Puerto Rico Government Debt and the U.S. Federal Government:

Potential Assistance Tools and Policy Practice

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"We want to continue to hear firsthand the economic and financial issues that are important for businesses and families, and we will continue to do all that we can to support local communities and decision makers in advancing good economic and fiscal outcomes."

William C. Dudley, President of the Federal Reserve Bank of New York, *An Update on the Competitiveness of Puerto Rico's Economy*, July 31, 2014

1 Introduction

1.1 The federal government and financial crises

Even a cursory examination of U.S. government actions during the recent financial crisis and economic slowdown in the United States leaves no doubt that the federal government has a multitude of tools at its disposal to confront financial disruptions and to attempt to mitigate their adverse effects. Leading the way during this crisis, as well as in various other crises over the last century, were the Federal Reserve System and the Treasury Department. The U.S. legal system has provided these agencies with an evolving set of powers that allow them to step in when crisis management is required. The goal is generally to avoid systemic problems, referring to repercussions of financial crises that have the potential to affect large segments of the financial markets or of the real sectors of the economy.

In any given crisis situation, questions arise as to whether the federal agencies should intervene from a policy perspective, whether they have the capacity – legal, financial, etc. – to attack the problems, and whether they have the tools that are required in the particular case at hand. The recent financial crisis provides many examples that shed light on these questions. What was the reasoning for the Federal Reserve and the Treasury to intervene in some cases but not in others? Were policy tools readily available or did they have to be constructed? Were statutory and regulatory powers sufficient to meet the challenges?

The history of Federal Reserve and Treasury Department intervention in past financial crises suggests that these agencies are driven by one important general principle: when there's a will, there's a way. Only a handful of the policy tools that were employed by these agencies in the financial upheavals of 2008 were previously available. The first step was to conclude that the situation was sufficiently serious to warrant intervention. The next question was, what kind of intervention? Here the Federal Reserve and the Treasury took somewhat different paths. Whereas the Federal Reserve concluded that it already had the legal and regulatory powers to address various problems, the Treasury sought new federal legislation that would enable the agency to take dramatic steps.

In this paper, we examine these questions with a view to possible application to a financial crisis presently occurring in a local jurisdiction within the U.S. economic system, in particular to the fiscal and financial problems currently confronting the Commonwealth of Puerto Rico. As in the case of the recent global financial crisis, solutions are not obvious and straightforward. Serious questions exist about the magnitude of possible disruptions, about legal powers, and about the existence of effective tools to deal with the problems. From the point of view of the Commonwealth of Puerto Rico there is no doubt of the need to ask these difficult questions. Similarly, a case can be made that the potential repercussions to the United States, while proportionately less catastrophic, are sufficient in magnitude to warrant the attention of federal authorities.

1.2 Puerto Rico government debt and liquidity

The fiscal and financial problems that Puerto Rico faces today are well known, so there will be no attempt here to provide a comprehensive discussion of the details, which can be found elsewhere. However, it is helpful to state at the outset some of the salient facts to provide a context for the analysis of the paper.

In principle, the government of the Commonwealth of Puerto Rico is constitutionally bound to run a balanced budget. However, the constitution does allow for limited borrowing powers in order to provide the government the flexibility it needs to meet its obligations on a year-by-year basis. Since the enactment of the constitution in 1952, the government has exercised its borrowing powers repeatedly and its debt has accumulated over time to a significant level exceeding $70 billion. On an ongoing basis, the government has to provide for current spending needs and at the same time service the considerable accumulated debt obligation.

Following a protracted recessionary period in Puerto Rico that started around 2006, the government has recurrently faced liquidity problems, even after the enactment of a sales tax and other fiscal revenue measures, as well as strengthening controls on the spending side. As a result, the major rating agencies downgraded Puerto Rico government debt at various times within this period, culminating in a downgrade below investment grade for the first time in May 2014. So far the Commonwealth has not been completely shut out from debt markets, but the situation is becoming increasingly precarious with the need to bring new debt issues to market in order to maintain minimum levels of liquidity.

Under these circumstances, the question of potential intervention by U.S. federal authorities to alleviate the liquidity pressures assumes great importance and urgency. Are there mechanisms whereby federal agencies can provide assistance of some sort? That assistance is not necessarily in the form of unilateral grants, but rather it behooves policy makers to consider

a broad array of alternatives that could improve the situation and that would be consistent with the U.S. legal framework and policy tools.

