back to fiscal health and has fully implemented any required fiscal controls and governance structures. It is assumed in this scenario that the council sets debt payments such that they account for a high but sustainable percent of government revenues.⁵ This scenario also assumes that the economic policy steps previously outlined are adopted.

The Puerto Rican economy performs much better under this scenario. Though the island suffers more job losses over the coming year, they are modest, and employment growth resumes in earnest by the end of the decade (see Table 4). Unemployment declines, and by 2020 it is back to where it was prior to the start of the recession. Although net out-migration continues, it occurs at a much more modest pace.

Table 4: Puerto Rico Economic Outlook Under the Restructuring Scenario

	2015	2016	2017	2018	2019	2020	Avg annual growth 2015-2020
Nonfarm employment, ths	909	906	907	913	922	931	0.5
% change	0.0	-0.3	0.2	0.6	1.0	1.0	
Gross state product, 2009\$ bil	95.7	94.3	93.7	93.8	94.3	95.0	-0.1
% change	-0.1	-1.5	-0.6	0.1	0.6	0.8	
Unemployment rate, %	12.0	11.8	11.7	11.5	11.3	11.1	
Civilian labor force, ths	1,131	1,120	1,115	1,111	1,109	1,108	-0.4
% change	-1.3	-1.0	-0.5	-0.3	-0.2	-0.1	
Population, ths	3,511	3,483	3,452	3,421	3,394	3,370	-0.8
% change	-0.9	-0.8	-0.9	-0.9	-0.8	-0.7	
Net migration, ths	-38.4	-40.1	-42.4	-41.0	-36.9	-33.6	
Disposable personal income, 2009\$ mil	56,703	55,577	54,427	54,170	54,288	54,741	-0.7
% change	1.0	-2.0	-2.1	-0.5	0.2	0.8	
Wages and salaries, \$ mil	26,666	27,835	29,185	30,547	31,776	32,890	4.3
% change	3.8	4.4	4.9	4.7	4.0	3.5	

Sources: BLS, BEA, Census Bureau, FHFA, Moody's Analytics

Under any scenario, Puerto Rico has a difficult road ahead. For sure, this is in part the island's own making. But the problems are also due to the long shadow of the Great Recession. What U.S. lawmakers decide to do or not do to help Puerto Rico out of its fiscal bind in coming weeks will determine the island's economic path for years to come. Doing nothing will ensure that the decade-long recession will continue to deepen through the remainder of this decade. Puerto Rico will suffer an economic depression. Allowing the territory to restructure its debts and expand Medicaid benefits will break the economic downturn and provide a basis for a more stable fiscal situation. U.S. lawmakers should act.

¹ This is as of September 2015, according to the [Commonwealth's Financial Information and Operating Data Report](#), November 6, 2015.

² Gross national product differs from gross domestic product by the difference between net income that flows into an economy and net income that flows out. Puerto Rico GNP is about 25% smaller than GDP, as the island experiences significant net outflows of income, primarily because of income earned at multinational pharmaceutical and tourism-related companies operating on the island.

³ The commonwealth presented a [proposal](#) for debt restructuring to its creditors on February 1, 2016.

⁴ This view is expressed in "[The Budget and Economic Outlook for Puerto Rico](#)," testimony before the Senate Finance Committee by Douglas Holtz-Eakins, September 29, 2015.

⁵ See "[Bankruptcy Risk Premium in the Municipal Securities Market](#)," Tima T. Moldogaziev, Sharon N. Kioko, and W. Bartley Hildreth, paper for the 2014 Municipal Finance Conference.

⁶ The Merchant Marine Act of 1920, also known as the Jones Act, regulates maritime commerce in U.S. waters and between U.S. ports. The law requires that all transport between U.S. ports is done on U.S.-built ships. This significantly raises costs of shipping between the U.S. mainland and Puerto Rico.

⁷ Various potential structural reforms that if implemented would increase the island's long-term growth are presented in "[Puerto Rico Fiscal and Economic Growth Plan](#)," September 9, 2015. The plan was prepared by a working group appointed by Puerto Rico's governor.

⁸ A detailed description of these scenarios is available in [Puerto Rico Looks Into the Abyss](#), Mark Zandi, Dan White and Bernard Yaros, Moody's Analytics white paper, November 2015.

⁹ A description of the Moody's Analytics regional economic models is available upon request.

¹⁰ This scenario is based on a set of policy steps recently proposed by the Obama administration. The administration's proposals are presented in [testimony by Antonio Weiss](#), Counselor to the U.S. Treasury Secretary to the Senate Committee on Energy and Natural Resources on October 22, 2015.

STATEMENT FOR THE RECORD

Hearing of the House of Representatives' Committee on Financial Services
Subcommittee on Oversight and Investigations

on

Puerto Rico's Debt Crisis and Its Impact on the Bond Market

TESTIMONY

OF

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February 25, 2016

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Chairman Duffy, Ranking Member Green, and members of the subcommittee – this testimony was originally presented on February 2, 2016 before the Committee on Natural Resources Subcommittee on Indian, Insular and Alaska Native Affairs. Due to the subject matter of this hearing, “Puerto Rico’s Debt Crisis and Its Impact on the Bond Market,” I would like to submit this testimony for the record of today’s subcommittee hearing.

My name is Thomas Moers Mayer.¹ I have spent the better part of a decade working on municipal insolvencies and observing how municipal insolvencies work in and out of bankruptcy, and I have spent the last year examining the Commonwealth’s fiscal situation and economy in light of its claim that it cannot pay its bondholders.

I offer that experience and my views today on behalf of my clients, certain funds managed by Franklin Advisers (“Franklin”) and by OppenheimerFunds, Inc. (“Oppenheimer”) in connection with their investment in approximately \$10 billion of bonds issued by the Commonwealth of Puerto Rico and most of its 16 governmental corporations.

Who Invests In Puerto Rico?

Franklin and Oppenheimer have for many years been two of the largest investors in bonds issued by Puerto Rico and its governmental corporations; to the best of my knowledge, my clients collectively constitute the largest holders of Puerto Rico bonds.

Franklin and Oppenheimer are mutual funds who invest on behalf of hundreds of thousands of retail investors. Franklin alone has approximately 200,000 investors in the funds that own bonds issued by Puerto Rico and its government corporations; Oppenheimer has over 400,000 individual investors in its municipal bond funds, most of which hold Puerto Rico bonds.

These bondholders are individual savers who receive tax-exempt income derived from Puerto Rico municipal bond holdings. Most tax returns showing tax-exempt income are filed by taxpayers over 65² and most report incomes under \$100,000.³ The average investment in one of Oppenheimer’s funds is \$50,000.

