Testimony of
Alex J. Pollock
Distinguished Senior Fellow
R Street Institute
Washington, DC

To the Committee on Natural Resources
U.S. House of Representatives

Hearing on "The Status of the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA): Lessons Learned Three Years Later"

May 2, 2019

Six Lessons

Mr. Chairman, Ranking Member Bishop, and Members of the Committee, thank you for the opportunity to be here today. I am Alex Pollock, a senior fellow at the R Street Institute, and these are my personal views. I have spent almost five decades working in and on the banking and financial system, including studying the recurring insolvencies of municipal and sovereign governments. I have personally experienced and studied numerous financial crises and their political aftermaths, and have authored many articles, presentations, testimony and two books on related subjects. Prior to R Street, I was a resident fellow at the American Enterprise Institute 2004-2016, and President and CEO of the Federal Home Loan Bank of Chicago 1991-2004.

In my view, there are six key lessons about PROMESA, the massive insolvency of the government of Puerto Rico, and the role of the Oversight Board we should consider. These are:

1. The fundamental bargain of PROMESA was sound. But it could be improved.
2. In such situations, a lot of conflict and controversy is unavoidable and certain.
3. The Oversight Board should have more power: in particular, it should have the same Chief Financial Officer provisions as were so successfully used in the Washington DC reforms.
4. Oversight boards are likely to last more than three years. In Puerto Rico, all the problems were of course made more difficult by the destructive hurricanes, and the flow of federal emergency funds into the Puerto Rican economy now makes the financial problems more complex.
5. Large unfunded pensions are a central element in these situations and set up an inescapable conflict between the claims of bondholders and pensioners.
6. Progress must operate on three levels of increasing difficulty:
    a. Equitable reorganization of the debt (including pension debt)
    b. Reform for efficiency and reliability in the fiscal and financial functioning of the government
    c. Reforms which allow a growing, enterprising successful market economy to emerge from the historic government-centric economy.

1. <u>The fundamental bargain of PROMESA was sound. But it could be improved.</u>

As it considered PROMESA, the Congress was faced with a municipal insolvency of unprecedented size. As one analyst correctly wrote, "There is no municipal borrower remotely as insolvent as Puerto Rico." Indeed, adding together its $70 billion in bond debt and $50 or $60 billion in unfunded pension debt, the government of Puerto Rico has debt of more than six times that of the City of Detroit, the previous all-time record holder, as it entered bankruptcy.

The fundamental bargain Congress constructed in PROMESA to cope with Puerto Rico's financial crisis made and makes good sense. It may be described as follows:

-To the Puerto Rican government: We will provide reduction and restructuring of your unpayable debts, but only if it is accompanied by fundamental financial and government reform.

-To the creditors: You will get an appointed board to oversee and reform Puerto Rico's finances, but only if it also has debt reduction powers.

This is a sound bargain. The resulting Oversight Board created by the act was and is, in my judgment, absolutely necessary. But its members, serving without pay, were as we all know, given an extremely difficult responsibility. So far, significant progress has been made, but much remains to do. Let us hope the Senate promptly confirms the existing members of the Board, so that its work may continue uninterrupted.

In the negotiations leading to PROMESA, it was decided to create an Oversight Board, less powerful than a control board. I thought at the time, and it seems clear in retrospect, that it would have been better—and would still be better--for it to have more of the powers of a financial control board, as discussed further under Lesson 3.

Two well-known cases of very large municipal insolvencies in which financial control boards were successfully used were those of New York City and Washington DC. In 1975, New York City was unable to pay its bills or keep its books straight, having relied on, as one history says, "deceptive accounting, borrowing excessively, and refusing to plan." In 1995, Washington was similarly unable to pay its vendors or provide basic services, being mired in deficits, debt and financial incompetence.

Today, New York City has S&P/Moody's bonds ratings of AA/Aa1, and Washington DC of AA+/Aaa. We should hope for similar success with the financial recovery of Puerto Rico.

2. <u>In such situations, a lot of conflict and controversy is unavoidable and certain.</u>

Nothing is less surprising than that the actions and decisions of the Oversight Board have created controversy and criticism, or that "the board has spent years at odds with unhappy creditors in the mainland and elected officials on the island."

As one Oversight Board member, David Skeel, has written, the Board "had been sharply criticized by nearly everyone. Many Puerto Ricans and economists…argued that our economic projections were far too optimistic…. Creditors…insisted that the economic assumptions in the fiscal plan were unduly pessimistic and…provided too little money for repayment."

