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BY ELECTRONIC MAIL

April 25, 2017

U.S. Senator Thom Tillis
c/o Towers_Mingledorff@Tillis.senate.gov

U.S. Senator Tom Cotton
c/o Brian_Colas@Cotton.senate.gov

Re: FOMB Response to Your Letter dated April 7, 2017 (the "Letter")

Dear Senators Tillis and Cotton:

The Financial Oversight and Management Board for Puerto Rico ("FOMB") has received and reviewed your Letter and very much appreciates this opportunity to respond.[1]

FOMB's Statutory Mission:

The Mission: PROMESA section 101(a) provides the purpose of the FOMB is to provide a method for Puerto Rico to achieve fiscal responsibility and to restore access to the capital markets.

Returns to Creditors: Subject to the objectives of achieving fiscal balance and market access, which can only be achieved by ensuring economic growth in

[1] The Letter expresses concerns stemming from certain responses we recently provided at the March 22 hearing of the House Committee on Natural Resources Subcommittee on Indian, Insular, and Alaska Native Affairs.

Puerto Rico, the FOMB intends to maximize returns to creditors. The nub of the issue with the creditors alluded to in your Letter is the size of the economic pie available to be divided. The creditors insist that the pie is larger than FOMB's economists and consultants believe it to be. The FOMB shares the creditors' desires to enlarge the funds available for debt service, but cannot adopt lofty assumptions for available funds without violating PROMESA § 101(a) because PROMESA §§ 104(i) and 314(b) both require outcomes consistent with a certified fiscal plan's debt sustainability analysis.

To address the questions in your Letter, after the Executive Summary we provide the material facts and economic principles at issue, and then an explanation of how the facts and economic principles answer your questions and concerns.

<u>Executive Summary</u>:

1. <u>Fiscal Plan Increases Revenues and Cuts Expenses to the Maximum</u>: The fiscal plan the FOMB certified starts by increasing revenues and cutting virtually *all* expense areas, including education, healthcare, pension, employment, and even legislative expenses.

    a. <u>The FOMB Pushed Revenues, Expenses, and Clawbacks to the Limits of Where they Will Maximize Funds for Debt Service without Preventing Necessary Economic Growth</u>: The one undisputed economic principle governing the fiscal plan is that *no* solution to Puerto Rico's fiscal distress is possible if its negative economic growth is not reversed. The FOMB has cut *all* categories of expenses up to the point where its economists have determined that further material annual cuts for the foreseeable future would (a) prevent growth from reaching levels needed to ensure fiscal sustainability, and (b) create minimally larger short-term savings at the expense of a significantly lower resource envelope over the medium and long-term. Put differently, trying to impose additional cuts would create the opposite effect than creditors want. It would render Puerto Rico's viability impossible because further short run savings would lead to an unstoppable downward fiscal spiral in the long run.

2. <u>Fiscal Plan Confronts Two Fiscal Cliffs</u>: (a) Puerto Rico has unfunded pension liabilities to public employees approaching $50 billion and its three

public pension funds are each either already out of funding or will be out of funding in summer 2017. Average pension benefits are $14,000 per year, and roughly one-third of employees are ineligible for Social Security benefits. Therefore, Puerto Rico will need to begin paying pensions of nearly $1 billion per year that in recent years were paid out of a drawdown of pension system assets. (b) In December 2017, Puerto Rico will exhaust its supplemental Medicaid funding from the federal government. This imposes new healthcare coverage demands on Puerto Rico's own resources of approximately $850 million in the next fiscal year (FY 18, July 2017-June 2018) that is projected to reach almost $2.4 billion a year by FY 26.

3. <u>The Fiscal Plan Does Not Elevate All Spending over Debt Service, and Does Respect Priorities</u>: The creditors' concerns reported in the Letter are that all non-debt spending is elevated above debt service and there is no differentiation between non-essential and essential services. The creditors have it in reverse. The fiscal plan first reduces spending and increases revenue to the maximum extents possible without preventing the essential reversal of Puerto Rico's fiscal sustainability, and then computes the funds available for debt service. The whole purpose of increasing revenues, cutting expenses and reallocating tax revenues to the Commonwealth is to respect priorities and to maximize funds for debt service.

