Long Term Financial Management & Investor Relations

Governmental management of Puerto Rico can learn a great deal from past local government financial crises 1975-1992

Vitamins, Chicken Soup, Antibiotics or Surgery are the options.

THE OUTCOME IS INCOME®

"Puerto Rico 2025", released in 2004, was a valuable and constructive economic development project looking to the future of Puerto Rico. Its 10 key focus areas ranged from innovation & enterprise, through governmental services like education, health public safety, utilities and transportation. The project's goals were admirable and in some respects, necessary for the continued vitality of the Commonwealth. A supporting document from that time stated the need to "Insure lifespan of the recommendations by anchoring project in the private sector to the greatest extent possible." In hindsight, a prudent recommendation, because the project assumed a "fiscal policy that facilitates and encourages productivity, income generation and savings".

The goals were lofty, but unachieved. Almost immediately after the report was released, Puerto Rico began a 10 year unbroken string of deficits financed with borrowing. Many of the goals were predicated upon governmental action; those actions were replaced with the fiscal expediency of short-term budgets that failed to support a 20 year goal of economic freedom and prosperity. Annual budgets with no regard for future consequences was the rule of the day; political leadership focused more on getting re-elected than on the long-term consequences of budgets passed with the need to mortgage the future with debt to pay for current spending. Without a long-term view of governmental finances, Project 2025 was almost doomed before the ink dried on the report.

Long-term governmental financial planning is one of my passions. I served on the National Advisory Council on State and Local Budgeting (NACSLB) which identified 60 of the best financial management practices implemented by the nation's best-run states and cities. While I was with Fitch Ratings in 2002, I boiled down those 60 best practices in a Fitch report to highlight the best 12 practices that could mean a positive difference in an issuer's bond rating. I called it "The 12 Habits of Highly Successful Finance Officers", a report which Fitch Ratings continues to use in discussions with state and local financial management.

Many of the practices are common sense and easy to describe:

- Maintain budget reserves against emergencies and recession
- Create budget plans that span four years or more, beyond the short-term decisions of today;
- Adopt formal "Debt Affordability Plans" to manage and control debt before it becomes unmanageable.

These various practices were gauged using scores between 5 and 15 points. A perfect score was 120. When Fitch reviewed all of its ratings using new criteria incorporating an assessment of financial management, it became clear that a mere passing grade was around 35 points; excellent scores were 65 points or above. The practices had to be able to be demonstrated with copies of actual governing or policy documents adopting these goals. I used to call it a city or state's "Take-Home Test on Financial Management"-it was clear and objective as to whether a local government was actually implementing the best financial management practices.

Since I devised this "grading system, it was easy for me to apply it to Puerto Rico. The score was zero. The Commonwealth of Puerto Rico cannot even report its audited financial statement on a timely basis. Analysts are still waiting for the audited financial statement of June 30 2014---documented financial operations are now nearly two years behind.

Vitamins, Chicken Soup, Antibiotics or Surgery?

Many of my following comments are from a speech I gave in late 1991, a time when New York City, Philadelphia, Massachusetts and California were flirting with bankruptcy and bond defaults. I saw them first-hand as S&P's lead analyst following distressed local governments. The title was "Vitamins, Chicken Soup, Antibiotics or Surgery": Ideas to solve those issuers' problems during that economic recession.

The key feature, identified as one of the best ways to improve an issuer's bond rating, was the adoption and implementation of a multi-year budget or financial forecast. The key to this practice is that it forces governments to project and disclose the financial effects of any budget decisions made in the current year, for at least three years beyond the political discussions of today. The degree and detail of these plans depended on the current state of fiscal health for an issuer.

The best-run and highest rated issuers used long-term planning as a "vitamin" supplement to keep their financial status healthy. Examples here are New York City, and the State of Maryland.

Having lived near Jewish neighborhoods in New York, my mother-in-law told me that chicken soup is commonly called the "Jewish penicillin"—good for what ails you when you begin feeling under the weather. Here, financial plans need to be in place to address fiscal stress that normally accompanies a recession, to keep finances from going "underwater". Pittsburgh and Baltimore employ multi-year budgeting in this way.