The settlement of defaults, reorganization of debt and creation of fiscal discipline is of necessity passing out losses and pain, accompanied by intense negotiations. Of course, everyone would like someone else to bear more of the loss and themselves less. It is utterly natural in the "equitable reorganization of debt" for insolvent debtors and the creditors holding defaulted debt to have differing views of what is "equitable."

If only one side were critical of the Oversight Board, it would not be doing its job. If it is operating as it should, both sides will complain, as will both ends of the political spectrum. In this, I believe we must judge the Oversight Board successful.

The financial control boards of New York City and Washington DC are now rightly considered as a matter of history to have been very successful and to have made essential contributions to the recovery of their cities. But both generated plenty of complaints, controversy, protests and criticism in their time.

In Washington, for example, "city workers protested by blocking the Control Board's office with garbage trucks during the morning rush hour." In the board's first meeting, "protesters shouted 'Free D.C.' throughout the meeting, which was brought to an end by a bomb threat." Later, "in one of its most controversial actions, the Board fired the public school superintendent, revoked most of the school board's powers, and appointed its own superintendent to lead the system."

In New York, the board "made numerous painful, controversial decisions that the administration of Mayor Abraham D. Beame was unwilling or unable to make. It ordered hundreds of millions of dollars in budget cuts above those proposed by the administration and demanded the layoffs of thousands of additional city workers. It rejected a contract negotiated by the city's Board of Education…it also rejected a transit workers' contract."

What did this look like at the time? "In the eyes of many people in the city, it was most distasteful," said Hugh Carey, then Governor of New York State. "They saw the control board as the end of home rule, as the end of self-government." Another view: "The city of New York was like an indentured servant."

In restructurings of debt and fiscal operations, it has been well observed that a "key factor is making sure that the sacrifice is distributed fairly." But what is fair is necessarily subject to judgment and inevitably subject to dispute.

3. <u>The Oversight Board should have more power: in particular it should have the same Chief Financial Officer provisions as were so successfully used in the Washington DC financial reforms.</u>

As PROMESA came into effect, as has been observed, "The most obvious obstacle…was that no one really knew what Puerto Rico's revenues and expenditures were." This financial control mess, stressed by expert consultants at the time, highlights the central role in both creating and fixing the debt crisis, of financial management, reporting and controls. Progress had been made here with efforts of both the Oversight Board and Puerto Rico, as the certified fiscal plan has been developed. But the government of Puerto Rico still has not completed its audited financial statements for 2016 or 2017, let alone 2018.

Of the historical instances of financial control boards in municipal insolvencies, there is a key parallel between Puerto Rico and Washington DC: in both cases, there is no intervening state. The key role played by New York State, or by Michigan in the Detroit bankruptcy, for example, is missing. The reform and restructuring relationship is directly between the U.S. Congress and the local government.

The most striking difference between the Washington DC board and the Oversight Board is the greater power of the former. This was true in the initial design in 1995, but when Congress revised the structure in 1997 legislation, the Washington board was made even stronger. Most notably, the Washington design included the statutory Office of the Chief Financial Officer, which answered primarily to the control board and was independent of the mayor. Puerto Rico has created its own Chief Financial Officer, as good idea as far as it goes, but it lacks the reporting relationship to the Oversight Board and the independence which were fundamental to the Washington reforms.

Today, long after Washington's financial recovery, the independence remains. As explained by the current Office of the Chief Financial Officer (OCFO) itself:

"In 1995, President Clinton signed the law creating a presidentially appointed District of Columbia Financial Control Board…. The same legislation…also created the position of Chief Financial Officer, which had direct control over day-to-day financial operations of each District agency and independence from the Mayor's office. In this regard, the CFO is nominated by the Mayor and approved by the DC Council, after which the nomination is transmitted to the U.S. Congress for a thirty-day review period.

"The 2005 District of Columbia Omnibus Authorization Act…reasserted the independence and authority of the OCFO after the Control Board had become a dormant administrative agency on September 30, 2001, following four consecutive years of balanced budgets and clean audits."

If PROMESA were ever to be revised, for example trading additional financial support for additional reform and financial controls, as happened in the Washington DC case in 1997, I believe the revision should include structuring an Office of the Chief Financial Officer for Puerto Rico on the Washington DC model.

