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PUERTO RICO GOVERNMENT DEVELOPMENT BANK PRESIDENT MELBA ACOSTA FEBO ADDRESSES U.S. SENATE FINANCE COMMITTEE, CALLS FOR FEDERAL SUPPORT FOR COMMONWEALTH

Washington, D.C. – Puerto Rico Government Development Bank President Melba Acosta Febo today addressed the U.S. Senate Committee on Finance to discuss the ways Congress can support the Commonwealth of Puerto Rico as it takes action to address its fiscal and healthcare crises. Acosta Febo's testimony discussed the steps Puerto Rico has already taken, the lessons learned from former World Bank and International Monetary Fund economist Dr. Anne O. Krueger's Puerto Rico – A Way Forward report released in June, the elements of the Fiscal and Economic Growth Plan, and the necessity of Congress extending Chapter 9 bankruptcy protections to the Commonwealth's public corporations.

"Congress must act now because the failure to act is not an option for the 3.5 million Americans living in Puerto Rico," said Acosta Febo.

The full text of Acosta Febo's remarks from today is below.

Chairman Hatch, Ranking Member Wyden, and Members of the Committee:

My name is Melba Acosta-Febo, and I am the President of the Government Development Bank for Puerto Rico (the "GDB"). Before assuming this position in October 2014, I was the Secretary of Treasury of the Commonwealth of Puerto Rico.

I want to thank the Committee for giving the Commonwealth of Puerto Rico ("Puerto Rico") and the GDB the opportunity to participate in this hearing. The GDB is charged with safeguarding the long-term fiscal stability of Puerto Rico and promoting its economic competitiveness. The GDB is also charged with serving as the fiscal agent and financial advisor for Puerto Rico and all of its instrumentalities. The GDB has a significant interest in and knowledge of the subject matter of this hearing.

The Crisis in Puerto Rico

The fiscal, economic, and liquidity crisis in Puerto Rico has passed the tipping point. The Legislative Assembly has declared a state of emergency, Puerto Rico has lost access to the capital markets on sustainable terms, and Puerto Rico faces an economic and liquidity crisis beyond what any jurisdiction in the United States has faced in generations. This crisis threatens the health, safety and welfare of the 3.5 million Americans living in Puerto Rico, many of whom are moving to the mainland – notably to Florida – at a rate of almost 100,000 per year. As I describe below, this crisis did not develop overnight, and it is not the result of any one factor, political decision or political party. Rather, this crisis is the culmination of decades of ill-advised public policy – both in San Juan and in Washington – coupled with a persistent stagnating economy, seemingly unlimited access to easy credit, and a market willing to lend.

While the United States economy as a whole has recovered from the recent financial crisis, Puerto Rico's economy never came out the other side of that crisis, having contracted more than 20 percent in real terms over the last eight years, which few countries in the world have experienced. Federal policy towards Puerto Rico has, if anything, exacerbated the situation. For example, the repeal and phase-out by Congress of Section 936 of the U.S. Internal Revenue Code, which provided tax benefits for certain businesses (including large pharmaceutical companies) operating in Puerto Rico, has led to a significant contraction in employment in Puerto Rico's manufacturing sector. By some estimates, between 1996-2014 the phase-out of Section 936 itself caused the loss of 270,000 jobs when its total effect is calculated. Chairman Hatch, to his credit, worked with Puerto Rico and introduced a replacement to Section 936 in 2001. Had that legislation been enacted, the crisis we find ourselves facing today may well have been avoided.

Puerto Rico's fragile fiscal state and the breakdown of its healthcare system has also been adversely affected by chronic underfunding of Medicare and Medicaid. Under Medicaid, for example, Congress both caps the amount of Medicaid funding that the federal government provides annually to Puerto Rico ($329 million in 2015) and limits the share of federal matching funds (known as Federal Medical Assistance Percentage (FMAP) at a fixed percentage (55 percent)). The Patient Protection and Affordable Care Act (ACA) provided some relief from these formulaic limitations but those funds are scheduled to be depleted in fiscal year 2017. Several members of this Committee introduced S. 1961, which would address many of the inequities in how federal healthcare programs are applied to Puerto Rico.

The contraction of Puerto Rico's economy has resulted in rising budget deficits at all levels of government, including at Puerto Rico's municipal or "public" corporations.

