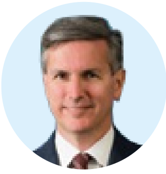
FIXED INCOME

Update on Puerto Rico as Aug. 1 Debt Deadline Missed

August 3, 2015



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admin

The last time we checked in with Rafael Costas and Sheila Amoroso about Puerto Rico was right after the island's governor announced that Puerto Rico's debt was "not payable" under its current terms. Much has happened since then. Costas and Amoroso share with us this update.

As part of the budget for Fiscal Year 2016, Puerto Rico's legislature did NOT make an appropriation to ensure payment of the principal and interest due on $1.09 billion of Public Finance Corporation (PFC) bonds.[1] While we believe there is other money available to pay, today we learned that the governor and his administration have announced that they did not make the full $57.9 million payment due on August 1; only a partial payment of $628,000 was made.[2]

Only three of our municipal bond funds own PFC bonds. The exposures as of 8/26/15[3] are:

– Franklin High Yield Tax-Free Income Fund: 0.18%

– Franklin California Tax-Free Income Fund: 0.03%

– Franklin Federal Tax-Free Income Fund: 0.03%

To give you an update on the broader picture of what is happening with Puerto Rico debt, we must go back to June when in a televised speech, Puerto Rico Governor Alejandro Garcia Padilla stated his belief that the commonwealth's debt was not payable, and announced the creation of a "working group" of local officials that would propose a five-year plan to restructure Puerto Rico's debt and government by August 31. This announcement impacted Puerto Rico's debt markets quite negatively, but there have been other significant events since then.

The same week of the governor's announcement, the US House of Representatives' Republican leadership announced that it did not have enough votes to get H.R. 870 (the bill that would grant Puerto Rico access to Chapter 9 of the US Bankruptcy Code) out of committee. A similar bill was introduced in the US Senate by Democratic senators Charles Schumer (NY) and Richard Blumenthal (CT), but it, too, has been unable to gather Republican support and has stalled in the Senate.

The following week, the US Court of Appeals ruled 3-0 in our favor in the case that several of our municipal bond funds and Oppenheimer Funds brought against Puerto Rico last year, challenging the Debt Enforcement and Recovery Act (DERA) that Puerto Rico's legislature passed in June 2014. The Appeals Court upheld the US District Court's ruling that DERA was unconstitutional. While Puerto Rico has stated that it will appeal the Court of Appeals ruling to the US Supreme Court, it has yet to do so and has a limited time to file. We are encouraged that four federal judges have now ruled in our favor.

The Puerto Rico Electric Power Authority (PREPA) forbearing creditor group—of which we are a member—also delivered its financial restructuring counterproposal to PREPA and its advisors on July 20, 2015. While PREPA initially rejected the proposal, we have been having conversations among all stakeholders and PREPA that may eventually lead to the market-based, consensual solution that would be preferable to litigation. There is no assurance that such a consensual deal will be struck; failure to come to an agreement by September 1, 2015, will cause the current forbearance agreement by its terms to automatically terminate on September 15, 2015.

The market also awaits the report the governor's "working group" is expected to submit by August 31. In that report we should get a public statement about the Commonwealth's plan to deal with its current financial crisis, which should include some indication of its proposed treatment of creditors.

Lastly, in our opinion, the governor's wishes to restructure Puerto Rico's debt will likely be very difficult—and expensive—to realize. Many kinds of creditors are involved in Puerto Rico (mutual funds, hedge funds, insurance companies and retail investors) who will cite the very real legal and constitutional protections that general obligation and sales tax (COFINA) bonds grant in their indentures and in Puerto Rico's constitution itself. At the very least, in our assessment, Puerto Rico can expect creditors to seek legal affirmation and protection of their contractual rights. Unfortunately, we think it will likely be a long and costly legal battle regardless of the outcome.

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What Are the Risks?

Franklin High Yield Tax-Free Income Fund

All investments involve risks, including possible loss of principal. Because municipal bonds are sensitive to interest rate movements, the fund’s yield and share price will fluctuate with market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in the fund adjust to a rise in interest rates, the fund’s share price may decline. Investments in lower-rated bonds include higher risk of default and loss of principal. Puerto Rico municipal bonds have been impacted by recent adverse economic and market changes, which may cause the fund’s share price to decline. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond’s issuer, insurer or guarantor, may affect the bond’s value. The fund may invest a significant part of its assets in municipal securities that finance similar types of projects, such as utilities, hospitals, higher education and transportation. A change that affects one project would likely affect all similar projects, thereby increasing market risk.

Franklin California Tax-Free Income Fund

All investments involve risks, including possible loss of principal. Because municipal bonds are sensitive to interest rate movements, the fund’s yield and share price will fluctuate with market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in the fund adjust to a rise in interest rates, the fund’s share price may decline. Because the fund invests principally in a single state, it is subject to greater risk of adverse economic and regulatory changes in that state than a geographically diversified fund. Puerto Rico municipal bonds have been impacted by recent adverse economic and market changes, which may cause the fund's share price to decline. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. The fund may invest a significant part of its assets in municipal securities that finance similar types of projects, such as utilities, hospitals, higher education and transportation. A change that affects one project would likely affect all similar projects, thereby increasing market risk.

Franklin Federal Tax-Free Income Fund

All investments involve risks, including possible loss of principal. Because municipal bonds are sensitive to interest rate movements, the fund's yield and share price will fluctuate with market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in the fund adjust to a rise in interest rates, the fund's share price may decline. Puerto Rico municipal bonds have been impacted by recent adverse economic and market changes, which may cause the fund's share price to decline. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. The fund may invest a significant part of its assets in municipal securities that finance similar types of projects, such as utilities, hospitals, higher education and transportation. A change that affects one project would likely affect all similar projects, thereby increasing market risk.

Investors should carefully consider a fund's investment goals, risks, sales charges and expenses before investing. To obtain a summary prospectus and/or prospectus, which contains this and other information, talk to your financial advisor, call us at (800) DIAL BEN®/342-5236 or visit franklintempleton.com. Please carefully read a prospectus before you invest or send money.

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1. Source: Source:Commonwealth of Puerto Rico, May 2015.

2. Source:Commonwealth of Puerto Rico, August 3, 2015.

3. Figures represent approximate % of assets in Puerto Rico Public Finance Corporation (PFC) bonds. Updated as of 8/26/15. Holdings subject to change.

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