4. <u>Oversight boards are likely to last more than three years. In Puerto Rico, all the problems were of course made more difficult by the hurricanes, and the flow of emergency funds into the Puerto Rican economy now makes the financial problems more complex.</u>

As we come up on the third anniversaries of PROMESA and the Oversight Board, we can reflect on how long it may take to complete the Oversight Board's responsibilities of debt reorganization and financial and fiscal reform. More than three years.

The New York City control board functioned from 1975 to 1986, or eleven years. There was a milestone in 1982, which was the resumption of bank purchases of its municipal bonds. That took seven years.

The Washington DC control board operated from 1995 to 2001, or six years. (Both boards still remain in the wings, capable of resuming activity, should the respective cities backslide in their financial disciplines.)

Everything in the Puerto Rico financial crisis was made more uncertain and difficult by the destruction from the disastrous hurricanes of 2017. Now, as in response, large amounts of federal disaster aid are flowing into the Puerto Rican economy.

How much this aid should be is of course a hotly debated political issue. But whatever it turns out to be, this external flow makes the formation of the long-term fiscal plan more complex. Whether the total disaster relief is the $82 billion was estimated by the Oversight Board, the $41 billion calculated as so far approved, or some other number, it is economically a large intermediate-term stimulus relative to the Puerto Rican economy, with its GDP of approximately $100 billion.

There are significant issues of how effectively and efficiently such sums will be spent, what the economic boost will be as they generate spending, employment and government revenues, whether they can result in sustainable growth or only a temporary effect, and therefore how they will affect the long-term solvency and debt-repayment capacity of the government of Puerto Rico. Even if none of these funds go to direct debt payment, their secondary effects on government revenues may. How to think through all this is not clear (at least to me), but a conservative approach to making long-term commitments based on short-term emergency flows does seem advisable.

The Oversight Board will have to come up with some defined approach to both long and short-term outlooks, as it continues its double project of debt reorganization and fiscal reform. That is yet another difficult assignment for them, requiring time and generating controversy.

5. <u>Large unfunded pensions are a central element in these situations and set up an inescapable conflict between the claims of bondholders and pensioners.</u>

Puerto Rican government pension plans are not only underfunded, they are basically unfunded. At the time a PROMESA, a generally used estimate of the pension debt was $50 billion, which added to the $70 billion in bond debt made $120 billion in all. It appears that there is in addition $10 billion in unfunded liabilities of government corporations and municipalities, making the pension debt $60 billion, and thus the total debt, before reorganization haircuts, $130 billion. As I learned from an old banker long ago, in bankruptcy, assets shrink and liabilities expand.

How are the competing claims of bondholders and pensioners equitably to be settled? This is an ever-growing issue in municipal and state finances—very notably in Illinois and Chicago, for example, as well as plainly in Puerto Rico. The bankruptcy settlement of the City of Detroit did give haircuts to pensions—a very important precedent, in which the state constitution of Michigan was trumped by federal bankruptcy law. But the pensions turned out in Detroit, as elsewhere, to be de facto senior to all unsecured bond debt. This reflects the political force of the pensioners' claims and needs.

On April 30, the Oversight Board demanded that the government of Puerto Rico act to enforce required contributions to pension funds from several public entities and municipalities. It is "unacceptable to withhold retirement contributions from an employee and not immediately transfer that money into the individual retirement account where it belongs," wrote our colleague on the panel, Natalie Jaresco. She is right, of course. Except that it is worse than "unacceptable"—it is theft.

Pensions as a huge component of municipal insolvencies will continue to be a tough issue for the Oversight Board, as well as for a lot of other people.

6. <u>Progress must operate on three levels of increasing difficulty:</u>
    a. <u>Equitable reorganization of the debt (including pension debt)</u>
    b. <u>Reform for efficiency and reliability in the fiscal and financial functioning of the government</u>
    c. <u>Reforms which allow a growing, enterprising successful market economy to emerge from the historic government-centric economy.</u>

Three years into the process, the first of these requirements is difficult and controversial, but well under way.

The second is harder, because it is challenging government structures, embedded practices, power, and local politics. Relative to addressing insolvency, the most important areas for reform are of course the financial and fiscal functions. Reform would be advanced by the creation of an Office of the Chief Financial Officer on the Washington DC model.

The third problem is by far the most difficult. Solving the first two will help make solving the third possible, but the question of how to do this is not yet answered, subject to competing theories, and major uncertainty. We all must hope for the people of Puerto Rico that it will nonetheless happen.

Thank you again for the chance to share these views.