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Public Finance – US

Puerto Rico bondholder recovery patterns echo major municipal bankruptcies

Bondholder recoveries in Puerto Rico's bankruptcy-like proceedings reinforce patterns seen in municipal bankruptcies over the past 15 years such as Detroit (Ba2 positive) and Jefferson County, Alabama (A3 stable). As in those cases, credit fundamentals in Puerto Rico have outweighed legal protections as a driver not only of default but also subsequent recovery. Legal provisions have certainly influenced recovery, but often in unpredictable ways. Also, some debt classes have avoided impairment altogether and pensioners have received better treatment than bondholders.

Overall, recoveries in the Puerto Rico case look to range from as little as 2% to around 80% among the various debt classes (see Exhibit on page 2), depending on factors such as breadth of revenue as well as bondholders' legal recourse and specific negotiating opportunities. The large variance in recoveries is evident from the likely minimal recovery on the Puerto Rico Public Finance Corp.'s (PFC) unsecured lease appropriation debt to the considerable one on the Puerto Rico Sales Tax Financing Corp.'s (COFINA) senior bonds. Several classes of debt, notably the University of Puerto Rico and the Puerto Rico Aqueduct and Sewer Authority (PRASA), did not default and remain unimpaired.

The Puerto Rico defaults comprise the largest amount by dollar volume of a municipal entity and component issuers in modern history. Recoveries on about 80% of defaulted principal across the commonwealth's various debt-issuing entities have been decided.[1] The latest round of recoveries settled in March — covering some 40% of principal or about $24 billion — includes the status of general obligation (GO) debt, pension (Employees Retirement System) bonds, unsecured lease obligations, and debt issued under infrastructure and convention center financing entities. The fate of approximately $50 billion in pension liabilities that we did not rate was also resolved.[2]

These recoveries came with the adoption of the most recent plan of adjustment (POA). That followed a long hiatus since the resolution of the COFINA sales tax and Government Development Bank (GDB) obligations between late 2018 and early 2019. (For more on the defaults, negotiations and pending recoveries, see US municipal bond defaults and recoveries, 1970-2021).

Bondholder recoveries in Puerto Rico case vary widely

Issuing entity	Default date	Amount (millions)	Pledge	Recovery
Puerto Rico Public Finance Corp.	8/3/2015	$1,200	Appropriation	2%-5%
Puerto Rico Infrastructure Financing Authority	1/1/2016	$1,640	Rum excise tax	12% + CVI
Government Development Bank for Puerto Rico	5/1/2016	$4,130	General resources	<35%
Puerto Rico GO/GO guarantee bonds	7/1/2016	$17,650	General obligation	53% + CVI
Puerto Rico Highways and Transportation Authority subordinated bonds	7/1/2016	$52	Highway revenues	Pending
Puerto Rico Sales Tax Financing Corp. (COFINA) senior bonds	6/1/2017	$7,700	Sales tax	82%
Puerto Rico Sales Tax Financing Corp. (COFINA) subordinate bonds	6/1/2017	$9,900	Sales tax	50%
Puerto Rico Industrial Development Co.	7/3/2017	$156	Commercial rent payments	Pending
Puerto Rico Electric Power Authority (PREPA)	7/3/2017	$8,960	Electric revenue	Pending
Employees Retirement System bonds	7/3/2017	$3,160	Employer pension contributions	10%
Puerto Rico Highways and Transportation Authority '68	7/3/2017	$815	Highway revenues	18% + CVI
Puerto Rico Highways and Transportation Authority '98	7/3/2017	$3,456	Highway revenues	2% + CVI
Puerto Rico Convention Center District Authority	7/3/2017	$386	Hotel occupancy taxes	19% + CVI
Puerto Rico Aqueduct and Sewer Authority (PRASA)	Did not default	$3,699	Water and sewer revenues	N/A
Puerto Rico Municpal Finance Agency	Did not default	$470	Local government taxes	N/A
Puerto Rico Highways and Transportation Authority (Teodoro Moscoso Bridge)	Did not default	$99	Toll revenue	N/A
University of Puerto Rico	Did not default	$496	Tuition, fees and other revenue	N/A
Pension liabilities (Moody's estimated ANPL)	N/A	$51,000	N/A	N/A

CVI refers to contingent value instruments.
Sources: Plan of adjustment and Moody's Investors Service

Broadly, the recoveries to date are a reminder of the power of credit fundamentals — leverage, operational balance and economic capacity — over security features on paper. While legal security will influence recovery, credit fundamentals drive defaults and the pace of recovery, but only relative to other bonds. Legal pledges on bonds appear to offer no leverage, for example, against pension obligations, which often have no similar legal covenants or other protections.