These people live on Main Street, not Wall Street.⁴ These investors are ordinary people who invest for retirement and for their children’s education. They are taxpayers who want to

¹ I am a partner and co-chair of the Corporate Restructuring and Bankruptcy Group at Kramer Levin Naftalis & Frankel, LLP. See Exhibit A. I am also a member of the National Bankruptcy Conference (the “NBC”), which provided its own statement in support of a predecessor to H.R. 870. I was not a signatory to the NBC’s statement and abstained from a vote on it. My testimony today is not on behalf of the NBC, which has not reviewed it.

² *Statistics of Income, 2013 Individual Income Tax Returns*, Publ. 1304, U.S. DEP’T OF THE TREASURY, INTERNAL REVENUE SERVICE, Table 1.5 at 81 (2013), <https://www.irs.gov/pub/irs-soi/13inalcr.pdf> (hereinafter “*IRS Publ. 1304*”).

³ *Id.* Table 1.4 at 43.

⁴ The “household sector” held almost 42% of all municipal bonds as of September 30, 2015. *Federal Reserve Statistical Release Z.1, Financial Accounts of the United States, Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Third Quarter 2015*, Bd. of Governors of the Fed. Reserve Sys. 101 (Dec. 10, 2015), <http://www.federalreserve.gov/releases/z1/current/z1.pdf>. Mutual funds together held an additional 19%. *Id.*

buy tax-free bonds. Indeed, about 9.5 million U.S. taxpayers invest in municipal bonds to get tax-free income, either directly or through funds like Franklin's and Oppenheimer's.⁵

Puerto Rico is the only large issuer whose bonds are tax-free in every state of the union,⁶ and it is likely that most municipal bondholders (or fund holders) hold, directly or indirectly, Puerto Rico bonds.

These investors bought their bonds after Congress expressly excluded Puerto Rico from using chapter 9. My own clients – on behalf of more than half a million investors – bought their bonds in reliance on Puerto Rico's exclusion from chapter 9.

How Congress decides to address Puerto Rico's fiscal situation could directly impact millions of Americans in every state of the Union and the Commonwealth of Puerto Rico. Indeed, it is probable that more citizens invest in Puerto Rico bonds than still live in Puerto Rico.

Finally, it is important to remember that many Puerto Ricans invest in Puerto Rican bonds. We estimate that \$15 billion of Puerto Rico bonds were purchased by Puerto Ricans. These are Puerto Rico's own hardworking citizens who pay Puerto Rico taxes⁷ – or they are former residents of Puerto Rico who have moved to the mainland and depend on the bonds of their native Commonwealth for income.

These Puerto Rican investors, like mainland investors, bought their bonds after Puerto Rico was excluded from chapter 9.

It is these on-island and mainland investors whose money has gone to build and operate Puerto Rico's firehouses, police stations, schools, sewer and water systems, highways, convention center and electrical plants. It is these investors, on-island and mainland, who have been champions of Puerto Rico and have interests that align with those of the people of Puerto Rico in seeing the Commonwealth thrive over the long-run.

And it is these individual, retail investors who Puerto Rico needs. Puerto Rico needed their investment in the past and Puerto Rico will need their investment in the future. Puerto Rico needs to raise billions of dollars for new electrical plants to meet air pollution regulations, for new water lines to avoid droughts in San Juan, for new sewer lines to meet water quality requirements, for maintenance of highways and bridges, for ordinary short term financing that every government needs to finance expenses between one tax collection cycle and the next.

⁵ In 2013, 5,987,263 tax returns reported tax exempt income, comprised of 3,556,447 tax returns from married couples filing jointly, or 7,112,894 individuals, and 2,430,817 other individual tax returns, for a total of 9,543,711 individuals. *IRS Publ. 1304*, supra note 2, Table 1.3 at 40.

⁶ See 48 U.S.C. § 745.

⁷ As discussed below, Puerto Ricans do not pay federal income tax, but they do pay the Federal Insurance Contributions Act tax.

A municipality that forces a restructuring on its bondholders will be locked out of the market for low-cost investment grade municipal bonds.⁸ Thus, harming Puerto Rico's investor base as part of a restructuring will only make Puerto Rico's recovery harder, if not impossible, by shutting Puerto Rico out of the normal low-cost investment grade municipal bond market. It will leave Puerto Rico no recourse except to lenders who charge extraordinarily high rates to compensate for risk, or – in the end – the U.S. Treasury. It will also have a negative effect on the value of the \$15 billion in Puerto Rico debt owned by on-island investors, leading to less money spent in the economy.

The only way to assure the Main Street retail investors who have entrusted their savings to Puerto Rico in the past that they can do so in the future is the creation of a strong, independent and federally appointed Authority.

⁸ See, e.g., *Ratings Methodology: US Local Government General Obligation Debt*, MOODY'S INVESTORS SERVICE 21 (Jan. 15, 2014) (considering defaults or "government's willingness and/or ability to meet financial obligations" as a factor in methodology for rating U.S. local government general obligation debt).

The Problem to Be Solved

The Commonwealth blames its problems on the individual retail investors who trusted the Commonwealth with their money. We submit that the Commonwealth created its own problems through over-optimistic revenue forecasting when budgeting, an economy with too much government and too little private enterprise, and poor management of public resources.

Consider:

- KPMG, the Commonwealth's own consultant, estimates that the Commonwealth could have obtained an additional \$2.5 billion in revenue each year by improving tax collections and simplifying its tax structure.⁹ This problem, again, is not new – it was highlighted in a 2006 report by the Brookings Institution.¹⁰
- KPMG likewise reports that the Commonwealth collects only 56% of its sales and use taxes.¹¹
- The Commonwealth's funding gap is in material part due to municipal subsidies. These are required because municipalities base their property taxes on assessed valuations from the 1950s.¹²
- The Commonwealth has failed to file its audited financial statement for fiscal year 2014. Its most recent audited financial statements cover through June 2013 – over two years ago.

Similar problems arise at the level of governmental corporations. The Puerto Rico Electric Power Authority, or PREPA, provides the best example.

- PREPA bills governmental corporations for power but historically has not collected what it is owed.¹³
- PREPA allows private customer bills to go unpaid for months before shut-off – and then instantly re-connects on payment without an adequate security deposit, effectively giving its customers months and months of credit. As of January 2015, PREPA suffered a 6% theft rate – the highest of any utility in the United States.¹⁴

⁹ See excerpts from KPMG, *Unified Tax Code of Puerto Rico: Tax Policy Implementation Options Executive Summary* (Oct. 31, 2014), available at http://www.hacienda.gobierno.pr/sites/default/files/unified_tax_code_of_pr_executive_summary_0.pdf (attached hereto as Exhibit B) (hereinafter the "*KPMG Report*").

¹⁰ James Alm, *Assessing Puerto Rico's Fiscal Policies*, in RESTORING GROWTH IN PUERTO RICO: OVERVIEW AND POLICY OPTIONS 71 (Susan M. Collins et al. eds. 2006) (hereinafter "RESTORING GROWTH IN PUERTO RICO").