Historically, to close unanticipated operating deficits, Puerto Rico and its public corporations relied on debt financing, and the credit markets had been willing to supply the funds. So while the economy has contracted by more than 20 percent over the past eight years, outstanding public debt has increased by more than 60 percent. Today, Puerto Rico and its public agencies, divisions, instrumentalities and public corporations collectively have amassed approximately $73 billion in public debt. In addition, Puerto Rico's public pension funds, although subject to a major overhaul in 2013 that reduced future accruals, still face significant unfunded actuarial accrued liabilities – approximately $45 billion by some estimates – and will run out of funds altogether to pay benefits to their 166,000 beneficiaries by 2018 without substantial additional governmental contributions, contributions that will put further strain on Puerto Rico's budget.
Beyond these economic and fiscal constraints, Puerto Rico's labor and demographic characteristics are bleak. Unemployment has remained at elevated levels since the financial crisis: Puerto Rico's unemployment rate as of June 2012 was 14.6% but has since dropped to 11.6% as of June 2015 while unemployment in the rest of the United States has dropped to 5.1%. While the labor participation rate in the United States was 62.6% as of July 2015, the labor participation rate in Puerto Rico was 39.5% as of July 2015, which is a symptom of deeper structural problems and a combination of local and federal policies that often incentivize individuals not to work. In 2014 there were 660,500 non-farm jobs in Puerto Rico, which is approximately 100,000 fewer jobs than in 2005 or a 13% decline over the period; an economy with a total labor force of about 1.2 million persons lost more than 100,000 jobs in less than a decade. By contrast, the number of non-farm jobs in the mainland increased by 4% over the same period. Poverty levels are also extremely high. Indeed, the median annual household income is $19,000, which is only 36.7 percent of the median income in the United States.
Moreover, due to outmigration to the mainland, Puerto Rico's population has declined every year since 2006; the same year of the phase-out of Section 936.

Puerto Rico's demographic trends are also deeply troubling. The remaining population is becoming increasingly elderly and outside the labor force. Persons 60 years and older represent more than 20% of the population (the highest in the United States) and children aged five years or less have decreased from approximately 295,406 in 2000 to approximately 187,371 in 2014, a reduction of 37%. This means Puerto Rico will have fewer people participating in the economy going forward, shrinking the tax base and making it more challenging to service its outstanding debt and finance necessary public services.

Actions Taken by Puerto Rico to Address the Crisis

Puerto Rico's Governor, the Hon. Alejandro García-Padilla, took office in 2013. Governor García-Padilla has been honest and forthcoming about the crisis that Puerto Rico faces and has forcefully responded to these unprecedented challenges in an effort to achieve fiscal sustainability and to place Puerto Rico on a path for long-term success. Since taking office, the Governor and the Legislature have materially reduced budget deficits by raising revenues and cutting expenses; imposed unprecedented cost-control measures at the central government and public corporations (including suspension of economic clauses of collective bargaining agreements, across-the-board freezes of wages and salaries, prohibiting extraordinary labor bonuses); established strict limits on government payroll (as of May 2015, there were 116,000 Central Government employees, compared to 158,000 in May 2008, a 27 percent reduction in central government employment); eliminated subsidies to public corporations such as the Puerto Rico Water and Sewer Authority; implemented comprehensive pension reform that sought to shift all government employees from defined benefit to defined contribution pension plans, and increased employee contributions to the retirement systems; enacted a law known as the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (the "Recovery Act") to create an orderly process to restructure the debt of Puerto Rico's public corporations; approved and overseen ongoing debt restructuring negotiations at the Puerto Rico Electric Power Authority ("PREPA"); prohibited GDB from providing deficit-financing loans; completed and is actively exploring public-private partnerships for state-owned assets and operations; and reformed rates at certain public corporations.

These measures build on the work of successive administrations that have tried to address Puerto Rico's stagnant economy through a mix of policies that have increased taxes, reduced the size of the public sector, reduced pensions to current employees, and increased water rates and highway tolls. In each case, however, economic growth has failed to materialize, and budget deficits have persisted as Puerto Rico's tax base has shrunk, creating an even greater dependence on deficit financing. As a result of persistent economic stagnation, more than half a million Puerto Ricans have left the island in the last ten years seeking better opportunities on the mainland. This is a trend that does not augur well for our future.