Potential intervention by federal agencies in the current Puerto Rico crisis requires careful consideration of legal issues, awareness of the history of policy actions in financial crises, and an assessment of current conditions in Puerto Rico under criteria that are partly objective and partly subjective. Not least among the complications this analysis entails is the fact of Puerto Rico's territorial status, which is different from any other local jurisdiction within the United States. Whereas federal law makes frequent reference to "the United States," application of any statute or regulation to Puerto Rico requires careful analysis of each statute and regulation on a case-by-case basis.

Whatever the associated difficulties, asking these questions is of paramount importance given the severity of the crisis and the potential for repercussions in Puerto Rico and the United States. The Federal Reserve has taken notice of these problems. Since 2012, the Federal Reserve Bank of New York, which is charged within the Federal Reserve System with regional jurisdiction over Puerto Rico, has issued two major studies and other shorter pieces and statements about the island's economy and finance. These publications have identified problems and suggested some possible solutions. In addition, the president of the Bank has twice extended the offer to Puerto Rico contained in the epigraph to this paper "to do all that we can to support local communities and decision makers in advancing good economic and fiscal outcomes."

Thus, the logical question becomes, what can the Federal Reserve and the Treasury do to support local decision makers in their pursuit of good economic and fiscal outcomes for Puerto Rico? What types of action are allowed by existing statute and regulation? What policy tools are available that could be applied in the case of Puerto Rico? Is there an argument to advance new federal laws or to amend existing regulation? How do these possible actions fit within the historical context of federal crisis management in the United States? Is there a will to take action now with regard to Puerto Rico's economic future?

1.3 Objectives of this paper

This discussion paper has three principal goals. The first is to review the framework under which federal assistance could be extended to Puerto Rico. This framework would include the laws and regulations governing the relevant government agencies, as well as the administrative structures within which they operate. As indicated earlier, the main focus is on the Federal Reserve System and the Department of the Treasury, which historically have been at the forefront of financial crisis management at the federal level.

A second goal of the paper is to examine the actual policy practice of the federal government in addressing financial crises in the past. Of course, this practice extends back to U.S. colonial days and the establishment of the U.S. Treasury under Alexander Hamilton, but for these purposes we examine cases since the 1970s, which would be more in line with present conditions. The cases included occurred in various sectors, including municipalities and private financial and nonfinancial firms. The purpose of this analysis is to cull ideas that could be applied to the case of Puerto Rico.

This third and final goal of the paper is to suggest possible alternatives to deal with the pressing issues regarding the fiscal and financial crisis in Puerto Rico. These suggestions are informed by the analysis described above and include options that are in line with both the principles and practices of the U.S. federal government in dealing with prior crisis situations. As is well known, there is no simple existing law or regulation that was designed specifically to address the problems faced by Puerto Rico today. However, a multitude of existing measures were designed to deal with similar situations, and it is important to identify possible ways to make use of such means and in the process to accept enthusiastically the offer of help extended by the Federal Reserve to decision makers in Puerto Rico.

2 The statutory, regulatory, and administrative framework

2.1 The Federal Reserve Act of 1913

The starting point for our analysis is the framework that governs the Federal Reserve System, emanating from the Federal Reserve Act of 1913 as amended. There are two main reasons for this starting point. First, the Federal Reserve has been involved since its creation in managing most, if not all, of the important financial crises that have occurred in the United States. Second, the Federal Reserve has demonstrated a keen interest in the financial health of Puerto Rico, as evidenced by recent studies published by the Federal Reserve Bank of New York. Those studies have gone beyond fact-finding to the suggestion of concrete policy initiatives. Moreover, the Federal Reserve has offered to come to the aid of communities and decision makers in Puerto Rico. Therefore, it is natural to ask what specific form or forms Federal Reserve assistance might take and to look to its legal framework for answers.

The Federal Reserve Act was enacted in 1913 to bring stability to a U.S. financial system that had experienced serious turmoil on several occasions since the latter part of the nineteenth century. Thus, the institutional focus of the Federal Reserve on crisis management is more than a century old. The sections of the Federal Reserve Act that are most relevant for the case of Puerto Rico today were not in the act at its inception in their present form, but were added or modified later to reflect changing economic realities and to apply the accumulated

policy experience acquired over more than a century. In this discussion, we focus primarily on Sections 2A, 13(3), and 14(2) of the Federal Reserve Act.

Section 2A was added to the Federal Reserve Act in 1977 to establish explicit goals for the Federal Reserve in its conduct of monetary policy. Specifically, this section requires that "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Thus, in the conduct of its monetary policy operations, the Federal Reserve is mandated to consider the implications of its actions for these multiple goals and, in particular, for the promotion of maximum employment.