¹¹ See excerpts from *KPMG Report*, supra note 9 (attached hereto as Exhibit B).

¹² Anne O. Krueger, et al., *Puerto Rico – A Way Forward*, 20 (July 13, 2015), available at <http://www.bgfpr.com/documents/FinalUpdatedReport7-13-15.pdf> (hereinafter "*Krueger Report*").

¹³ *Accounts Receivable and CILT Report*, FTI Capital Advisors, LLC, 16 (Nov. 15, 2014), <http://www.acepr.com/Docs/restrukturacion/PREPA%20AR%20and%20CILT%20Report%20Final.pdf>.

¹⁴ *Id.* at 45, 49; Siemens PTI Report Number R054-15, Integrated Resource Plan, Addendum I: Losses Considerations (July 15, 2015), available at

- PREPA's current labor contract allows employees to get a year's pay for nine months of work, and an employee earns overtime for more than 8 hours on any day even if the employee works less than 40 hours a week.¹⁵
- PREPA's 200 top managers are politically appointed and change with every administration.¹⁶
- According to publicly-filed contracts, PREPA plans to dramatically over-pay for solar and wind – buying such power at an average cost of about 17 cents per Kwh,¹⁷ greatly in excess of PREPA's average cost of producing additional power at 11.33 cents per Kwh in 2016¹⁸ and *double* the 8.6 cents which Lazard estimates is the levelized cost of utility-scale solar power nationwide.¹⁹

These facts illuminate why PREPA is a poster child for the creation of a strong Authority. First, a strong authority could provide a credible assessment of PREPA's financial condition that could provide the basis for reforms. Second, a strong authority could enact the reforms that so far the Commonwealth and its municipalities have refused to adopt.

A Strong Authority Can Fix These Problems

In light of the Puerto Rico government's inability to manage its profound fiscal and operational problems, Congress should consider establishing an Authority for Puerto Rico based on what Congress did with a control board for the District of Columbia back in the 1990s, when the District of Columbia had its financial problems. Many observers agree that the control board which Congress created for the District of Columbia was instrumental in the District's dramatic revitalization that is evident today.

<http://www.aepr.com/Docs/Ley57/PREPA%20IRP%20Addendum%201%20%E2%80%93%20Draft%20for%20PRECA%20review%20-%20July%207-2015%20-%20Losses%20Consideration.pdf>.

¹⁵ *Krueger Report*, supra note 12, at 18; Collective Bargaining Agreement Between PREPA and the Union of Electrical and Irrigation Industry Workers of Puerto Rico (Aug. 24, 2008), available at <http://www.utier.org/Contenido/CONVENIOFINALWEB.pdf>. Employees receive 30 paid vacation days, 19 paid sick days and 20 paid holidays, for a total of 69 paid days off each year. *Id.* Assuming there are 260 working days in a year, PREPA employees accrue paid time for approximately 25%, or about three months, of each year. Unused vacation days can be carried over for a year; sick days can be accumulated and carried over from year to year without limit. *Id.*

¹⁶ *Hearing Before the Puerto Rico Senate Committee on Energy Matters and Water Resources* (Apr. 14, 2015) (Testimony of Lisa Donahue, Chief Restructuring Officer of PREPA).

¹⁷ C. Kunkel et al., *Opportunity for a New Direction for Puerto Rico's Electric System*, INSTITUTE FOR ENERGY ECONOMICS AND FINANCIAL ANALYSIS (Sept. 10, 2015), available at <http://ieefa.org/wp-content/uploads/2015/09/Opportunity-for-A-New-Direction-for-Puerto-Ricos-Electric-System-Sept-10-2015.pdf>.

¹⁸ See PREPA, *PREPA's Transformation: A Path to Sustainability*, 9, as set forth in *PREPA Public Disclosure* (July 22, 2015), available at <http://emma.msrb.org/ER906457-ER708173-ER1109700.pdf>. PREPA's July 2015 report estimated the 11.33 cents cost of buying additional power based on current and currently-projected natural gas and oil prices. The IEEFA's September 2015 Report, although issued two months later, used 2014 natural gas and oil prices (more than twice as high) to support IEEFA's conclusion that renewable power is cheaper than conventional power.

¹⁹ LAZARD, *Levelized Cost of Energy Analysis – Version 8.0, 2* (2014), available at www.lazard.com/media/1777/levelized_cost_of_energy_-_version_80.pdf.

Moreover, I would note that, when Congress examined legislative proposals to help the District of Columbia in the 1990s, opting for a control board, it also considered permitting the District of Columbia to access chapter 9 – but it expressly rejected that option because it found that:

[T]he Bankruptcy Code as it stands is neither intended to nor designed to promote judicial restructuring of a municipal government that suffers chronic, structural budget deficits. . . . Unlike a Control Board, the [Bankruptcy] Court provides no mechanism for acquiring independent financial expertise services. Nor can it provide legally binding guidance to the debtor on administrative or structural reform.²⁰

If Congress were to create an Authority for Puerto Rico and also grant chapter 9 for Puerto Rico, chapter 9 would not only: (1) undermine the rule of law and result in a bailout of Puerto Rico on the backs of well over a million U.S. taxpayers throughout the mainland (and Puerto Rico) who are retail investors in Puerto Rico bonds, but also (2) undermine the reforms hoped to be achieved through an Authority, as Puerto Rico could simply repudiate its debts through bankruptcy, thereby alleviating the political imperative to implement tough reforms recommended by the Authority.

A strong Authority provides the best chance to fix the problems of Puerto Rico and its governmental corporations. The Authority should have a small number of board members – I suggest 5 – because the smaller the board the stronger it will be.

A strong Authority must have board members from both Puerto Rico and the mainland that are acceptable to both Congress and Puerto Rico. The board should be bipartisan, appointed by the President and confirmed by the Senate, have experience in municipal finance and inspire the trust and confidence of Puerto Rico's creditors.

The board members will be asked to work long and hard on the problems of Puerto Rico. Their terms should be several years because Puerto Rico's problems will not be solved quickly. Further, board members should be compensated so that the Authority obtains the committed service of the most serious, experienced and best people – and Congress should seek out members who are preferably fluent in Puerto Rico's two official languages, English and Spanish, to help ensure effective communication with both Congress and the people of Puerto Rico.

The Authority should retain an executive director of unquestioned competence, stature and dedication, and the Authority should have the resources to hire committed, experienced, knowledgeable and bilingual financial professionals.

The powers of the Authority should be broad and must include the power of the purse, but they need not trespass on the sovereignty of the Commonwealth.

²⁰ *District of Columbia Financial Responsibility and Management Assistance Act of 1993*, H.R. Rep. No. 104-96, at 17 (1995).

The United States Treasury already funds billions of dollars to Puerto Rico every year and the Commonwealth is asking for more – more Medicaid and federal credit support. The continuation of, or increase in, any support from the federal government can be conditioned on the Authority's approval of the Commonwealth's budget on a yearly basis – just as the District of Columbia Control Board's approval was required for the District to have access to federal funding.