Notwithstanding ten years of tax and rate increases and the reduction of the government's workforce and reform of government wages and benefits, Puerto Rico faces an immediate liquidity crisis resulting from its inability to access the credit markets on sustainable terms to refinance upcoming debt-service obligations. In recent months, Puerto Rico has been forced to implement emergency "one time" measures to keep the government functioning, including borrowing from the state insurance companies, terminating monthly set-aside payments for debt service on the central government debt, delaying payment of tax refunds to residents and further stretching payment of accounts payables to vendors and third parties. While these emergency measures have temporarily avoided a shutdown of the Government of Puerto Rico, without access to the capital markets to refinance maturing debt, Puerto Rico may run out of emergency measures by the end of this year (and before a large general obligations payment due in January 2016), threatening the ability of the Government to continue to provide essential services to its residents and to pay its debts when due. In order to protect the 3.5 million citizens of the United States living in Puerto Rico, immediate action is required.

The Krueger Report

After it became apparent that the difficult fiscal adjustment measures taken by Puerto Rico in 2013 and 2014 were not having the desired result of restarting economic growth and stabilizing public finances, the Governor commissioned a team of economists led by Dr. Anne Krueger, the former Chief Economist at the World Bank and First Deputy Managing Director of the International Monetary Fund (IMF), to undertake a comprehensive analysis of Puerto Rico's fiscal and economic challenges with the goal of identifying a course of action that could return the island to fiscal health and economic growth.

In June 2015, Dr. Krueger published her findings in a report entitled Puerto Rico – A Way Forward, which is commonly referred to as the Krueger Report. I have attached a copy of the Krueger Report, for inclusion in the hearing record, as Exhibit A, which I hereby incorporate into my testimony. The Krueger Report identified a number of economic shocks – including the phase-out of Section 936 noted above, a sharp decline in home prices during the recent financial crisis, and the Great Recession, among others – that have contributed to Puerto Rico's economic stagnation. The Krueger Report further identified a number of supply side factors contributing to the weak state of the economy, including relatively high labor costs, complex labor regulation and structural disincentives to work, outmigration of 1% annually (roughly ten times the rate of West Virginia, the only state currently experiencing subzero growth), and the high costs of energy and transportation, among others. In addition to economic factors, the Krueger Report also identified a number of fiscal problems that have contributed to Puerto Rico's unsustainable debt-load. Specifically, the Krueger Report indicates that Puerto Rico's revenue projections have historically contained extremely optimistic assumptions, leading to an annual revenue shortfall of roughly $1.5 billion.

Beyond identifying the cause of Puerto Rico's crisis, the Krueger Report identified prescriptive measures to reverse these trends and created a model to project future financing gaps after implementing the recommended measures. The Krueger Report's recommendations included items that must be implemented by Puerto Rico itself, as well as items that require assistance and policy change at the federal government. Critically, the Krueger Report found that even after implementing many of the recommended economic and fiscal measures, large residual financing gaps would persist well into the next decade, implying a critical need for debt relief from a significant proportion of the principal and interest falling due in Puerto Rico over the next six years.

The Fiscal and Economic Growth Plan

Promptly after the Krueger Report's release, Governor García Padilla ordered the creation of the Working Group for the Fiscal and Economic Recovery of Puerto Rico (the "Working Group") and charged it with developing a plan for economic growth and fiscal and institutional reform. The Working Group, in conjunction with its advisors, conducted extensive due diligence on various Commonwealth funds, agencies and public corporations that are supported by taxes and appropriations and that have contributed to the fiscal deficits identified in the Krueger Report, in order to create a holistic projection of Puerto Rico's finances and to examine various measures that could be implemented to address ongoing financing gaps. I serve on the Working Group in my capacity as President of GDB, and I have intimate familiarity with its diligence and findings.

