There has been no systemic spillover effect of the crisis in Puerto Rico to the broader municipal bond market. The most important factor in determining the credit quality of an issuer is the underlying credit fundamentals (economy and operating entity), with covenants offering potentially less protection under stressful conditions.

The Puerto Rico situation bears watching closely for an additional takeaway: How will bondholder and pensioner rights (i.e., general obligation (GO) bondholders vs. pensioners; GO bonds vs. revenue bonds) be enforced, given the unique and extreme nature of the Commonwealth’s financial and economic impairment? Will the sanctity of the special revenue pledge be preserved, as has been the enduring precedent?

Puerto Rico Problems Not Systemic to Broader Market

![Graph showing yield spread to AAA GO and Broad Muni Index Yield Spread to AAA GO]

Puerto Rico yield spread correlation to general market index = -0.50

Source: Bloomberg Barclays Puerto Rico Index and Broad Municipal Index Long Maturity as of April 30, 2017

STANDISH OUTLOOK

Regarding the Title III process, there is no concrete precedent to determine how the judge will treat the various stakeholder groups. There is a strong possibility that Puerto Rico residents, including pensioners, will receive favorable treatment at the expense of general obligation bondholders. It is not clear that historical bankruptcy precedence will be applied to the Puerto Rico revenue bond issues. Recently, in Detroit, MI, Stockton, CA, and Vallejo, CA, the special revenue security provisions protected the revenue bondholders from impairment.

The restructuring process is likely to endure for years, and may only be the first step towards permanent financial stability. Absent meaningful fiscal and economic reforms, Puerto Rico is likely to continue its negative trajectory.

NOTABLE THEMES OF PUERTO RICO RESTRUCTURING AND TITLE III PETITION

The Commonwealth of Puerto Rico filed a Title III petition with the U.S. District Court for the District of Puerto Rico in San Juan on May 5, 2017, which would allow the island’s government to restructure its debts under a bankruptcy-type process. The filing roughly coincides with the May 1 expiration of a stay on litigation against the Commonwealth, and is reflective of the PROMESA legislation.

Puerto Rico currently has approximately $74 billion of debt outstanding, as well as approximately $48 billion in unfunded pension liabilities.

Efforts at reaching a negotiated settlement prior to the filing failed, due to the conflicting interests of the numerous stakeholders involved. The most notable disagreement is among general obligation and COFINA (sales tax) bondholders, both of which believe they have a first claim on sales tax receipts.