With respect to the Commonwealth's government corporations, the Authority should have the same power that Michigan had over Detroit and has over its other cities: the appointment of a manager with power to hire, fire, reject and renegotiate contracts, revise work rules, and restructure pensions.²¹

A strong Authority can bring expenditures under control. I cite the financial problems and recovery of New York City in the mid to late 1970s as the largest example. New York's budget had ballooned in the 1960s and 1970s as government grew bigger and bigger.²²

Only outside intervention brought New York City's budget under control. Everyone remembers New York State's imposition of the Municipal Assistance Corporation, which to this day ensures that the City keeps its books in accordance with Governmental Accounting Standards. Fewer people remember that the U.S. Treasury also exercised oversight over New York – there was a special office created in Washington to deal with New York City.²³

The oversight was effective, its results well known. New York City brought its labor costs under control, cut the size of its government and set the stage for an economic recovery.

More recently, the District of Columbia Control Board, with Anthony Williams as chief financial officer and later mayor, brought the District from deficit and fiscal crisis to surplus in less than two years.²⁴

The Authority's role should not be permanent. Just as with the District of Columbia Control Board, the Authority's control should expire upon a congressionally approved determination of success, which should include, among other factors, access to short and long term capital markets at reasonable rates, a balanced budget for a few years in a row, and audited, credible financial statements.

Only after maximum operational changes have been made and maximum operational savings have been achieved, and only if debt restructuring is still necessary, the manager could then have the power to negotiate and implement a restructuring with the vote of two-thirds of the debt to be restructured.

²¹ See generally 2012 Mich. Pub. Act 436, the Local Financial Stability and Choice Act.

²² See Exhibit C.

²³ MARTIN SHEFTER, POLITICAL CRISIS FISCAL CRISIS: THE COLLAPSE AND REVIVAL OF NEW YORK CITY 134, 151 (Columbia Univ. Press Morningside ed. 1992).

²⁴ See ALICE RIVLIN, ET AL., BUILDING THE BEST CAPITAL CITY IN THE WORLD, A REPORT BY DC APPLESEED AND OUR NATION'S CAPITAL 109 (2008), <http://www.brookings.edu/~/media/Research/Files/Reports/2008/12/18-dc-revitalization-garrison-rivlin/appendix.PDF> (hereinafter the "BROOKINGS REPORT") (attached hereto as Exhibit D).

Finally, it is critical that neither the Authority nor Puerto Rico have the authority to authorize chapter 9 filings because chapter 9 in its current form allows municipal debtors to do as little possible by paying creditors as little as possible.

Chapter 9 used to give creditors a vote – indeed, prior to 1978, it required agreement by a majority of bonds to even begin a case²⁵ – but the 1978 statute reduced the vote to a formality. So long as a chapter 9 plan has been accepted by one class of creditors, no matter how small, it can be confirmed over the objection of all other creditors, no matter how large or how many.²⁶

Chapter 9’s other requirements – that the plan be “fair and equitable,” “not discriminate unfairly” and be “in the best interests of creditors” – provide little protection to creditors,²⁷ who do not even have the ability to propose their own plan.²⁸

Once in chapter 9, the Bankruptcy Code bars the court from ordering the municipality to do anything²⁹ – the municipality cannot be compelled to cut its costs, raise its revenues, collect its taxes, renegotiate its contracts, restructure its pensions, reform its budgets, anything. The only thing a court can do is dismiss the case.

So the argument often heard, that chapter 9 “builds consensus,” is fake. A municipality is free to make minimal operational changes, cut a deal with one favored class of creditors, and tell all other classes that their votes mean nothing. The only remedy that creditors have in chapter 9, and the only power a court has with respect to the municipal debtor, is to get out of chapter 9.

No matter how strong the Authority or its emergency managers, the availability of chapter 9 or any compulsory debt restructuring reduces the incentive of any government to enact real reforms, will cut access to the capital markets and inevitably lead the Commonwealth and its governmental corporations returning to Congress for financial support.³⁰

²⁵ Section 83(a) of the Bankruptcy Act of 1898, *as amended by* The Municipal Bankruptcy Act of 1937. Pub. L. No. 302, 50 Stat. 652 (1937) (codified at 11 U.S.C. § 403(a) (1970)).

²⁶ 11 U.S.C. § 901(a) (incorporating § 1129(a)(10)). Chapter 9 also allows debtors to classify disparate creditors together, even if the results will be inequitable. In Stockton’s bankruptcy case, unsecured bond claims were classified with the much larger retiree medical claims, even though retiree medical claimants could also look to a spouse’s insurance, the Affordable Care Act, and their pension claims, which were being paid in full. *See In re City of Stockton, Cal.*, 526 B.R. 35, 62 (Bankr. E.D. Cal. 2015) *aff’d in part, dismissed in part*, 542 B.R. 261 (B.A.P. 9th Cir. 2015).

²⁷ In Detroit’s bankruptcy case, *In re City of Detroit, Mich.*, 524 B.R. 147 (Bankr. E.D. Mich. 2014), Bankruptcy Judge Rhodes held that paying one group of bondholders 13 cents while pensioners received 59-60 cents was not “unfair discrimination” because it did not offend “the judgment of conscience,” including “the Court’s experience and sense of morality.” This standard – which had never before been applied to “unfair discrimination” – allowed the court to confirm the plan irrespective of the bondholder vote. *Id.* at 253, 256-58.

The “best interests of creditors” test also does little to protect creditors. In the Detroit case, Judge Rhodes further held that the plan was in the best interests of creditors because bondholder remedies would not yield a better result outside of bankruptcy. *City of Detroit*, 524 B.R. at 213-17. Precedent under old Chapter IX required a municipality to do what it could to pay creditors. *See Fano v. Newport Heights Irrigation District*, 114 F.2d 563, 565-66 (9th Cir. 1940).

²⁸ 11 U.S.C. § 941.

²⁹ 11 U.S.C. §§ 903-904.

³⁰ Some witnesses have predicted that governmental corporations can obtain “debtor in possession” or “DIP” financing in a chapter 9 bankruptcy case. There is no basis for this prediction. No private sector lender makes a

Chapter 9 Would Hinder, Not Help, The Authority

A comparison of the District of Columbia (which had a control board but no access to bankruptcy via chapter 9), with Jefferson County, Alabama (chapter 9, no control board) and the City of Detroit (chapter 9, 18-month emergency manager³¹) shows why a strong control board is required and why chapter 9 is an impediment to required reform.

The District of Columbia Control Board closed D.C. General Hospital over the objections of the D.C. City Council because the District had to cover deficits of \$90 million – and because a local system of clinics and hospitals could provide better and less expensive medical care for residents.

