In the Know: Perspective on Problems in Puerto Rico

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In the Know: Professionals at Franklin Templeton Investments offer a quick but insightful update on a pressing investment topic.

Today, Rafael Costas and Sheila Amoroso discuss the problems plaguing Puerto Rico. Puerto Rico's governor recently declared that the commonwealth would need to seek significant concessions from many of its creditors, including a possible period of bankruptcy to restructure outstanding debt totalling $72 billion. Following the announcement, ratings agency Standard & Poor's lowered its credit rating on Puerto Rico to "CCC-" with a negative outlook, from "CCC+."

In a television address broadcast to the entire island Monday night, Puerto Rico's governor Alejandro Garcia Padilla openly stated what he was quoted as saying over the weekend in a recent *New York Times* interview: that a point has been reached at which the debt is "not payable." He called for creditors and bondholders to provide significant debt relief by forgoing interest and principal for the next "few years." He did not provide any details or proposals beyond that. Rather, he announced the creation of a working group comprised of senior administration and legislative officials to work with bondholders and creditors on a plan of restructuring. Puerto Rico bonds have weakened again today following the speech.

In our opinion, the governor's wishes are going to be very difficult—and expensive—to realize. Many kinds of creditors are involved in Puerto Rico (including traditional buyers such as mutual funds, as well as banks, hedge funds and individual retail holders who live in Puerto Rico or the United States), who will cite the very real legal and constitutional protections that general obligation and sales tax (COFINA) bonds grant in their indentures as well as in Puerto Rico's constitution. At the very least, in our assessment, Puerto Rico can expect creditors to seek legal affirmation and protection of contractual rights. Unfortunately, we think it will likely be a long and costly legal battle regardless of the outcome.

Another Isolated Incident in a Large Market

We do not see the latest news about Puerto Rico as spilling over into the overall muni market, which we view as healthy overall.

Many state and local governments have experienced increased revenues as the economy has improved since the end of the last recession while they have also been careful in taking on additional debt. To be sure, challenges remain for some state and local governments, primarily rising costs associated with pensions and health care. We believe that similar to other headline-grabbing examples, such as Detroit and Stockton, CA, the situation in Puerto Rico is unique to the issuer. No other state/US territory is currently in the financial straits that Puerto Rico finds itself.

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