The concept of "maximum employment" is not clearly defined, but analysts and the national media often look to aggregate economic indicators such as the unemployment rate, monthly employment level reports, and weekly figures on unemployment claims for signs as to whether the Federal Reserve is accomplishing its goals in this regard. Local governments and the local media, however, are more likely to look at the employment situation through the prism of their own local conditions. So, when the Federal Reserve addresses the goal of maximum employment, should it take local conditions into account?

There is evidence both from the governance structure of the Federal Open Market Committee (FOMC), which oversees monetary policy at the Federal Reserve, and from the information it gathers for its meetings that local economic conditions are important in the conduct of monetary policy. First, the FOMC includes as its members the seven governors of the Federal Reserve Board, but also the twelve presidents of each of the Federal Reserve Banks located in cities across the country. All twelve bank presidents attend the meetings, which occur about every eight weeks, and report on economic conditions in their districts. Only five Bank presidents have an official vote on committee decisions at any one time.

In addition to its governance structure, the FOMC receives and discusses the "Beige Book" reports on local economic conditions, which are put together by each of the twelve Federal Reserve district banks. This report was confidential and closely guarded in the 1970s, when it was known as the "Red Book." The report was declassified and its contents widely circulated starting in 1983, when the name was changed to reflect its new public status.

The implications of the mandate in Section 2A of Federal Reserve Act and of the structure of the FOMC seem clear: the Federal Reserve must take local economic and financial conditions into account in its conduct of monetary policy, and the goal of maximum employment must be viewed from both the national and local perspectives.

As the recent Federal Reserve reports highlight, Puerto Rico is part of the Second District of the Federal Reserve, which includes New York State, parts of Connecticut and New Jersey, as well as Puerto Rico and the U.S. Virgin Islands. The interest in Puerto Rico's economy demonstrated by the Federal Reserve Bank of New York in its recent studies is perfectly consistent with the mandate and goals of the Federal Reserve, and the offer of assistance from the leadership of the bank is in line with this mandate.

What specific form or forms can that assistance from the Federal Reserve to Puerto Rico take? The following sections of the paper consider the legal and regulatory background for clues about what it possible in this regard. Two sections of the Federal Reserve Act come to the fore as potentially supportive of aid to Puerto Rico, as both were supportive of many of the forms of assistance that the Federal Reserve provided to various sectors of the U.S. economy during the economic and financial crisis of 2007 and beyond.

Section 13(3) governs Federal Reserve lending to individuals, partnerships, and corporations, and it has the potential to address the needs of local communities and corporate decision makers. During the recent financial crisis, this section of the Federal Reserve Act was used to support lending and other forms of financial assistance to various corporations that were severely affected by the crisis. Section 14(2) covers the purchase of debt instruments by the Federal Reserve in the open market. This section provided the basis for the well-known "quantitative easing" programs enacted by the Federal Reserve to provide monetary stimulus to the U.S. economy at a time when short-term interest rates were at or close to their zero lower bound. Are debt purchases a possible venue to support the local economy in Puerto Rico?

2.2 Section 13(3) of the Federal Reserve Act

The Federal Reserve is the lender of last resort for the U.S. economy, which for the most part in practice entails extending short-term credit to banks for the purposes of liquidity management. For example, a bank that is short of reserves toward the end of a reserve maintenance period may obtain the required reserves from the federal funds market, but the bank may also approach the Federal Reserve discount window and obtain a short-term loan. The rules require that these loans be extended only for liquidity purposes and may not be granted to an insolvent institution.

In fact, the lending powers of the Federal Reserve go well beyond short-term loans to banks, and these extended powers have been exercised over the years and in particular during the recent financial crisis. Lending powers are discussed in the present Section 13(3) of the Federal Reserve Act, entitled "Discounts for individuals, partnerships, and corporations" and are administered under the tenets of Regulation A of the Federal Reserve.

Section 13(3) is a depression-era addition to the Federal Reserve Act dating to 1932, and it has undergone various changes over the years. Very recently, the section was extensively amended by the Dodd-Frank Act of 2010, so the rules that were applied during the financial crisis prior to mid-2010 were different textually from the rules as they stand today. However, the transition to the new language is not yet complete since the Federal Reserve is still in the process of finalizing the changes to Regulation A that were required under the 2010 Act.[1] Since the transitional phase is still ongoing, it is useful to start by examining Section 13(3) as it stood before the 2010 amendments.

After December 1991 and before the Dodd-Frank Act of 2010, the text of Section 13(3) read as follows.

> "In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 357 of this title, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal reserve bank: *Provided*, That before discounting any such note, draft, or bill of exchange for an individual or a partnership or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe."[2]

As noted earlier, Regulation A has been the instrument designed to implement this section of the Federal Reserve Act, and the particular section of Regulation A that applies to lending under Section 13(3) contains the following text.