On September 9, 2015, the Working Group released its conclusions and recommendations in a document titled the Puerto Rico Fiscal and Economic Growth Plan. I have attached a copy of the Fiscal and Economic Growth Plan, for inclusion in the hearing record, as Exhibit B, which I hereby incorporate into my testimony. The Fiscal and Economic Growth Plan reviews the historical measures taken to increase taxes and reduce expenses; analyzes the current liquidity and fiscal position of Puerto Rico; recommends certain fiscal and economic reform and growth measures, including measures that require action by the U.S. Government; proposes a new law known as the Fiscal Responsibility and Economic Revitalization Act that authorizes the Governor to establish and appoint members, from a list provided by third parties, to a financial control board in Puerto Rico; and identifies significant projected financing gaps, even assuming the implementation of the recommended fiscal reform and economic growth measures.
Although I have already touched on the historical measures and current liquidity and fiscal position of Puerto Rico, I would like to highlight briefly certain key portions of the Fiscal and Economic Growth Plan for the benefit of the Committee.

First, the Fiscal and Economic Growth Plan calls for significant – and in many cases, painful – local reforms across nearly all aspects of the economy and government. The Fiscal and Economic Growth Plan includes reforms to labor and welfare laws, tax and permitting simplification and reform, consolidation of schools and the elimination of municipal and higher education subsidies. It also proposes the adoption of a new accounting systems, a new budgetary process, and reforms to the structure of Puerto Rico's Treasury Department in particular and fiscal decision-making processes more generally. These "structural reforms" are aimed at spurring economic growth while new revenue and expense measures are aimed at restoring Puerto Rico's long-term fiscal health.

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Second, the Fiscal and Economic Growth Plan proposes legislation to be adopted by Puerto Rico's Legislative Assembly that would create an independent control board with jurisdiction over most government entities in Puerto Rico so as to assure budgetary discipline. Like control boards in other jurisdictions, Puerto Rico's control board will consist of qualified individuals who have knowledge and expertise in finance, management, and the operation of government. The control board will have the ability to monitor and ensure compliance with budgetary targets.

Third, the Fiscal and Economic Growth Plan calls on the U.S. Government to support Puerto Rico's effort to ensure long-term fiscal sustainability and growth. Specifically, the Fiscal and Economic Growth Plan calls on Congress to allow Puerto Rico access to a legal framework to restructure its liabilities in an orderly process; to provide equitable Medicare and Medicaid treatment and funding to address the humanitarian concerns tied to the healthcare crisis in Puerto Rico; to exempt Puerto Rico from the Jones Act to reduce costs and improve the ease of doing business; to modify federal minimum wages rules, welfare programs, and labor laws applicable to Puerto Rico to incentivize people to work and increase the labor participation rate; and to provide Puerto Rico with a tax treatment that encourages U.S. investment and job growth on the island. With respect to this last item, the Chairman and other members of the Committee, as well as our Resident Commissioner, the Hon. Pedro Pierluisi, have moved forward legislation that would have helped Puerto Rico compete against foreign countries and attract manufacturing investment. These pro-growth measures could include amending the U.S. Internal Revenue Code to add a new Section 933A to permit U.S.-owned businesses in Puerto Rico to elect to be treated as U.S. domestic corporations; enacting an economic activity tax credit for U.S. investment in Puerto Rico designed as a targeted, cost-efficient version of former Section 936 of the Internal Revenue Code; and exempting Puerto Rico from base erosion and/or minimum tax measures in the event the U.S. moves towards a territorial taxation system.

Finally, like the Krueger Report, the Fiscal and Economic Growth Plan recognizes that, notwithstanding implementation of key measures to restore growth in Puerto Rico, significant financing gaps will remain over the next decade necessitating debt relief across the Commonwealth's many different credits. The Working Group's advisors have already begun discussions with creditors that own significant amounts of Puerto Rico's debt. The goal of these discussions is to achieve, through consensual negotiations, an agreement with creditors to amend the payment terms of the Commonwealth's debt so as to avoid widespread defaults and to give Puerto Rico the breathing room necessary to implement the Fiscal and Economic Growth Plan.

Debt Relief and the Necessity of a Restructuring Regime for Puerto Rico

Notwithstanding Puerto Rico's best efforts to adjust its debts in a consensual manner as contemplated and discussed above in the context of the Fiscal and Economic Growth Plan, the likelihood of success would be materially improved if Puerto Rico had a legal framework within which to do so. The unavailability of any feasible legislative option to adjust debts has created an overall environment of uncertainty that makes it more difficult to address Puerto Rico's fiscal challenges and further threatens Puerto Rico's economic future. I would like to explain why this is so important for Puerto Rico, and how the lack of such a framework has already had significant adverse consequences in our ongoing restructuring efforts at PREPA.

