The Puerto Rico Debt Crisis and Why You Should Care About It

June 9, 2016 â€“ Even if you watch the news every evening and read the newspaper daily, you can be forgiven if you donâ€™t know about the debt crisis in Puerto Rico. The mainstream television news programs havenâ€™t covered it much and newspapers have relegated the discussion to the back page because very frankly, most people find the discussion boring. But what is happen in Puerto Rico is actually a very big deal. It is especially to anyone who invests in bonds, and to any entity that issues bonds â€“ public or private. And today, the House of Representatives took an already bad situation and made it immeasurably worse.

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Puerto Rico is an island commonwealth and a territory of the United States. It has its own government, which is very similar to a state government. In that capacity, the islandâ€™s government has been issuing bonds to fund various projects. Unfortunately, it has issued more bonds than it can repay. It now owes $72 Billion to bond holders and is about to default on a $2 Billion interest payment it owes to them.

Typically, when the federal government, or state governments, issue bonds, the debt associated with those bonds is considered â€œsovereign debt.â€• Without going into a long explanation about how sovereign debt is different from corporate or personal debt, you need to know that sovereign debt canâ€™t legally be discharged in bankruptcy court. In fact, sovereign entitiesâ€¦ like the federal government and state governmentsâ€¦ canâ€™t legally declare bankruptcy.

And when sovereign entities run out of money, the people that are supposed to get repaid first areâ€¦ wait for itâ€¦ bond holders. Thatâ€™s actually true for corporations too. When companies declare bankruptcy, if those companies issued any bonds, the bond holders are first in line to collect their money.

In 2008, when congress decided to bail out the auto industry, as a part of the bailout legislation it moved bond holders in those companies to the back of the line to collect their money. When that happened, we told our readers that they would have to be crazy to purchase corporate bonds in the future. By their very nature, bonds are supposed to be one of the safest investments you can make. Congress screwed that up.

In the case of Puerto Rico, the House of Representatives today passed legislation that will do pretty much the same thing for the island as the 2008 legislation did for the auto industry. While itâ€™s not being called a bankruptcy, it allows the island to restructure its debt and force a cram-down on bond holders. That means that anyone who invested in the islandâ€™s bonds will be forced to take pennies on the dollar for their investment. At the same time, it is quite likely that government employee pay, pensions and union contracts will not be impacted.

Many bond holders across the United States are small investors. They buy bonds to save for retirement or to generate additional income. And by purchasing bonds, they made a conscious decision to buy a low-risk investment; forgoing potential large gains in return for safe and steady income. There is no reason to believe that people investing in Puerto Ricoâ€™s bonds had any different motivations.

In essence, what congress did today was to rob those investors of both their principle and interest in order to protect government employeesâ€™ pay, pensions and union contracts. If that sounds unfair to you, thatâ€™s because it is.

But that isnâ€™t the end of it. If Puerto Rico can get away with this, there is no reason to believe that overextended states like Illinois wonâ€™t do the same thing. Once you make an exception for Puerto Rico, youâ€™re setting a precedent.

So, what we told our readers in 2008 about buying corporate bonds now applies to purchasing state bonds. At least it applies in the case of any state that is already experiencing financial problems. Gone are the days when you can listen to your stock broker tell you that bonds from any state are a safe bet. Do your own homework and if you have any doubts, look for another investment first.
byJim Malmberg
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