> "(d) *Emergency credit for others*. In unusual and exigent circumstances and after consultation with the Board of Governors, a Federal Reserve Bank may extend credit to an individual, partnership, or corporation that is not a depository institution if, in the judgment of the Federal Reserve Bank, credit is not available from other sources and failure to obtain such credit would adversely affect the

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[1] Regulation A amendments to comply with Dodd-Frank were issued by the Federal Reserve Board in January 2014 for comments by March 7, 2014. As of this writing, the final regulation is not yet in effect.

[2] 12 U.S.C.§ 343. The source for this text is FDsys, GPO's Federal Digital System, U.S. Government Printing Office (www.gpo.gov/fdsys).

economy. If the collateral used to secure emergency credit consists of assets other than obligations of, or fully guaranteed as to principal and interest by, the United States or an agency thereof, credit must be in the form of a discount and five or more members of the Board of Governors must affirmatively vote to authorize the discount prior to the extension of credit. Emergency credit will be extended at a rate above the highest rate in effect for advances to depository institutions."[3]

A few basic principles are clear from the Federal Reserve Act and Regulation A regarding the extension of credit to individuals, partnerships, and corporations under Section 13(3). Specifically,

- The definition of the borrower is quite broad and there is no requirement or presumption that the borrower be a bank or other financial institution.
- The borrower must be unable to secure "adequate credit accommodations" from banking institutions.
- Lending is in the form of a discount, which requires that adequate collateral be posted with the Federal Reserve in the form of notes, drafts, or bills of exchange.
- Credit may not be extended by a Federal Reserve Bank acting on its own accord, but requires assent from five or more members of the Federal Reserve Board.

Section 3 of the present paper examines the application of this law and of Regulation A in practice and in particular its use during the recent financial crisis. Section 4 will raise the question of whether Section 13(3) of the Federal Reserve Act could have some role in the management of the current financial situation in Puerto Rico.

2.3 Section 14(2) of the Federal Reserve Act

Since the present financial conditions of Puerto Rico are inextricably linked to a high level of local government debt, we consider now the powers of the Federal Reserve with regard to the purchase of debt instruments. Section 14 of the Federal Reserve Act is entitled "Open Market Operations" and deals precisely with purchases of debt instruments and other assets by the Federal Reserve for its own account. Most pertinent is Section 14(2), entitled "Purchase and sale of obligations of United States, States, counties, etc."

The full text of Section 14(2) is provided in Appendix A, but it is helpful to quote here a portion of the text here with parsing that elucidates some of the instruments that the Federal Reserve is permitted by law to purchase. Under the section, the Federal Reserve is allowed "To buy and sell, at home or abroad,

[3] This text is Section 201.3(d), 12 CFR Chapter II, January 1, 2014.

- “bonds and notes of the United States,
- “bonds issued under the provisions of subsection (c) of section 4 of the Home Owners' Loan Act of 1933, as amended, and having maturities from date of purchase of not exceeding six months, and
- “bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by any State, county, district, political subdivision, or municipality in the continental United States, including irrigation, drainage and reclamation districts, and
- “obligations of, or fully guaranteed as to principal and interest by, a foreign government or agency thereof…”

The first and third categories of debt listed above were included in the original Federal Reserve Act of 1913. The second and fourth are more recent. In particular, the fourth category was added relatively recently in 1980 to provide the Federal Reserve with greater flexibility to invest its foreign currency reserves.[4]

The third category above is clearly of interest in the context of the discussion of Puerto Rico. Is the Federal Reserve permitted to purchase debt securities issued by the government of Puerto Rico, its instrumentalities, or its municipalities? Since Puerto Rico is considered to be part of the Second Federal Reserve District, the answer would seem to be positive save for the fact that the borrowing locality must be “in the continental United States,” a qualification that dates to the original 1913 Federal Reserve Act.

What was the legislative intent of this geographical restriction? In 1913, all the states of the United States were located in the North American continent. Alaska and Hawaii had been territories of the United States since 1867 and 1898, respectively, but were not to become states until the late 1950s. Consequently, these two current states were excluded from the provisions of Section 14(2) at the time of passage of the Act, although they were subsequently included after becoming states. The present language of Section 14(2) with regard to the geographical exclusion remains the same, but the term "continental United States" is now defined in Paragraph 3 of Section 1 of the Federal Reserve Act to mean "the States of the United States and the District of Columbia."