For a local government in a more advanced state of fiscal stress, "antibiotics" may be required to restore financial health. Chicago, has seen its ratings tumble from Aa3 as recently as February 2013 to Ba1 on May 12, 2015. Its plan needs to provide more detail, more formal timetables, and a track record of achieving those targets before it can hope to see rating improvement. Despite these problems, Chicago remains in control of its financial future, and still enjoys market access, albeit under more strenuous conditions.

Finally, there are issuers that should be considered under "doctor's orders", including the need for major surgery. Detroit, far before it filed bankruptcy in 2013, was this kind of "patient". Clearly Puerto Rico, whose ability to borrow in the traditional bond market is questionable, is easily considered to be another "near-terminal" patient. If Puerto Rico ever hopes to regain the confidence of the municipal bond market, it will need to devise a budget plan that is conservative in its estimates; any budget gaps need to be

addressed early, and not pushed off into future years; firm timetables for targets need to be set, and a track record developed of achieving those goals; it must disclose its progress to investors on at least a quarterly basis, (especially for its cash flow and liquidity). Normally, when an issuer reaches this stage, the bond market usually demands that a supervisory "control board" be established to keep financial operations under tight control. Since Puerto Rico is a sovereign entity without any higher power of oversight because of its constitution, an outside control board is not feasible—this puts the leadership of Puerto Rico under more pressure to solve its problems on its own, without outside assistance.

BASIC ELEMENTS OF A MULTI-YEAR FINANCIAL PLAN			
VITAMINS	PREVENTATIVE	ADHERE TO MOST ELEMENTS OF BEST FINANCIAL MANAGEMENT PRACTICES	NYC, STATE OF MARYLAND
"CHICKEN SOUP"	ANTICIPATORY	HAVING FACED OCCASIONAL ECONOMIC /FINANCIAL STRESS "HEAD IT OFF BEFORE IT BECOMES A CRISIS	PITTSBURGH, PA; BALTIMORE MARYLAND
STRONG ANTI-BIOTICS	CURATIVE	FORMAL PLANS AND TIMETABLES ARE NECESSARY; ALTERNATIVE BUDGET ACTIONS MUST BE DEVELOPED; THE ISSUER IS STILL "IN CONTROL"	CHICAGO, ILL.
DOCTOR'S ORDERS: MAJOR SURGERY NEEDED	"PATIENT MAY BE TERMINAL"	BUDGETS MUST BE CONSERVATIVE; GAP CLOSING SHOULD BE CONCENTRATED IN EARLY YEARS OF THE PLAN; TIMETABLES MUST BE SET AND ACHIEVED; FREQUENT REPORTING UPDATES, AT LEAST QUARTERLY, ESPECIALLY FOR CASH FLOW; AN OUTSIDE CONTROL BOARD MAY BE NECESSARY	PUERTO RICO

Financial Disclosure & Bond Ratings

Despite its financial woes, Puerto Rico has improved its monthly and quarterly reporting, on its own as well as using the Government Development Bank as its official financial advisor. Given the magnitude of Puerto Rico's cash flow problems, however, financial analysts are on firm ground by demanding more detail, and more frequently. Operating with the equivalent sovereign powers of a State within the U.S., there is no excuse for Puerto Rico's failure to present audited financial statements for fiscal year ending June 30, 2014. At this point, verified financial results are nearly two years old.

I have to disclose that I worked for 26 years at two separate rating agencies (S&P and Fitch) between 1975 and 2003. I can honestly say that I am not an advocate for the bond raters. In February 2008, I testified before a House of Representatives' subcommittee that there were too many regulations where bond ratings were incorporated into laws that govern investment and banking, and that many of those regulations and laws should expunge bond ratings as a formal part of law or regulation.

The fact remains that bond ratings remain very influential in the investment decision process. The loss of investment grade ratings are a major Part of Puerto Rico's current financial crisis, because of its current and future need to sell bonds and borrow money for important public projects, like revitalizing the Electric Authority's generation plants.

I may be wrong, but I feel that since the loss of investment grade ratings, regular communications with the bond raters has probably suffered. I am sure Puerto Rico answers questions from rating agency analysts, but it is highly unlikely that Puerto Rico officials are taking the initiative to meet on a regular reporting basis to work on improving ratings.

