

**TESTIMONY**

of

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before the

**SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS**

**U.S. HOUSE OF REPRESENTATIVES**

**COMMITTEE ON FINANCIAL SERVICES**

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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 16<sup>th</sup> 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.