By contrast, there was no control board for Jefferson County, Alabama. Jefferson County's Cooper-Green Medical Center was costing the county \$10 million a year to employ over 528 staff with fewer than 38 patients, even though it had 100 available beds.³² The world-class University of Alabama/Birmingham Hospital is literally across the street with capacity to take Cooper-Green's patients. It took years – including two years in chapter 9 – for the County Commissioners to transition Cooper Green to an urgent care clinic.³³

Detroit had similar problems when it resorted to chapter 9.

Kebyn Orr, the emergency manager appointed by Governor Snyder, had an 18-month term to solve a range of problems.³⁴ Orr cut debt service and moved retiree medical benefits off the City's budget and onto the federal government through the Affordable Care Act, but he made minimal cuts to pension – zero reduction in current benefits for police and fire,³⁵ a 4.5 percent cut for general employees,³⁶ and he allowed the City to adopt some of the same questionable practices that led to pension underfunding in the first place.

DIP unless secured by a first lien on collateral. The government corporations cannot grant such a lien because most of them have already pledged all their collateral to existing bondholders. Therefore, if Puerto Rico's government corporations were given access to chapter 9, any bankruptcy case would be like General Motors and Chrysler – the only entity that would provide DIP financing would be the United States Government.

³¹ The statute providing for the appointment of Detroit's emergency manager gave the manager a term of 18 months.

³² See Barnett Wright, *Dr. Sandra Hullett of Cooper Green Hospital, Among 210 Who Received Lay Off Notices*, THE BIRMINGHAM NEWS (Dec. 20, 2012), http://blog.al.com/spotnews/2012/dr_sandra_hullett_ceo_of_coop.html; B. Wright, *Cooper Green Ending Inpatient, Emergency Room Services*, THE BIRMINGHAM NEWS (Dec. 12, 2012), http://blog.al.com/spotnews/2012/12cooper_green_mercy_hospital_to_2.html.

³³ *Id.*

³⁴ Mr. Orr ended up serving as Detroit's emergency manager from his appointment on March 2013 until Detroit emerged from bankruptcy in December 2014. Della Cassia, *Emergency Manager Kebyn Orr Steps Down as Detroit Emerges From Bankruptcy*, PBS Newshour (Dec. 12, 2014), <http://www.pbs.org/newshour/rundown/emergency-manager-kebyn-orr-steps-detroit-emerges-bankruptcy>.

³⁵ The cost of living adjustment was eliminated for police and fire retirees.

³⁶ Chris Christoff, *Detroit Pension Cuts from Bankruptcy Prompt Cries of Betrayal*, BLOOMBERG (Feb. 2, 2015), <http://www.bloomberg.com/news/articles/2015-02-05/detroit-pension-cuts-from-bankruptcy-prompt-cries-of-betrayal>.

Detroit's pension problems are far from solved. Detroit's plan put in place a ten-year moratorium on pension funding, but Detroit must make yearly payments thereafter. Recent projections show that the balloon payment due in 2024 has risen to \$195 million, approximately 71% higher than the \$114 million originally projected.³⁷ Even former Bankruptcy Judge Rhodes, now a consultant to the Puerto Rico government, who confirmed the City's plan of adjustment, has admitted that Detroit's bankruptcy was a "missed opportunity" for greater pension reform.³⁸

Lingering pension issues are one of many reasons that even now, over a year after Detroit emerged from bankruptcy, Detroit has no access to the low-cost ordinary municipal market. Detroit as an issuer still has a junk credit rating. Its new unsecured notes, issued under its bankruptcy plan, trade at around 23 cents on the dollar. Following its bankruptcy, Detroit has been able to access the credit markets only through secured debt issued by a State of Michigan entity secured by income tax revenues that the City never touches.³⁹ Puerto Rico has no entity to enable it to access the credit markets other than the United States Treasury.

By contrast, the D.C. Control Board was able to restore the District's access to the markets. By 2001, all three major rating agencies deemed the District's bonds investment grade.⁴⁰ One of my clients, Franklin Advisers, was an early investor in bonds issued by the District under the Control Board. Standard & Poor's now rates the District at AA – several notches above investment grade.

Orr made no structural changes to the Detroit government. The City exited chapter 9 with the same 28 government agencies it had when it entered bankruptcy.⁴¹ Note that Puerto Rico has at least 120 government agencies and 78 municipalities for an island with 3.5 million people.⁴²

By contrast, Mayor Anthony Williams and the D.C. Control Board focused on reducing government, collecting (not raising) taxes and attracting private sector employers to the District.

³⁷ See Matthew Dolan et al., *\$195M pension payment might derail Detroit's Recovery*, DETROIT FREE PRESS (Nov. 15, 2015), <http://www.freep.com/story/news/local/detroit-bankruptcy/2015/11/14/detroit-pension-balloon-payment-estimated-195m/75657200>.

³⁸ *Id.*

³⁹ See Michigan Finance Authority Offering Memorandum for Local Government Loan Program Revenue Bonds, Series 2014F (City of Detroit Financial Recovery Income Tax Revenue and Refunding Local Project Bonds) (Dec. 10, 2014).

⁴⁰ D.C.'s general obligation bonds were rated below investment grade in 1995; starting in 1998, as a result of the District's financial turnaround, the rating agencies began steadily increasing the ratings. See U.S. General Accounting Office, Testimony Before the Subcommittee on the District of Columbia, Committee on Government Reform, House of Representatives and Subcommittee on Oversight of Government Management, Restructuring and the District of Columbia, Committee on Governmental Affairs, U.S. Senate, "District of Columbia: Oversight in the Post-Control Board Period" 6 (June 8, 2001), <http://www.gao.gov/assets/110/108870.pdf>.

⁴¹ *City of Detroit – Expert Witness Report of Stephen J. Spencer* (July 2014).

⁴² *Annual Estimates of the Resident Population: April 1, 2010 to July 1, 2015*, U.S. CENSUS BUREAU (Jan. 22, 2016, 10:15 PM), http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=PEP_2014_PEPANNRES&src=pt; *Agency Directory*, PR.GOV (Jan. 24, 2016, 12:30 PM), <http://www2.pr.gov/Directorios/Pages/DirectoriodeAgencias.aspx>; Steven J. Davis & Luis A. Rivera-Batiz, *The Climate for Business Development and Employment Growth*, in RESTORING GROWTH IN PUERTO RICO, supra note 10, at 57.

The comparison of the District of Columbia with Puerto Rico is instructive. Puerto Rico's collection rates are extremely low:

Some analysts estimate that uncollected personal income taxes amounted to 29.7 percent of actual income tax revenues in 1987 and 24.9 percent of tax revenues in 1992.⁴³

The District recognized the importance of improving collections as a fundamental part of its turnaround:

In addition to strictly managing expenditures, the District's growth in revenue generation since FY1997 is a striking success. Total tax revenue grew by 92% and gross revenues increased almost 53% from FY 1997 to 2007. The District took three important steps to make this possible: (1) D.C. made improvements to its current revenue collection capacity; (2) it improved its overall financial health, and, thus, its capacity to generate revenue, especially through the real estate market; and (3) it developed cautious estimates of future revenues.⁴⁴

The contrasting experiences of Detroit and D.C. provide valuable instruction on the benefits of employing a strong control board to address the Commonwealth's problem and the dangers of resorting to chapter 9.