4. <u>The Fiscal Plan Computes Debt Capacity *after* Raising Revenues and Cutting Expenses</u>: The fiscal plan shows $7.873 billion available for debt service on $51.2 billion of debt[2] for the ten fiscal years through 2026, or an average of $787 million per year. Including the amendments introduced by the Board with the certified the fiscal plan, at a 4.5% interest rate, this would service interest and limited amortization of approximately $15 billion of debt.

5. <u>The FOMB Would Only Support a Self-Correcting Restructuring Plan</u>: While the FOMB does not believe the fiscal plan understates cash available for debt service in the first 10 years, it understands creditors are skeptical. To assure creditors they will receive the maximum available, the FOMB has advised creditors from the outset that it wants any restructuring plan to

[2] The certified fiscal plan covers the Commonwealth, PBA, COFINA, HTA, PRIFA, PRCCDA, PFC, UPR, ERS, GDB, and PRIDCO.

provide a mechanism for creditors to be paid more to the extent actual results exceed projections.

6. <u>The Real Issue is the Size of the Economic Pie, Not any Lack of Desire to Negotiate</u>: Your letter reports creditor concerns that the FOMB has failed to negotiate and to respond to creditor attempts to negotiate settlements. In fact, the FOMB and government held more than 30 meetings with creditor representatives from December 2016 through March 2017. The current governor was inaugurated January 2, 2017 and proposed a fiscal plan on February 28, 2017. On March 13, 2017, the FOMB certified an amended version of the governor's plan, which provided for the first time a debt capacity analysis, which was necessary to determine how much debt the government could offer creditors. Thereafter, creditors have requested a new fiscal plan that allows issuing them more fixed-payment debt. The FOMB and government convened a mediation on April 13, 2017. Mediation efforts are ongoing.

7. <u>The FOMB Prioritizes Title VI Settlements</u>: Your letter reports the creditors' concern that the FOMB is violating the letter and spirit of PROMESA by failing to pursue Title VI settlements. As the preceding paragraph demonstrates, the FOMB has endeavored to follow both the letter and spirit of the law. The creditors have refused to pursue Title VI settlements unless the FOMB certifies a fiscal plan providing more funds available for debt service. The PROMESA stay terminates by May 2, 2017. PROMESA does not allow the restructuring of pensions or any non-bond or non-financial contract in Title VI. Puerto Rico has $48 billion in unfunded pension liabilities that require restructuring, or else less money will be available for the creditors you have heard from. To deal with this reality, the FOMB has made clear that it may have to commence Title III cases to extend the stay and to restructure non-financial debt. If that were to occur, the FOMB would fold into its Title III plans any Title VI settlements reached with financial creditors. This is the most the FOMB can possibly do to foster Title VI settlements. Title VI settlements require both the FOMB and creditors to agree.

<u>Puerto Rico's Current Economic Condition</u>:

Economic Decline since 2006: From fiscal years 2006 through 2015, Puerto Rico's real GNP fell every year except one.[3] The Economic Activity Index comprised of four factors (payroll employment, electric power generation, cement sales, and gasoline consumption) fell from 160.0 to 124.1 between August 2005 and August 2016.[4]

Population Decline since 2003: From 2003, Puerto Rico's population has declined over 9% down to less than 3.5 million people in 2015.[5]

Poverty and Unemployment: According to the U.S. Census Bureau's 2015 community survey, 46.1% of Puerto Rico's residents live below the federal poverty level compared to the national average of 14.7%,[6] and 36% of the residents of Detroit,[7] whose financial distress was viewed by many as uniquely devastating. Puerto Rico's is more so. For Puerto Rico children under age 5, 63.7% live under the federal poverty level, compared to the national average of 22.8%.[8] Median household income in Puerto Rico was $18,626 in 2015, compared to $56,515 in the United States,[9] and to $27,862 in Detroit in 2011.[10] In October 2016, Puerto Rico's unemployment rate was 12.1%, and only 987,606 persons were employed, down 23% from 1,277,559 employed persons in December 2006.[11]

