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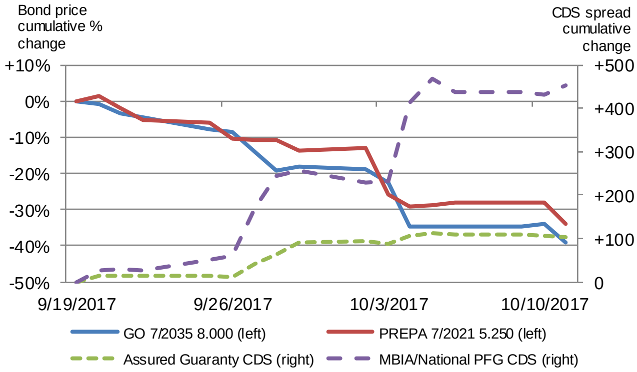
Puerto Rico bonds and bond insurer CDS come under pressure post-Maria

The arrival of a major hurricane typically has investors in property and casualty (P&C) insurance companies and catastrophe bonds scrambling to estimate potential damage based on the ever-changing path and intensity of the storm. However, one would typically not include bond insurers in the same boat as P&C insurance companies during hurricane season, but that changed last month with the arrival of Hurricanes Irma and Maria in Puerto Rico. Bond insurers Assured Guaranty, MBIA/National PFG, and AMBAC have approximately $12 billion in total par exposure to the island's municipal bond debt, with several insured issues already involved in bankruptcy proceedings. The total exposure to gross P&I payments is well over $20 billion, given that a large portion of the wrapped bonds have longer maturities. Puerto Rico filed for Title III bankruptcy protection on May 3 for a portion of its $73+ billion in outstanding debt – including general obligation bonds – making it the largest default of a US municipal bond issuer. Title III was included in Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), which was passed by the US Congress in June 2017 and is modelled after Chapter 9 protection, but without the requirement for a solvency test. PROMESA was specifically created for Puerto Rico – this US territory could not previously file for the same type of bankruptcy protection offered to most US municipalities (excluding US states).

On July 2, the Puerto Rico Electric Power Authority (PREPA) filed for Title III protection for approximately $9 billion in outstanding debt. High debt service burden, aging grid infrastructure, and reliance on less efficient oil powered turbines led to extremely high utility costs for the island's residents.

PREPA's predicament worsened with the arrival of category 5 Hurricane Irma in early-September, resulting in over 1 million residents without power; despite this, the issuer's bond prices remained relatively stable as initial estimates of the total damage to the island were less severe than expected. On September 20, category 5 Hurricane Maria made a direct hit on the island, further damaging the already weakened electrical infrastructure – and completely wiping out grid power for every resident on the island. The storm created a humanitarian crisis that immediately weighed on Puerto Rico's municipal bond prices as well as certain bond insurers' CDS spreads. The graph in **Figure 1** shows the Puerto Rico benchmark GO 7/2035 8.000 and PREPA 7/2021 5.250 uninsured bond prices and MBIA/National PFG, as well as Assured Guaranty's CDS spreads during the 21 days following Hurricane Maria's arrival. We note that AMBAC CDS did not immediately widen after the arrival of the second storm, which could be due to their lack of exposure to PREPA bond issues, while Assured Guaranty and MBIA/National PFG each have over $1 billion of gross P&I exposure. As of October 11, the GO bond prices have declined 39% and PREPA 34% to prices of 35.00 and 35.20, respectively. During that same period, CDS spreads for MBIA/National PFG widened 453bps and Assured Guaranty's 103bps to 736bps and 211bps, respectively. However, the prices for GO and PREPA bonds insured by either company continue to hover near par in a vote of confidence from bond holders who expect to be made whole despite the very likely principal loss on the issues.

Figure 1: Puerto Rico GO and PREPA bond price and Assured Guaranty and MBIA/National PFG CDS spread changes since Hurricane Maria



Source: IHS Markit

The negative sentiment in the bond market is likely warranted to some degree, as it is hard to fathom the extreme damage to the island will not weigh favourably for the issuers' cases in Title III bankruptcy proceedings, which are now expected to be delayed a few months as the island rebuilds. The court of public opinion is probably contributing to the negative impact on bond prices, as political rhetoric with little legal basis pertaining to full debt forgiveness have added substantial fuel to the sell-off. Full debt forgiveness is unlikely in the absence of any new legislation, as it would require the Oversight Board to overcome significant legal and constitutional hurdles. Regardless of the outcome of the Title III proceedings, the federal disaster relief funding may enable the island to modernize its electrical infrastructure through the potential conversion to more efficient natural gas turbines, addition of renewable energy production, and the building of a more storm resistant grid system, which should eventually lead to declines in the current unusually high utility costs for the island's inhabitants. This may also eventually revive economic growth.

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