CONCLUSION

Puerto Rico's problem in a nutshell is that its private sector employs too low a percentage of working-age citizens, its public resources are mismanaged and its government employs too great a percentage of its working-age citizens. The Commonwealth's cry of "humanitarian crisis" is nothing more than a plea for third parties – bondholders through cuts to debt service, the federal government through loans, grants or subsidies – to maintain the size of an un-maintainable and poorly managed government, to fund the patient's illness, not to cure it.

If Puerto Rico is to survive and flourish, it must create an island economy where the private sector generates income for its citizens and supports its own government. Supporting or increasing government expenditures will not work. Cutting debt service to maintain government spending will not work. A strong Authority which reduces government, enhances management of public resources and supports the private sector has a chance of doing so – as it did in D.C. and New York City. Any other solution leads the Commonwealth, as it led General Motors and Chrysler, back to the federal government for cash the private markets will no longer supply. In addition to eliminating access to private markets, access to chapter 9 would hurt individual investors – the very people who were willing to invest in Puerto Rico's infrastructure and development in the first place.

⁴³ James Alm, *Assessing Puerto Rico's Fiscal Policies*, in RESTORING GROWTH IN PUERTO RICO, supra note 10, at 71.

⁴⁴ THE BROOKINGS REPORT, supra note 24, at 113.

Exhibit A

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Thomas Moers Mayer

Partner

Co-chair, Corporate Restructuring and Bankruptcy

Thomas Moers Mayer is co-chair of Kramer Levin's 45-attorney Corporate Restructuring and Bankruptcy Department.

Mr. Mayer has represented Official Committees of Unsecured Creditors in some of the largest cases in history, including General Motors, Chrysler, Capmark, Smurfit-Stone and Dana Corporation. Mr. Mayer has also played major roles in the largest municipal insolvencies, representing holders of \$900 million in secured sewer warrants of Jefferson County, Alabama in that County's chapter 9 case and \$1 billion in Certificates of Participation in the Detroit chapter 9. Mr. Mayer leads the Kramer Levin team focused on heavily indebted Puerto Rico and its instrumentalities. He currently assists Amy Caton in her representation of \$2.4 billion of secured bonds issued by the Puerto Rico Electric Power Authority.

Mr. Mayer has also represented investors in financially distressed companies. His transactions include the 1991 acquisition of Wheeling-Pittsburgh Steel Corporation and the 2006 hostile takeover of WCI Steel Corporation, both through chapter 11 plans supported by the United Steelworkers of America. He is the leading scholar on trading claims and taking control of corporations in chapter 11, having authored or co-authored (with Chaim J. Fortgang) five published articles and the *Collier Bankruptcy Manual* chapter on the topic.

Chief Justice John Roberts of the United States Supreme Court appointed Mr. Mayer to the United States Judicial Conference Advisory Committee on Bankruptcy Rules for a three-year term starting October 1, 2014.

Mr. Mayer is a member of the National Bankruptcy Conference, a non-partisan organization of approximately 60 leading lawyers, law professors and bankruptcy judges which provides bankruptcy advice to Congress. He is also a Fellow of the American College of Bankruptcy, an honorary association of approximately 800 leading senior insolvency professionals.

Honors and Distinctions

- Listed in *Benchmark Litigation*, 2015
- Included in *The Best Lawyers in America*, 2015
- Recognized in *Chambers Global*, 2014
- Included in *Legal 500 US*, 2014
- Included in *New York Super Lawyers*, 2014
- Adjunct Professor, Cardozo Law School (1998)

Thomas Moers Mayer
Continued

Professional Affiliations

- Member, Association of the Bar of the City of New York

Education

- J.D., *magna cum laude*, Harvard Law School, 1981
Editor, *Harvard Law Review*
- A.B., *summa cum laude*, Phi Beta Kappa, Dartmouth College, 1977

Bar Admission

- New York, 1982

Clerkships

- Judge J. Edward Lumbard, U.S. Court of Appeals for the 2nd Circuit, 1981-1982

Exhibit B

**Commonwealth of Puerto Rico
Tax Reform Assessment Project**

*Unified Tax Code of Puerto Rico:
Tax Policy Implementation Options*

Executive Summary

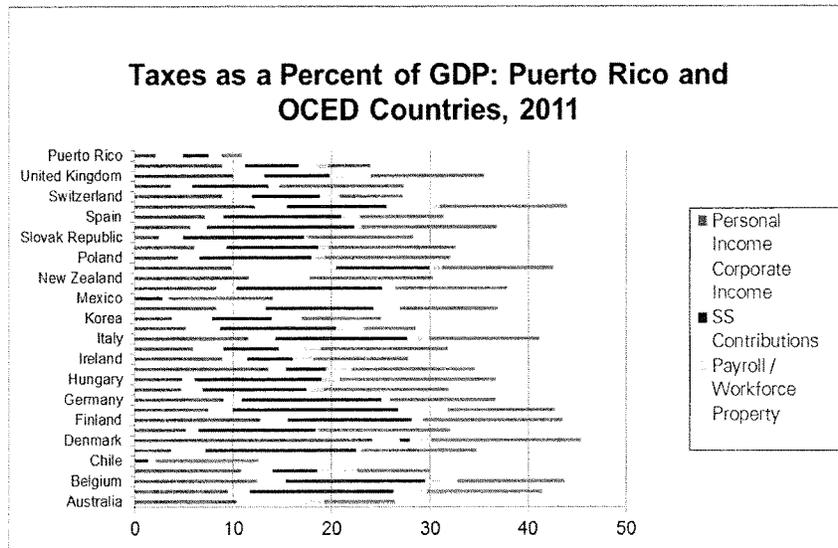
October 31, 2014

1.3 Summary of Principal Findings

1.3.1 High Level Observations

The current income and consumption tax structures are inordinately complex, due principally to a plethora of special provisions that for the most part were adopted in a haphazard manner over time generally to provide incentives for particular forms of economic activity. These special provisions have never been subjected to a cost benefit analysis. As shown in Tables 1 and 2, revenue from consumption and income taxes are below peer jurisdictions.

Table 1: Taxes as a Percentage of GDP in Puerto Rico Compared to Selected Jurisdictions⁴



⁴ (*) While Table 1 uses GDP as the measure of comparison across countries, the results are similar when using GNP as the measure of comparison. Puerto Rico taxes as a percentage of GNP is closer to 15% but still substantially lower than the tax liability of the peer countries shown.