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[3] Report to the House and Senate by the Congressional Task Force on Economic Growth in Puerto Rico, 114th Congress (December 20, 2016) at p. 9.
[4] *Id*. at 10.
[5] Puerto Rico Population, retrieved at: http://www.countrymeters.info/en/Puerto_Rico/; FactTank, "Historic Population Losses Continue across Puerto Rico" (Pew Research Center), retrieved at: http://www.pewresearch.org/fact-tank/2016/03/24/historic-population-losses-continue-across-puerto-rico/; Report to the House and Senate by the Congressional Task Force on Economic Growth in Puerto Rico, 114th Congress (December 20, 2016) at p. 13.
[6] Report to the House and Senate by the Congressional Task Force on Economic Growth in Puerto Rico, 114th Congress (December 20, 2016) at p. 9.
[7] Second Amended Disclosure Statement with respect to Second Amended Plan for the Adjustment of Debts of the City of Detroit, at 100, retrieved at: http://www.kccllc.net/detroit/document/1353846140416000000000062
[8] Report to the House and Senate by the Congressional Task Force on Economic Growth in Puerto Rico, 114th Congress (December 20, 2016) at p. 9.
[9] *Id.* at 11.
[10] Second Amended Disclosure Statement with respect to Second Amended Plan for the Adjustment of Debts of the City of Detroit, at 100, retrieved at: http://www.kccllc.net/detroit/document/1353846140416000000000062
[11] Report to the House and Senate by the Congressional Task Force on Economic Growth in Puerto Rico, 114th Congress (December 20, 2016) at p. 11.

Public Debt as a Percentage of Income: Puerto Rico has approximately $74.5 billion of bond debt and $48 billion of unfunded pension liabilities.[12] As of 2012, Puerto Rico's public debt as a percentage of aggregate income was 100.7%, as compared to 29% for New York, which has the highest ratio of public debt to income in the United States (the average is 16.8%).[13]

Immediate New Cash Needs:

The Pension Funding Cliff: As of June 30, 2015, the largest public pension fund (ERS), owing $33.2 billion, was negative 1.8% funded.[14] The highest funded public pension was 8.1% funded, and as a practical matter, virtually all public pension funding will be exhausted this summer for all pension plans, forcing the Puerto Rico government to pay public pensions or welfare out of general revenues. In fiscal year 2018, this will cost the Puerto Rico $989 million.[15]

To put Puerto Rico's $48 billion unfunded pension liability in perspective, the unfunded actuarial accrued liabilities in Detroit in 2013 were approximately $3.474 billion and the public pension funds were over 70% funded.[16]

Notwithstanding that the average pension benefit payment for government retirees in Puerto Rico is about $14,000 – about half the benefit of government retirees in the U.S., as shown below, the certified fiscal plan reduces pension payments to the extent combined pension and Social Security benefits exceed the federal poverty threshold of $1,000 per month.

The Medicaid Cliff: The Affordable Care Act provided supplemental Medicaid funding for territories, of which Puerto Rico drew an average of $917

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[12] Certified Fiscal Plan for Puerto Rico (March 13, 2017) at 26; footnote 13 below.
[13] An Update on the Competitiveness of Puerto Rico's Economy by the Federal Reserve Bank of New York (July 31, 2014) at 16 (Figure 12).
[14] Report to the House and Senate by the Congressional Task Force on Economic Growth in Puerto Rico, 114th Congress (December 20, 2016) at pp. 12-13.
[15] Commonwealth Fiscal Plan certified March 13, 2017 at p. 13.
[16] Second Amended Disclosure Statement with respect to Second Amended Plan for the Adjustment of Debts of the City of Detroit, at 91-93, retrieved at: http://www.kccllc.net/detroit/document/1353846140416000000000062

million per year from fiscal years 2012 through 2016.[17] Puerto Rico drew $1.3 billion in fiscal year 2016. The balance of the supplemental funding will be spent by the end of calendar year 2017.[18] There is no replacement funding thereafter. As the Congressional Task Force on Economic Growth in Puerto Rico reported in December 2016:

> "The government of Puerto Rico, which currently lacks the ability to borrow money in the capital markets to fill the large hole that will be left by the loss of federal funding, would presumably be compelled either to drop hundreds of thousands of current enrollees from the Medicaid program (harming quality of life and spurring outmigration) or to reallocate funds from other areas, such as payments to creditors and the provision of public services. *** Given its magnitude, the cliff is certain to disrupt any existing stability in the provision of health care services in Puerto Rico for a large number of beneficiaries."[19]

<u>Additional Cash Need</u>:

The fiscal plan takes into account these fiscal cliffs, as well as Puerto Rico's repeated understatement of its expenses in its annual budgets. The FOMB retained Ernst & Young ("E&Y") to bridge the last audited financials to the present. In its report, E&Y determined that the government's fiscal year 2017 expenditures could be understated by a range of $360 million to $810 million. The fiscal plan uses $585 million, the midpoint of this range, and adopts a variety of stringent measures to fill the gaps created by the fiscal cliffs and understatement of expenses.

<u>Certain Savings Measures Taken by Government or Imposed by FOMB</u>:

The certified fiscal plan provides within three years for:

(i) <u>Self Sufficient Municipalities</u>: a 100% reduction in subsidies to municipalities, amounting to approximately $375 million per year.

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[17] Report to the House and Senate by the Congressional Task Force on Economic Growth in Puerto Rico, 114th Congress (December 20, 2016) at 19 n.23.
[18] *Id*. at 19.
[19] *Id*. at 20.

(ii) Savings in Higher Education: a 50% reduction in contributions to higher education, amounting to approximately $475 million per year.

(iii) Savings in Personnel and Operating Expenses and Sectoral Subsidies: a 35% reduction in personnel and operating expense, amounting to approximately $1.6 billion per year and reductions in firm-specific subsidies in various sectors of $100 million per year.

(iv) Healthcare Savings: a 30% reduction in healthcare costs, amounting to approximately $800 million per year.

(v) Pension Savings: an average 10% reduction in pension expenses implemented in a progressive manner, amounting to approximately $250 million per year.

(vi) Cancellation of Christmas Bonus if certain liquidity targets are not satisfied.

(vii) Four-Day per Month Furlough if certain liquidity targets are not satisfied.

34% Overall Savings: After five years, the certified fiscal plan saves about $3.6 billion per year off the structural budget, starting with more than $1.1 billion of savings in its first year. The $3.6 billion savings represents a 28% reduction off projected structural spending levels in the Commonwealth of Puerto Rico's $12.85 billion of non-federal expenses in fiscal year 2022.

Reasons for Less Money Available for Debt Service than the FOMB and Creditors Want:

One undisputed principle guiding this restructuring is that the government and the FOMB cannot accomplish PROMESA's twin mandate for Puerto Rico to achieve fiscal responsibility and to restore access to the capital markets if we do not end Puerto Rico's negative economic growth and grow sufficiently.

Further Cost Cutting and Revenue Raising Produce Small Benefits for 10 Years and Detriments for the Next 32 Years: Virtually all the measures available for balancing the budget in the short term worsen economic growth, without which adequate debt service payments are impossible. As the certified fiscal plan provides, the savings measures negatively impact growth through FY 21 and real economic growth does not turn positive until FY 24, when the positive impact of the authorities' structural reform agenda (downplayed by the creditors) begins to take hold.[20]

The FOMB retained economists and consultants to gauge the impact on Puerto Rico's real growth outlook of the measures the FOMB is requiring to attain fiscal responsibility. The savings measures summarized above are so large that our advisors warn that (1) additional short-term cuts might produce slightly higher resources over the first 10 years, but never do over the longer 2018-60 period; (2) the amount of additional cutting is limited as the policies needed to generate annually further material resources is not consistent with a sustainable growth and primary balance path; and (3) with all the other downside risk, we cannot push the baseline path to the minimum of the viable range.

<u>FOMB Discussions with Creditors</u>:

<u>Creditor Meetings</u>: From December 2016 through March 2017, FOMB's members and advisors participated in over 30 meetings with representatives of the different creditor groups. Most groups met with the FOMB more than once. The Government joined the FOMB in most of those meetings and held many additional meetings. The FOMB did not decline to meet with any creditor group requesting a meeting.