What was the legislative purpose in 1913 for excluding territories such as Alaska, Hawaii, and Puerto Rico? Where does Puerto Rico currently fit within the Federal Reserve System and what to which services does it have access within the System? At first glance, the

[4] See, for example, David H. Small and James A. Clouse, “The Scope of Monetary Policy Actions Authorized under the Federal Reserve Act,” FEDS Paper No. 2004-40, Federal Reserve Board.

current text of the Federal Reserve Act appears to allow the Federal Reserve to purchase government bonds almost universally, except when the bonds are issued by Puerto Rico and other U.S. territories. Could this be the actual legislative intent? A look at the treatment of Puerto Rico in Federal Reserve regulations presently and historically sheds some light on this question and is the topic of the next section.

2.4 The status of Puerto Rico within the Federal Reserve System

The Foreword to the 2014 Federal Reserve Bank of New York study on Puerto Rico's economy starts off by saying that "At the Federal Reserve Bank of New York, we are proud that Puerto Rico is part of the Second District, which we represent in the Federal Reserve System." What exactly does it mean for Puerto Rico to be part of the Second District, and what rights and obligations does it entail?

Puerto Rico was not mentioned in the Federal Reserve Act when it first became law in 1913 nor is it mentioned in the present version of the Act, as amended. The original Act instructs the "The Reserve Bank Organization Committee," precursor to the Federal Reserve Board, to partition "the continental United States, excluding Alaska" into as many as twelve districts, which an equal number of regional reserve banks would cover and service. Thus, the 48 existing states were all accorded coverage under the act, but the Act itself is silent on whether U.S. territories would receive coverage or would become part of any of the Federal Reserve districts. The Act was subsequently amended in 1958 and 1959, respectively, to include Alaska and Hawaii in the mandatory composition of the districts when these states were "admitted to the Union," but to this day remains silent concerning U.S. territories.

The Federal Home Loan Bank Act of 1932 established a federal government structure to oversee the thrift industry in a way that parallels the supervision of commercial banks by the Federal Reserve. The approach to geographical coverage taken by the 1932 Act is in many ways the same as the approach in the Federal Reserve Act, as shown by the passages quoted in Table 1. The language is virtually identical with respect to the following provisions:

- Districts are defined by the respective Board.
- The number of districts is the same.
- Districts are apportioned with due regard to convenience and customary course of business.
- Districts may be readjusted by the respective Board from time to time.
- A single district Bank is established at one city per district
- Districts are designated by number.

However, the 1932 Act contains two notable differences from the Federal Reserve Act:

- Puerto Rico, the Virgin Islands, Alaska, and Hawaii (in that order) are included in addition to the Continental United states.
- Districts do not include fractional parts of states.

The approach taken in 1932 most likely reflects accumulated practical experience in implementing the law since 1913. The decision not to split states into different districts made design of the districts simpler and may also reflect advances in transportation and communication since 1913. The inclusion of the territories is likely indicative of the strong commercial and financial ties that existed between the continent and the territories and the fact that the new district Home Loan Banks would have to deal in practice with transactions involving the non-contiguous but politically integrated geographical regions. In fact, to clarify matters further, a definition in the 1932 Act indicates that "The term 'State' includes the District of Columbia, Puerto Rico, the Virgin Islands of the United States, and the Territories of Alaska and Hawaii."

The same practical considerations that led to the more inclusive act of 1932 applied to banking and to the Federal Reserve, but the Federal Reserve Act was not similarly adjusted at the time or at any time since then. Instead, the Federal Reserve has resorted repeatedly over the decades to redefinition of its coverage of territories through regulations required for implementation of the Federal Reserve Act. For instance, effective July 15, 1954, the Federal Reserve Board of Governors amended Regulations G and J to facilitate collection of cash and noncash items in "Territories, dependencies, insular possessions, and parts of the United States outside the Continental United States." Specifically, at that time the Board indicated that "For the purpose of the amended regulations, the Board of Governors has designated Alaska and Hawaii as being in and of the Twelfth Federal Reserve District, effective on and after July 15, 1954."[5]

A few years later, the Board took similar action with regard to Puerto Rico, once again amending Regulations G and J. In this case the decision was that "Effective January 1, 1958, the Board of Governors of the Federal Reserve System has designated Puerto Rico as being in or of the Second Federal Reserve District for purposes of Regulations G and J."[6] A 1958 article published in the Monthly Review of the Federal Reserve Bank of New York remarked that "Since the beginning of this year, Puerto Rico has been a part, though a special and in some respects limited part, of the Second Federal Reserve District. This marks another important forward step in strengthening the Commonwealth's monetary mechanism and in integrating

[5] Federal Reserve Bank of New York Circular No. 4125, July 16, 1954.
[6] Federal Reserve Bank of New York Circular No. 4538, December 2, 1957.

the Puerto Rican banking system with that of the United States."[7] Thus, although the designation was explicitly made only for the purposes of the two amended regulations, it was seen as prelude to an expanding relationship with the regional Federal Reserve Bank.