After other large municipal bankruptcies, the Puerto Rico proceedings reinforce the concept that once fundamentals deteriorate, multiple security types within a governing entity are at risk, but that any specific security's default, bankruptcy or recovery remains unpredictable. As noted, a number of Puerto Rico's issuing entities did not default, possibly in the cases of the University of Puerto Rico and the PRASA to avoid putting federal aid at risk.

The Puerto Rico case underscores that defined-benefit pensioners are likely to do much better than bondholders in recovery in a municipal bankruptcy (or similar) process. Recovery (14% notional, 10% time-value adjusted) on Puerto Rico's Employees Retirement System (ERS) bonds is remarkably similar to the Detroit pension certificates of participation (COPs) despite very different bond pledges.[3] The beneficiaries of Puerto Rico's defined-benefit pension plan may see little if any change in payout; some Detroit pensioners saw mild haircuts in addition to cuts in cost-of-living adjustments (COLAs). Proposed ERS haircuts were eliminated in the most recent POA, though COLAs and other benefit accruals may still be frozen for some.

While a legal pledge alone will not prevent a default when fundamentals deteriorate, the Puerto Rico proceedings show it can help bondholders in recovery in unanticipated ways. Holders of the $193 million 2011B Ports Authority Project Revenue Bonds — a small subset of the debt issued by the Puerto Rico Infrastructure Financing Authority (PRIFA) — received a relatively high recovery of approximately 78% in a December 30, 2019 settlement. Although secured by two GDB letters of credit, the bonds were also general, unsecured obligations of the Puerto Rico Ports Authority. In the end, the claim gave bondholders leverage with the Ports Authority, which needed to satisfy creditors before it could embark on a public-private partnership (P3) for a cruiseship terminal.

Puerto Rico's lengthy recovery process demonstrates that time and delay matter in recovery because of the lost time value of money. This is perhaps why relatively quick default settlements in the municipal sector are more common than protracted court battles, particularly given the absence of legal precedent compared to the corporate sector. Although effective March 15, the recoveries on GO, PRIFA and Puerto Rico Convention Center District Authority (CCDA) bonds will take time because each settlement includes "contingent value instruments" (CVI) in addition to cash; the CVI depends on the commonwealth's future economic growth, which may now be further hindered by inflation and energy costs. The GO and PRIFA defaults initially occurred in 2016, CCDA in 2017, while the PFC leases first defaulted in 2015; all have been ongoing. And the lost time value is significant: the GO cash recovery is 74% on a nominal basis, but closer to 53% on an adjusted, present-value basis.

Similar to other cases, the Puerto Rico proceedings show GO pledges can no longer be assumed to offer the highest and broadest level of protection. Puerto Rico GO recoveries have been both slower and lower than the COFINA sales tax debt, which received 82% recovery on senior bonds and 64% on blended senior and subordinate debt, compared to 53% for all GO debt, possibly rising to 60% including CVI. Moreover, selective repudiation within a single class of debt is now a reality and threats of repudiation during the settlement process resulted in nine different ranges of GO recoveries based on issuance date and issuer.

The value of appropriation-contingent pledges in distress can be very weak because once an event of non-appropriation occurs, bondholders have no legal recourse. The lease appropriation debt issued by the PFC, which was the first to default in 2015, might get an adjusted recovery of as little as 2%, and likely no more than 5%.

Court ruling limits protection for special revenue pledges

The Puerto Rico litigation triggered a court decision with potential ripple effects across the municipal market. The 1st US Circuit Court of Appeals on March 28, 2019 ruled that the commonwealth would not be required to use "special revenues" to pay debt service on Puerto Rico Highways and Transportation Authority (PRHTA) bonds during the pendency of proceedings, essentially deferring to the government's determination of how best to fund its important services.

The US Supreme Court denied further review in January 2020. The special revenue exemption to the "automatic stay" is thus not automatic, per the decision. While special revenue status may bolster ultimate recoveries, it does not necessarily insulate the bonds from default or impairment.

The first circuit court decision is only binding in Puerto Rico, Maine, Massachusetts, New Hampshire and Rhode Island, but sets a precedent likely to influence judges in other jurisdictions.

Moody's related publications

Data Report

» US Public Finance: US municipal bond defaults and recoveries, 1970-2021, April 21, 2022

Endnotes

1 At the time of publication, recoveries on defaults for the Puerto Rico Electric Power Authority (PREPA) and Puerto Rico Highways and Transportation Authority (PRHTA) — together just over $13 billion in principal — remained unresolved, though PRHTA recoveries based upon cash and "contingent value instruments" were proposed in the latest plan of adjustment.

2 As of the commonwealth's June 30, 2017 audited financial reporting, our adjusted net pension liability (ANPL) amounted to $38 billion, $727 million and $12.3 billion for its governmental activities, business-type activities and component units, respectively.

3 Detroit's COPs were unconditional contractual obligations, while the ERS bonds had a now-terminated claim upon pension contributions.

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