Table 2: Tax Collections as Percent of GDP -- Comparison of Puerto Rico to OECD Countries

	Puerto Rico	Average	Range
Personal Income	2.2%	8.3%	2.2 - 24.2%
Corporate Income	2.7%	3.0%	1.2 - 10.70%
SS Contributions	2.75%	9.00%	0.00 - 16.70%
Payroll/Workforce	0.21%	0.41%	0.00 - 4.44%
Property	0.75%	1.76%	0.29 - 4.16%
Goods/Services	2.216%	10.77%	2.06 - 15.91%
Total	10.66%	33.19%	

Table 3 presents data on the distribution of income and tax liability and shows that less than 10 percent of filers are responsible for almost 78 percent of income tax receipts.

Table 3: 2013 Income Tax Liability by Income Class (In Millions of USD)⁵

Income Level	Filers	Tax Liability (Excluding SS & Medicare)	Share of Tax (Excluding SS & Medicare)	Tax Liability (Including Social Security and Medicare)	Share of Tax (Including Social Security and Medicare)
Less than \$20,000	538,026	\$4	.2%	\$368	9.6%
Between \$19,999 and \$40,000	319,108	\$191	9.2%	\$791	20.6%
Between \$39,999 and \$60,000	107,107	\$270	13.0%	\$604	15.7%
Greater than \$59,999	89,459	\$1,614	77.6%	\$2,079	54.1%
Total	1,053,700	\$2,079	100.0%	\$3,842	100.0%

⁵ Distributional analysis based on 2012 individual tax returns provided by Department of Treasury.

**Commonwealth of Puerto Rico
Tax Reform Assessment Project**

Unified Tax Code of Puerto Rico:

Tax Policy Implementation Options

General Explanation of Principal Options

October 31, 2014

A credit system for goods acquired for resale requires the carrying forward of credits, which can create cashflow burdens. Further, the discretionary power in the Secretary to refund tax where merchants can demonstrate they will be in a regular refund position creates uncertainty.

The existing system is overly burdensome for taxpayers. It is estimated that the sales tax compliance rate is in the neighborhood of 56%, an obviously unacceptable number. While the elimination of the requirement to file sales and use tax returns by location rather than by entity has simplified the compliance process to a certain extent, the requirement to file separate municipality returns and use tax returns for imports imposes significant compliance costs. The inconsistency between the municipalities in the administration of the tax, combined with a lack of information sharing between the municipalities and Department of Treasury, hampers decision making and gives rise to differences in interpretation of legislation. For example, there are inconsistencies in determining the point in time a merchant is considered to have commenced trading – upon first sale, first payment of payroll, or upon laying the first stone of the establishment.

2.1.3 Descriptions of Options

The existing consumption tax structure could be replaced by a broad-based single rate Goods and Services Tax (“GST”) with regressivity relief accomplished through direct transfer payments. Financial services, residential housing, water and electricity would be exempt. Certain goods and services subject to excise tax could also be exempt. (See excise tax discussion below.) Businesses below a certain level of receipts, for example \$75,000, would not be required to register. Regressivity relief would be calculated to assure that households below a specified income level would not incur any additional tax burden under the new system. All consumption taxes would be collected and administered at the Commonwealth level and proceeds distributed to the municipalities from a dedicated fund pursuant to a revenue sharing formula

2.1.4 Analysis

GST, also known as Value Added Tax (“VAT”), is recognized as the most efficient consumption tax both in terms of revenue for governments and neutrality towards domestic and international trade. It is the most common consumption tax utilized today. Over 150 countries and 33 of the 34 OECD countries have implemented some form of GST.¹² Its recognized capacity to raise revenue in a neutral and transparent manner has contributed to its virtually universal adoption.

A broad based GST with a single rate minimizes compliance cost and, from an economic perspective, is the best policy choice.¹³ From an efficiency perspective, a moderate GST rate with a broad base and few exemptions is preferable to a higher rate with exemptions.

The move to a GST would lead to enhanced compliance and revenue when compared to current law. The tax rate would be a function both of revenue needs and the desirability of using consumption tax revenues to reduce the tax burden in other areas, particularly the individual income tax, or to replace revenues lost through repeal of existing provisions, such as the *Patente Nacional*.

¹² OECD (2012), *Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administrative Issues*, OECD Publishing, p. 28.

¹³ OECD (2012), *Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administrative Issues*, OECD Publishing, p. 73.

Exhibit C

POLITICAL
CRISIS

FISCAL
CRISIS

The Collapse and Revival
of New York City

MARTIN SHEFTER

 Columbia University Press

New York

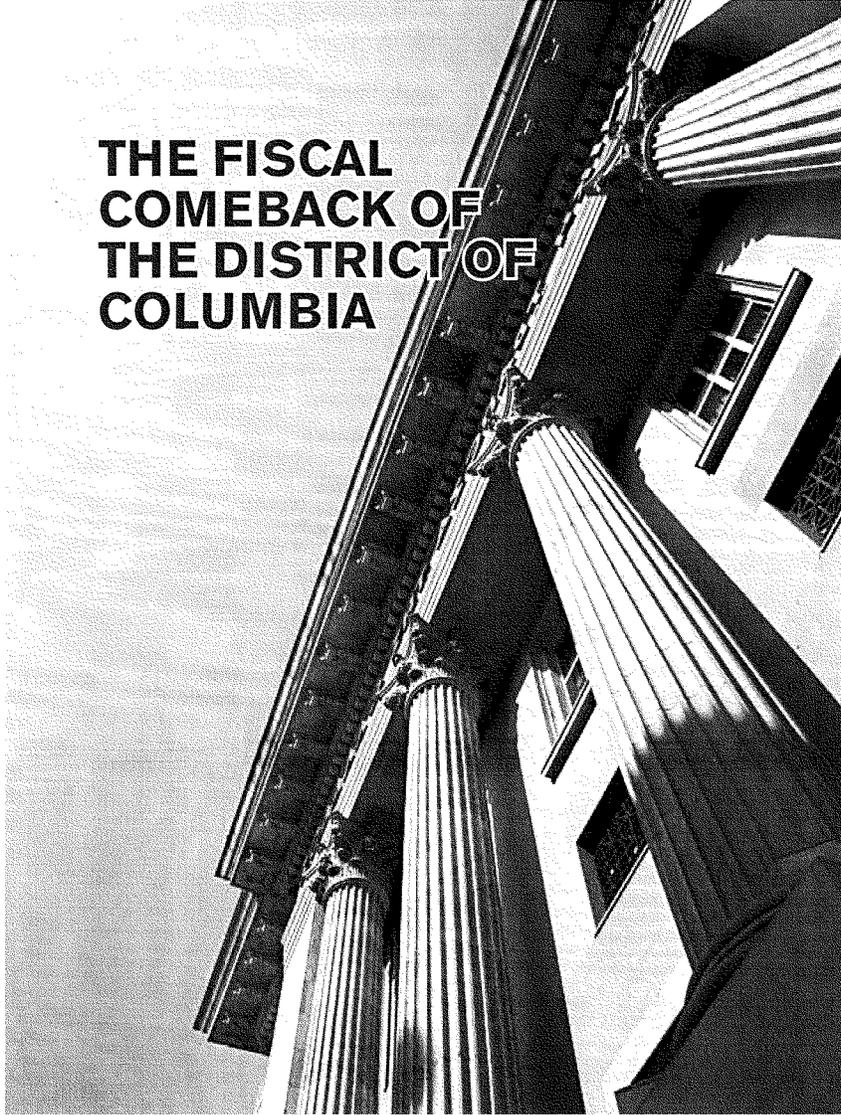
TABLE 5.2
*New York City Operating Expenditures by Object: Percentage Increase and
 Proportion of Total Increase, 1961-75*