As many of you may know, I testified in February before the Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the Committee on the Judiciary of the U.S. House of Representatives about the harmful effects associated with having no legal regime for debt restructuring in the context of a hearing on a bill to extend the protections of Chapter 9 to Puerto Rico. I described Puerto Rico's attempt to fill a statutory gap left by Congress in the Bankruptcy Code through the passage of the Recovery Act. The Recovery Act permits Puerto Rico's public corporations to adjust their debt in an orderly process – with creditor input and court supervision – much like the U.S. Bankruptcy Code while ensuring the continued provision of essential public services to residents in the event of a fiscal emergency at one of the public corporations.

Unfortunately, the Recovery Act has been held unconstitutional by the U.S. Court of Appeals for the First Circuit on the theory that the Recovery Act is preempted by section 903 of the Bankruptcy Code, which it held prohibits Puerto Rico from passing a law allowing for the adjustment of debt through a method of composition (Puerto Rico has filed a petition for certiorari with the Supreme Court of the United States). The practical and unfortunate result of this decision is that no legal regime is currently available for Puerto Rico to adjust debts through a court-supervised process.

The Lack of a Restructuring Framework Already Has Consequences, as Demonstrated by PREPA

The consequence of this predicament has already shown its impact in recent and ongoing debt restructuring discussions between PREPA and its creditors. I believe it is helpful to give the Committee context as to why this is so important. Specifically, PREPA has been able to reach a consensual agreement with a substantial group of its bondholders (both original and secondary market purchasers) and all of its fuel line lenders, which collectively hold nearly $4 billion of PREPA's outstanding obligations. However, a consensual restructuring has been held up by a few institutions that, in the absence of an effective debt-restructuring regime, can try to hold up or opt out of a comprehensive restructuring. The Recovery Act was specifically designed to avert this free rider situation.

What is more, even if all of the major institutional creditors with whom PREPA is currently negotiating were to agree to a consensual debt restructuring plan, the unavailability of a court to oversee the restructuring process and, ultimately, approve and validate the plan, adds complexity, cost, and delay to the process, none of which is in the interests of creditors, consumers, or PREPA's other stakeholders. Indeed, parties will be hesitant to lend new money, or buy new securities, without the finality offered by the approval of an adjustment plan by a court of competent jurisdiction as contemplated in Chapter 9 or the Recovery Act. In addition, without such a framework, even if PREPA reaches a consensual agreement with all of its key creditor groups, in the absence of an ability to bind "holdouts" such as could be achieved through a process like Chapter 9 or the Recovery Act, there is a built in incentive for "free riders" to sit on the sidelines while other creditors bear the burden of the debt adjustment. The cost of dealing with such "free riders" is ultimately borne by the creditors that participate in the restructuring. In a worst-case scenario, free-riders can drive up the costs of a restructuring to the point where no deal can be consummated, even with creditors who would otherwise be willing to participate, because the cooperative creditors are unwilling to subsidize the recoveries of the holdouts. This problem would not exist under Chapter 9 or a Recovery Act framework where a supermajority of creditors willing to compromise can bind a dissenting minority looking for a free ride.

Finally, it is worth emphasizing two of the primary benefits of a bankruptcy regime. The first is the availability of interim or "Debtor-in-Possession" financing while negotiations with creditors ensue, which has the critical benefit of avoiding a liquidity crisis. Such financing is not available under current law. With no court empowered to approve and supervise such financing, the Commonwealth and its instrumentalities will continue to deplete much-needed resources until a consensual restructuring is consummated. Access to such interim financing would help ensure that the Commonwealth and its instrumentalities can continue to provide basic government services to its residents while debt adjustments are implemented and a resolution to the debt restructuring discussions is achieved. Second, in the event that efforts to reach a consensual agreement fail, there would be a stay against creditor suits that would help protect the residents of Puerto Rico and the island's economy from the legal morass that would ensue.

In the case of PREPA, if negotiations continue for any lengthy period of time (as they have so far), or an event beyond PREPA's control occurs (such as a hurricane that generates unanticipated costs), PREPA could be left unable to provide power to millions of Americans. I need not explain the health and humanitarian consequences in such a scenario.