REGAINING THE CONFIDENCE OF BOND INVESTORS

I never worked at Moody's Rating Services, but they had an inscription above their front door that bears heeding. They described "CREDIT" as "Man's Confidence in Man".

That phrase summarizes Puerto Rico's biggest problem. In light of a decade of fiscal distress, how does the Commonwealth rebuild confidence with investors?

Despite tremendous efforts to reduce government costs and achieve truly balanced budgets, fiscal stability remains elusive. In addition to weak disclosure practices, the Commonwealth has chipped at investor confidence with plans for bankruptcy of its Authorities; seeking federal approval of a change in bankruptcy laws through Congress; stalling payments for Electric Authority debt, while reducing rates to customers that have reduced available revenue for debt by more than 25%; and bond issue plans that depend upon an unprecedented increase in taxes to balance a budget that might only allow the possibility of new borrowing to avert a cash crisis.

The administration, legislature, Government Development Bank and the heads of the operating authorities have created barriers or "walls" between them and the lenders that people like to call "Wall Street". As the Governor once stated recently, Wall Street IS_Main Street. It is comprised of individuals that buy Puerto Rico bonds directly, or buy shares of bond funds that contain Puerto Rico debt. Those individual investors, in many cases, relied upon the safety of interest payments and return of principal promised by Puerto Rico and its authorities. In order for Puerto Rico to thrive, the Island's leadership must "tear down these walls" that will inhibit investing in Puerto Rico's future.

ABOUT THE AUTHOR

Richard Larkin is a Senior Vice President and Director of Credit Analysis, joining HJ Sims in February 2008, where his first assignment was to testify before the

House of Representatives on the Bond Insurance Crisis. Dick worked at J.B. Hanauer from 2003-2008, where he performed high-yield municipal bond analysis for traders and brokers in Hanauer's five offices in New Jersey, Pennsylvania and Florida. Prior to joining Hanauer, Dick was a Managing Director in Fitch's public finance group and served as the Co-chairman of its Public Finance Criteria Committee. He covered high-profile tax-supported and revenue bond credits and had supervisory responsibility for credit surveillance and the training and development of the public finance staff. Prior to joining Fitch in 1998, Dick was a Managing Director and Chief Municipal Rating Officer at Standard & Poor's where he was responsible for municipal rating policies, practices, governance and criteria. Following a twenty-one year career at S&P, Dick served as a financial advisor to Fairmount Capital Advisors where he developed credit enhancement programs for public pension funds. Later, he helped found Reliance SRL, a rating agency that performed local credit ratings in Uruguay.

From 1988-1992, Dick was a charter member of the Anthony Commission on Public Finance, which was created to consider the effects of federal tax law on the ability of state and local governments to carry out their responsibilities to their citizens and to recommend improvements to those laws. From 1995-1998, Dick served on the National Advisory Council on State & Local Budgeting (NACSLB). This industry task force, comprising representatives from the private sector and officials from all levels of local government, identified and fostered 60 of the best budgeting practices that have been implemented by our best-run state and local governments.

Dick earned his BA in economics from Iona College and a Masters in economics from Fordham. In 1999-2000, he was a key participant in the implementation of Fitch's Default Study and revision of its criteria and ratings. During the same period, he authored the definitive study on the impact of municipal government's management practices on credit ratings, defining for issuers a rating agency's relative evaluation of best management practices. Dick has had hands-on rating experience in 42 states, at all levels of state and local government covering virtually every type of debt structure and security pledge. He has been a frequent speaker at state and national Government Finance Officers' Association (GFOA) conferences, and has articles published in national media and public finance textbooks. Dick has appeared frequently on CNBC, Bloomberg Television and Fox Business News, and has been widely quoted in the Wall Street Journal, BusinessWeek, the Bond Buyer and Bloomberg reports, as well as many other media outlets. Dick serves on the Policy Committee for the Securities Industry and Financial Markets Association (SIFMA), and is on the Technical Committee of Municipal Bonds For America (MBFA), a public/private coalition charged with educating government officials about the benefits of tax-exemption for municipal bonds for government issuers as well as the investment market. He was also awarded the National Federation of Municipal Analysts' Award for Excellence in 1996, and in 2008, 2009, 2010, 2011, 2013 & 2014 was elected the First Team Special Revenue Bond Municipal Analyst by Smith's Research & Gradings.