The September 1, 1967 amendment to Regulation J went further. As in the 1958 amendment, Puerto Rico was designated as part of the Second Federal Reserve District. However, in this case the amended Regulation J included Puerto Rico under the definition of "State" for the purposes of the regulation. Specifically, one of the definitions indicated that "The term 'State' means any State of the United States, the District of Columbia, or Puerto Rico, or any territory, possession or dependency of the United States."

While most Federal Reserve regulations since the 1950s treat Puerto Rico as a state or as part of the Second District, two regulatory revisions from the 1960s treat Puerto Rico paradoxically as a foreign country. Regulation K applies to U.S. corporations engaged in foreign banking activities and the 1963 revision includes the following language among its definitions: "'Abroad', 'foreign', or 'foreign country' refers to one or more foreign nations or colonies, dependencies, or possessions thereof, overseas territories, dependencies, or insular possessions of the United States, or the Commonwealth of Puerto Rico."[8] Similar treatment is found in 1963 and 1967 revisions to Regulation M, which applied to foreign activities of U.S. banks. In these amendments, the Commonwealth of Puerto Rico is included in the definition of "foreign country" or "country."[9]

Classification of Puerto Rico as a foreign country in Regulations K and M is puzzling in the context of all the other Federal Reserve regulations that have treated the Commonwealth since the late 1950s as a state and as part of the Second Federal Reserve District. For the purposes of these two regulations, a bank chartered in Puerto Rico is considered a foreign bank and a Puerto Rican branch of a bank with a U.S. national or state charter is considered a foreign branch. At the same time, however, the same bank and branch would be considered domestic U.S. banking institutions and part of the Second Federal Reserve District for the purposes of virtually any other regulation and for Federal Reserve functions such as cash and check processing and bank supervision.

Puerto Rico is also treated essentially as a foreign country in U.S. law concerning foreign bank participation in domestic markets (12 U.S.C. § 3101), which is not part of the Federal Reserve Act. In the code, "'foreign bank' means any company organized under the laws of a

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[7] "Puerto Rico's Monetary System and Economic Growth," Federal Reserve Bank of New York Monthly Review of Credit and Business Conditions," March 1958.
[8] Federal Reserve Bank of New York Circular No. 5398, October 7, 1963.
[9] Federal Reserve Bank of New York Circulars No. 5385, September 8, 1963, No. 5398 and No. 5958, March 15, 1967.

foreign country, a territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands, which engages in the business of banking, or any subsidiary or affiliate, organized under such laws, of any such company."

Instances of treatment of Puerto Rico as a foreign country in banking law and regulation are few. Various other Federal Reserve regulations since the 1950s have included Puerto Rico under the definition of "State," have designated Puerto Rico as part of the Second District, or have done both. The only exceptions are regulations K and M. A representative summary of these regulations is provided in Table 2 and the text of the corresponding circulars and regulations is provided in Appendix B.

The treatment of Puerto Rico in current Federal Reserve regulation closely parallels the historical treatment described above. Several of the regulations listed in Table 2 have been eliminated or superseded, so not all apply presently. Among current regulations, Puerto Rico is mentioned explicitly in at least 11 Federal Reserve regulations, as well as in related regulations pertaining to other bank regulatory agencies in the United States, namely the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS). These Federal Reserve and related regulations are listed in Table 3 and the corresponding text is provided in Appendix C. There is an overlap with the historical list in Table 2 but some of the early regulations no longer apply and others have been amended to include explicit references to Puerto Rico. The only current regulation that treats Puerto Rico differently from a state or part of the Second Federal Reserve District is Regulation K, which is the current version of the regulations that included Puerto Rico as a foreign country in the 1960s.

In summary, the preponderance of regulatory language in Federal Reserve regulations shows that Puerto Rico is treated in the same way as a state and, although less explicitly in current regulation, as part of the Second Federal Reserve District. The inconsistent treatment of Puerto Rico as a foreign country in Regulation K presents an opportunity for regulators to take another look at the full system of Federal Reserve laws and regulations and to rationalize them in this regard.

Harmonization of regulatory approaches to the case of Puerto Rico is important because regulations form an integral part of the legal context of statutes that govern the actions of the Federal Reserve and other federal agencies. "In analyzing a statute's text, the [Supreme] Court is guided by the basic principle that a statute should be read as a harmonious whole, with its separate parts being interpreted within their broader statutory context."[10] Analysis of Federal

[10] Larry M. Eig, "Statutory Interpretation: General Principles and Recent Trends," Congressional Research Service Report for Congress No. 97-589, December 19, 2011.