<u>Timing of Formulation of Restructuring Proposals</u>: Pursuant to PROMESA § 104(i)(1), FOMB can only certify a Title VI restructuring agreement if it is consistent with the entity's debt sustainability. To determine debt sustainability, either a fiscal plan or most of the work for a fiscal plan needs to be completed. Puerto Rico's prior governor proposed a fiscal plan in 2016, but declined to remedy the PROMESA violations that the FOMB identified. Puerto Rico's current governor, Governor Rosselló Nevares, was inaugurated January 2, 2017 and proposed a fiscal plan on February 28, 2017. The FOMB amended and certified the governor's fiscal plan on March 13, 2017, less than three months after the new governor took office.

<u>Restructuring Proposals</u>: Promptly after certification of the fiscal plan, the FOMB and the government undertook a joint effort to formulate restructuring

[20] Certified Fiscal Plan for Puerto Rico (March 13, 2017) at 10.

proposals for all major credits, based on the debt sustainability analysis in the certified fiscal plan.

Creditor Resistance to FOMB/Government Making Restructuring Proposals: The certified fiscal plan's debt sustainability analysis makes plain the funds available for debt service. Creditors responded by asking the FOMB to certify a new fiscal plan with more frothy and optimistic assumptions.

Mediation: In March 2017, the FOMB and the government requested holders of General Obligation debt ("GO debt") and COFINA debt to participate in a mediation with the FOMB and the government commencing April 3, 2017. Those debts together account for approximately 55% of the total bond debt to be restructured. Ultimately, the mediation commenced April 13, 2017 under the auspices of former Bankruptcy Judge Allan Gropper, nominated by a plurality of creditors. The FOMB remains hopeful that the mediation will lead to consensual resolutions at some point.

The Creditor Concerns Reported in Your Letter Form Part of Current Negotiations:

It is important to recognize that the creditors whose concerns you reported in your Letter are in the midst of negotiations with the FOMB and government. When viewed in the full context of facts set forth above, it becomes clear that airing those concerns is part of their negotiating strategy. In fact, the creditors already know most of the answers in this response.

Negotiations: Your Letter mentions that creditors have alleged the FOMB and the government have not attempted to negotiate and have failed to respond to creditors' attempts to initiate negotiations. As set forth above:

1. The FOMB and the government held over 30 meetings with creditors from December 2016 through March 2017.
2. The FOMB never declined any creditor's request to discuss its claims.
3. Because the prior governor would not cure violations in his fiscal plan, and the new governor was not inaugurated until January 2, 2017 and initiated a new business plan, a debt sustainability analysis could not be completed before March 13, 2017.
4. Creditors who made the same complaints to us as reported in your Letter are the same creditors who asked us to take more time to redo the fiscal plan.

Title VI is the Spirit of PROMESA: Contrary to complaints that the FOMB has violated PROMESA's emphasis on Title VI, the FOMB has actively pursued Title VI settlements in the following ways:

1. The FOMB and the government have been attempting to negotiate.
2. The FOMB has been steadfast from the outset that it favors Title VI over Title III.
3. Congress crafted PROMESA so that the stay terminates on May 2, 2017. The only means of obtaining a general stay after May 1, 2017 is to commence a Title III case.
4. Congress crafted PROMESA so that pension liabilities and other liabilities not constituting bond debt or other financial debt likely cannot be resolved in Title VI, and likely can only be resolved in Title III. As explained above, there is $48 billion of unfunded pension debt the government cannot pay in full.
5. To carry out the spirit of PROMESA notwithstanding that only Title III can provide a stay and restructure pension debt, the FOMB has told bondholders for many months that even if it must resort to Title III, it would continue negotiating with bondholders and would incorporate into a plan under Title III any Title VI-type settlement it makes with bondholders.