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To be clear, I discuss PREPA only as one example of the difficulty of restructuring debts in the absence of a clear legal regime. And while PREPA is making progress towards a consensual restructuring, PREPA has been in negotiations for well over a year and a number of significant creditors continue to hold out, hoping to free ride on those creditors who have already agreed to the deal. But for Puerto Rico, PREPA is only one of the nearly seventeen Puerto Rico issuers that may need to adjust their debt as contemplated by the Fiscal and Economic Growth Plan. The absence of a legal regime to restructure the Commonwealth's liabilities in an orderly process may potentially doom the ability of the Commonwealth and its creditors to achieve a comprehensive debt restructuring that will allow Puerto Rico to jump start its stagnant economy.

Conclusion

In conclusion, I would like to reiterate that the situation in Puerto Rico has passed the tipping point, and that Puerto Rico, in the face of an immediate liquidity crisis, has no access to the capital markets on sustainable terms and faces significant financing gaps over the next decade. Puerto Rico has taken the important step of developing a clear roadmap to address these challenges, which roadmap requires the implementation of difficult and painful measures, including the creation of a control board to monitor spending and compliance with the fiscal and economic growth plan.

I stress that while reasonable minds may differ as to the propriety of the specific measures that need to be taken – both at the local and federal levels – the fact remains that Puerto Rico faces significant liquidity and financing shortfalls that require the U.S. Government to act. Congress must act now because the failure to act is not an option for the 3.5 million Americans living in Puerto Rico. Indeed, federal action is essential, as outlined in the Krueger Report and the Fiscal and Economic Growth Plan and discussed in detail above, including parity for Medicaid and Medicare funding. Puerto Rico also speaks in unison in seeking access to a legal regime to adjust its debts as one necessary and critical step to achieving the objectives of the Fiscal and Economic Growth Plan.

The current crisis in Puerto Rico has been long in the making; it is the byproduct of a now decade-long stagnation in economic activity on the island, stagnation that threatens the ability of Puerto Rico to meet the essential needs of its residents and to avoid a disorderly default on its $73 billion of indebtedness. But, as part of the United States and subject to its laws and regulations, Puerto Rico can only do so much for itself to mitigate the crisis and avoid these devastating results. It needs the assistance of the U.S. Government to get out of this crisis, to achieve equitable funding in important federal programs such as Medicaid and Medicare, to eliminate discrimination against it (versus the Virgin Islands, for example) in the application of the Jones Act and to give it access to an insolvency regime to facilitate an orderly restructuring of its debts. These areas in which we need immediate changes in federal law and policy can help to facilitate an orderly resolution of Puerto Rico's current crisis. We have been unable to forestall a more chaotic situation by executing "one time" emergency measures; however, without an insolvency regime there will be greater loses to our creditors, our economy and our people.

I thank the Committee for recognizing the urgency of these matters by holding this hearing, and for giving the Puerto Rico and the GDB the opportunity to participate here today. I look forward to working with all of the members of the Committee to ensure that the health, safety and well-being of 3.5 million United States citizens is safeguarded and to making common cause with you in creating a better future for all the residents of Puerto Rico.

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Forward-Looking Statements

The information included in this statement contains certain forward-looking statements. These forward looking statements may relate to the fiscal and economic condition, economic performance, plans and objectives of the Commonwealth of Puerto Rico or its agencies or instrumentalities. All statements contained herein that are not clearly historical in nature are forward looking.

This statement is not a guarantee of future performance and involves certain risks, uncertainties, estimates, and assumptions by the Commonwealth and/or its agencies or instrumentalities that are difficult to predict. The economic and financial condition of the Commonwealth and its agencies or instrumentalities is affected by various financial, social, economic, environmental, and political factors. These factors can be very complex, may vary from one fiscal year to the next, and are frequently the result of actions taken or not taken, not only by the Commonwealth and/or its agencies or instrumentalities, but also by entities such as the government of the United States of America or other nations that are not under the control of the Commonwealth. Because of the uncertainty and unpredictability of these factors, their impact cannot, as a practical matter, be included in the assumptions underlying the Commonwealth's or its agencies or instrumentalities' projections.

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