Reserve regulations shows that the treatment of Puerto Rico is fairly harmonious with a few noticeable exceptions.

2.5 Internal Revenue Code

Instructions for filing individual federal income taxes state that “Puerto Rico has its own separate and independent tax system,” which would seem to indicate that Puerto Rico is treated as a foreign country for U.S. Internal Revenue purposes.[11] In practice, the Puerto Rico system is not entirely separate since its operation is closely coordinated with that of the Internal Revenue Service.

For individuals, there are various tests to determine whether they should file local tax returns only or both local and federal returns. These rules apply to “bona fide” residents of Puerto Rico, a designation defined in terms of physical presence, tax home, and foreign connection criteria. The potential independence of the local and federal tax systems is clearest in the case of U.S. citizens or resident aliens who are bona fide residents of Puerto Rico during the entire tax year and derive all their income from local sources. Such individuals file only local tax returns and pay only local income taxes. Other cases are treated differently and may require filing federal returns and payment of federal taxes.

For individuals who are U.S. citizens or resident aliens but who are not bona fide residents of Puerto Rico during the entire tax year, income from Puerto Rico sources is treated in a manner more consistent with income from foreign sources. Income from Puerto Rico (and worldwide sources) must be reported in federal returns, but a foreign tax credit may be obtained for taxes paid to Puerto Rico. One difference from the case of income from other countries is that the Internal Revenue Service indicates that Puerto Rico tax returns must be filed in that case, where it only indicates that foreign country returns may have to be filed in the case of other countries.

Notwithstanding the coordination and explicit rules in the case of Puerto Rico, income from Puerto Rico sources is arguably treated as foreign income for federal return purposes, which is consistent with the statement of the Internal Revenue Service that the local tax system is “separate and independent.”

2.6 The U.S. Department of the Treasury

Unlike the Federal Reserve, the Department of the Treasury does not have a standard set of statutes and regulations to guide its involvement in the management of financial crises in the United States and abroad. Instead, it relies on working with Congress to pass legislation to provide the powers necessary for it to deal with individual crises.

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[11] Source: Internal Revenue Service Publication 570 “Tax Guide for Individuals with Income from U.S. Possessions.”

For example, as the recent financial crisis deepened in 2008, Congress passed the Emergency Economic Stabilization Act to grant the Treasury powers to intervene with the private sector in various dimensions, including direct financial investment in private corporations. Through the Troubled Asset Relief Program (TARP), the Treasury provided funds and other assistance to homeowners, the auto industry, the banking industry, and insurance giant AIG.

Involvement of the Treasury in such activities has a long history and has not been limited to domestic financial crises in the United States. For example, the Treasury was directly involved in the management of Latin American financial crises in the 1980s. A clear sign of the central role the Treasury played at the time is that two international initiatives to deal with those problems came to be known as the Baker Plan and the Brady Plan, respectively, in deference to two Secretaries of the Treasury who spearheaded the plans.

In addition to providing funds directly, the Treasury has contributed other forms of assistance in specific crises such as the ones involving New York City in 1975 and the Chrysler Corporation in 1979. Important Treasury participation will be seen in some of the economic crises reviewed in the following section.

3 Federal government crisis management in practice

3.1 New York City 1975

The City of New York faced a financial crisis of major proportions in 1975. The city found itself on the verge of defaulting on its $14 billion debt and declaring bankruptcy. After trying multiple options to access the credit market and after receiving extensive help from New York State, New York City was not making sufficient progress. The Federal government stepped in, passing the Financial Emergency Act and the New York City Seasonal Financing Act. The first bill created a board to oversee the city's financial affairs, while the second paved the way for a $2.3 billion loan to the city. This loan came with conditions such as raising fees for some city services, cutting other services, reducing pension benefits for city workers, and increasing city taxes.[12]

The Federal Reserve did not provide funds directly, but it assisted the city in the formulation of a financial plan. In the 1975 Annual Report of the New York Federal Reserve Bank, its president Paul Volcker issued the caveat that "…it should be understood that the Federal Reserve Act provides the System with very limited emergency powers to lend to nonbank borrowers." The report also goes on to say that involving the Federal Reserve to a greater extent could hurt its ability to execute monetary policy. These views set a precedent for

[12] See, e.g., Roger Dunstan, "Overview of New York City's Fiscal Crisis" California Research Bureau, March 1, 1995.

the Federal Reserve stance in future municipal crises, though the power to lend to nonbanks was interpreted quite differently in 2008.