Whether the Fiscal Plan Legally Complies with a Statute Is a Legal Question: Your Letter states that during the House Subcommittee on Indian, Insular, and Alaska Native Affairs' March 22 hearing I was asked whether the certified fiscal plan complies with PROMESA. I said it does, because that is my belief. When it appeared the same question was being repeated, I believed the subcommittee might be referring to the COFINA-GO dispute, and I responded that the FOMB had not taken a position on that dispute. But, your Letter asserts my response was "unsatisfactory," and that I did not explain why the fiscal plan is compliant. While I am not a lawyer, I am advised that PROMESA section 201(b) governs the compliance requirements, and that it has fourteen subdivisions, which would make it difficult for me to give a complete explanation in the context of a hearing even if I had fully appreciated the focus of the question.

PROMESA Is on Track to have Puerto Rico Achieve Fiscal Responsibility and Access to the Capital Markets: Your letter provides that because of my response (discussed above) and the creditors' reports of their concerns, you are concerned PROMESA is not on track to have Puerto Rico achieve fiscal responsibility and access to the capital markets. As explained above, that a nonlawyer did not provide a legal explanation to a complex legal question is not a cause for concern. But, more importantly, the very fact that creditors demanding that Puerto Rico pay them more complain that the FOMB has not accommodated them, demonstrates that the FOMB is assuring that Puerto Rico will achieve fiscal responsibility and access to the capital markets. If the FOMB had yielded and approved higher payments, Puerto Rico would again be overleveraged and almost assuredly locked out of the capital markets.

Your Request for Compliance Certification, PROMESA § 201(b)(1) Analysis, and Meeting with Your Staffs: Your letter requests a compliance certification of the fiscal plan. Pursuant to PROMESA § 201(e), the FOMB provided a compliance certification to the governor and legislature, a copy of which is enclosed herewith. Additionally, your Letter requests that the FOMB meet with your staffs about current progress under PROMESA on several fronts, and we are pleased to arrange such a meeting.

Finally, your Letter requests an explanation stating in detail how each requirement of PROMESA § 201(b)(1) is satisfied. This letter addresses in detail the issue you raised under PROMESA § 201(b)(1), namely how the fiscal plan "respects" local priorities and the like. As you know, Congress deployed the word "respect," while consciously twice declining to use "comply with."[21] "Respect" provides flexibility and is different than the words Congress used for other fiscal plan requirements, such as to "ensure" the funding of essential public services, "provide" adequate funding for public pension systems, and "provide" for the elimination of structural deficits. I assume this is the requirement you are most concerned with, and I have explained throughout this letter how the fiscal plan respects priorities by reallocating tax revenues to the Commonwealth, increasing revenues, and cutting expenses. If you would like the FOMB and its advisors to address some of the other requirements, we would be happy to meet with you or your staffs.

What Congress Can Do:

The FOMB invites Congress to help enlarge the pie, such as by renewing the flow of Medicaid funds under the Affordable Care Act to Puerto Rico, which funds

[21] 162 Cong. Rec. H3600-01, 162 Cong. Rec. H3600-01, H3601.

will otherwise be exhausted in December 2017. The bipartisan Congressional Task Force on Economic Growth in Puerto Rico unanimously reported:

> "…However, Task Force members agree that, irrespective of these larger policy disagreements and the congressional debates they will continue to generate in the coming years, an equitable and sustainable legislative solution to the financing of Puerto Rico's Medicaid program should be enacted early in 2017."[22]

Similarly, the FOMB encourages Congress to consider other Task Force recommendations.

<u>Conclusion</u>:

In summary, PROMESA requires the FOMB to achieve for Puerto Rico fiscal responsibility and market access. Subject to those requirements, the FOMB wants to maximize returns to creditors and to ensure economic growth. The FOMB is balancing fairness to Puerto Rico's people with paying creditors while not allowing debt to exceed levels that would prevent fiscal responsibility and market access.

We trust this letter adequately addresses your concerns, and as always, we are at your service.

Sincerely,

José B. Carrión, Chair
& all Members of the FOMB

C: Elías Sánchez Sifonte
Natalie Jaresko

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[22] Report to the House and Senate by the Congressional Task Force on Economic Growth in Puerto Rico, 114th Congress (December 20, 2016) at 17.