	Expenditures in Millions		Percentage Increase 1961-75	Proportion of Total Increase 1961-75
	1961	1975		
Wages, Pensions, and Fringe				
Benefits	\$1,334.7	\$5,520.6	313.6%	45.1%
Social Welfare	303.9	2,822.0	828.6	27.1
Hospitals	159.4	631.5	296.1	5.1
Debt Service	386.7	1,383.5	257.7	10.7
Contracts, Supplies, Equipment,				
Other	180.2	1,296.7	619.6	12.0
TOTAL	\$2,364.9	\$11,654.3	392.7	100.0

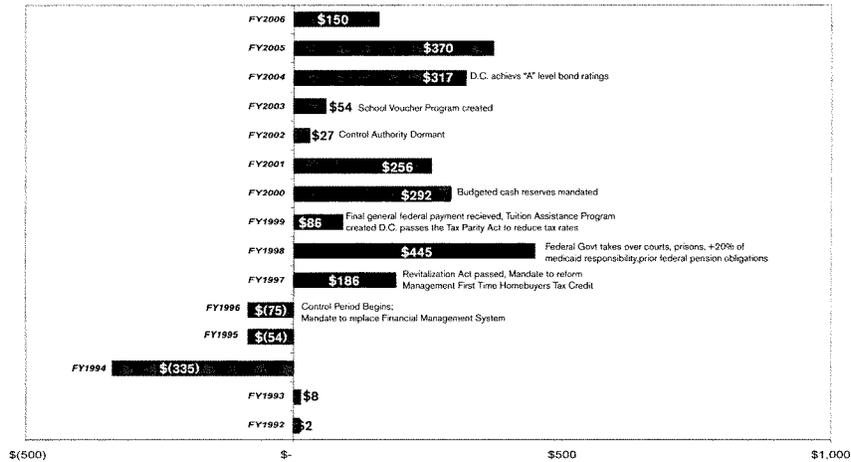
SOURCES: City of New York, *Annual Report of the Comptroller, 1960-61* and 1974-75; Temporary Commission on City Finances, *The City in Transition*, Appendix III, table 4

Exhibit D

**THE FISCAL
COMEBACK OF
THE DISTRICT OF
COLUMBIA**



District of Columbia, Year-end Operating Budget Balance, \$M, FY1992-FY2006
Significant Federal Actions



repaid all advances made by the U.S. Treasury during the early Control Period years.³⁰⁹ This financial progress enabled the Control Board to dissolve a year earlier than scheduled.

Since regaining Home Rule autonomy, the city has balanced its operating budget every year, replacing the deficit it once accumulated with annual budget surpluses, as shown in the table below. As a result of on-going annual surpluses, the District now has a sizeable balance in the General Fund of \$1.494 billion at the end of FY2007. The General Fund balance is the cumulative sum of all annual surpluses and deficits beginning with Home Rule.

Fiscal Discipline to Prevent Overspending

Over the past decade, the District's spending has been strictly disciplined. The District's local anti-deficiency law, enacted after the Control Period, prevents agency

heads from overspending a current budget, and its violation could result in termination or even more severe actions. The District's lawmakers have clearly affirmed the intent to stay within spending authorities. Indeed, the city only achieved its impressive string of eleven balanced budgets because it was willing to make some very difficult decisions in order to maintain its fiscal health. Perhaps one of the most painful decisions came in FY2000, when the city chose to close D.C. General Hospital, the city's only full-service public hospital. Many residents used D.C. General for primary and routine care, as well as for emergency and hospital care. Yet with the hospital's expenditures exceeding budgeted revenues by as much as \$90 million a year, there was no way to keep the hospital open without risking the District's newly-found financial stability.

The city continued to make hard choices in order to balance the budget for the next

Source: Alice Rivlin, et al., Building the Best Capital City in the World, A Report by DC Applesseed and Our Nation's Capital, Appendix II (December 2008).

**United States House of Representatives Subcommittee on Oversight and Investigations of
the Committee on Financial Services (the “Subcommittee”)**

Puerto Rico’s Debt Crisis and Its Impact on the Bond Markets

February 25, 2016

Clarification Regarding Remarks by Congresswoman Nydia M. Velázquez

March 2, 2016

This statement is submitted for the record in connection with remarks made by Congresswoman Nydia M. Velázquez during the above referenced hearing.

Specifically, during the hearing Congresswoman Velázquez stated (at the 1:30:55 mark): “There is a lot of blame to go around. Mismanagement of the Puerto Rican government, Mr. Battle, you know, **you worked for the Government bank and while you were in office, the debt doubled**. So, there is a lot of blame to go around, including this same body...”. This statement calls for clarification.

The use of incorrect and misleading information to influence public opinion and the public record must be avoided by all who, one way or another, are involved in finding solutions to Puerto Rico’s problems. One of the most damaging causes of the problems we face today is precisely the lack of transparency and excessive partisan politics seeking the advancement of agendas that do not necessarily benefit Puerto Rico and the 3.5 million US citizens who call the island home.

Pursuant to official data from the Government Development Bank for Puerto Rico (“GDB”)¹ and the Commonwealth’s Financial Information and Operating Data Reports, the Island’s public debt as of December 31, 2008 and December 31, 2012 stood at approximately \$56.5 billion and \$70 billion, respectively. This represents a 25% increase in total public debt outstanding between 2009 and 2012. More specifically, during the period that I served as President of the GDB (March 2011 through December 2012), public debt increased by 10%. This data differs materially from the information contained in Congresswoman Velázquez.

Congresswoman Velázquez’s statement is an example of one of the many things we have done wrong for many years as some try to tarnish reputations and distort facts. My silence following the Congresswoman’s remark was by no means an acceptance of said statement, but rather my respect for the pre-established rules of the Subcommittee. I hope the information included herein sets the record straight and clarifies any misunderstanding.

Juan Carlos Battle
Former President of GDB (2011-2012)

¹ Puerto Rico’s Public Debt Monthly Report, Tiered Operational Management Information System.