3.2 Chrysler 1979

After the oil price shocks of 1973 and 1979, auto-maker Chrysler was on the verge bankruptcy, since the vehicles it produced had generally low gas mileage. In 1980, Congress passed an act that allowed a federal loan guarantee of $1.5 billion to Chrysler.[13] The argument put forward in support of this bill was that a large number of jobs would be lost, with seriously detrimental effects for the Midwestern region and the country as a whole. Additionally, it was argued that the United States should remain a strong player in the global automobile industry, for which federal assistance was required.[14]

3.3 Developing economies in the 1980s

The financial crises of the 1980s in various developing economies are frequently associated with the specific cases of Mexico, Argentina, and Brazil and with their participation in the Brady Plan. The plan was named after Nicholas Brady, Secretary of the Treasury in the George H.W. Bush administration. In fact, the problems were more far-reaching and many other countries facing serious straits took advantage of the assistance provided by the Brady Plan. In Latin America, other participants included Costa Rica, Venezuela, Uruguay, and the Dominican Republic, with broader geographical representation including Nigeria, Jordan, and Bulgaria.[15]

The Brady Plan had many facets. It involved, for instance, a menu of options for creditors of participating countries to agree to some form of debt restricting, or of the restructuring of debt service payments. The menu strategy was intended to deal with the heterogeneity of creditors affected by the various crises. Another feature of the Plan was the securitization of bank debt, in effect converting bank loans into securities that could be traded in public financial markets.

A third strategy introduced by the Brady Plan was the collateralization of national debt of participating countries. In order to provide creditors with greater assurance that debt would be repaid as scheduled, principal and interest on some bonds were collateralized through the posting of Treasury securities, including long-term zero-coupon Treasury bonds issued specifically for those purposes. The bonds used as collateral were purchased using the

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[13] Public Law 96-185.

[14] See, e.g., James M. Bickley, "Chrysler Corporation Loan Guarantee Act of 1979: Background, provisions, and cost." Washington, DC: Congressional Research Service, 2008 and Congressional Budget Office, "Estimating the Value of Subsidies for Federal Loans and Loan Guarantees," August 2004.

[15] John Clark, "Debt Reduction and Market Reentry under the Brady Plan" Federal Reserve Bank of New York Quarterly Review, Winter 1993-94.

countries' own resources, as well as funds from international donors and from the World Bank and International Monetary Fund.[16]

3.4 Bear Stearns 2008

Financial instability at Bear Stearns became clear in January of 2008. According to the Federal Reserve, Bear Stearns notified them on March 13, 2008 that they would not be able to uphold their financial obligations. On March 14, the Federal Reserve saved Bear Stearns from collapse by providing a bridge loan of $12.9 billion, and justified the loan by citing Section 13(3) of the Federal Reserve Act. Even with this large loan, Bear Stearns was in fact insolvent and unable to avoid bankruptcy on March 17. At that point, the Federal Reserve of New York created a limited liability company named Maiden Lane LLC, which acquired many of Bear Stearns assets and received a $30 billion loan from the Federal Reserve along with another $1 billion from JP Morgan Chase.[17]

At the time these events occurred, Bear Stearns was not a commercial bank and the loan extended by the Federal Reserve was unusual. Later in the financial crisis, the Federal Reserve continued to broaden its interpretation of Section 13(3) of the Federal Reserve Act. In addition, all the large securities firms in the United States obtained commercial bank charters and their principal supervision shifted from the Securities and Exchange Commission to the Federal Reserve. This shift also allowed easier access to the discount window through Section 13(3) for these firms.

3.5 AIG 2008

As of 2008, insurance giant AIG had accumulated a large and unmanageable risk exposure, to a large extent through credit default swaps.[18] Confidence in AIG's ability to perform on those commitments was rapidly deteriorating and AIG's credit rating dropped. To maintain its positions, AIG faced a $14.5 billion collateral call that they could not post. To attempt to allay fears of a massive systemic crisis, the Federal Reserve Board and the Treasury instructed the New York Federal Reserve Bank to issue an $85 billion loan to AIG to allow the company to continue to operate.[19] The Federal Reserve justified these moves by arguing that the systemic importance of AIG was too great and by invoking Section 13(3) of the Federal Reserve Act.

Later, former AIG CEO Greenberg brought a suit against the Federal Reserve, charging that AIG was forced to accept unfavorable terms in the deal in return for Federal Reserve

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[16] Federal Reserve "Trading and Capital-Markets Activities Manual" February 1998.

[17] See, e.g., Stephen G. Cecchetti, "Crisis and Responses: The Federal Reserve in the Early Stages of the Financial Crisis," Journal of Economic Perspectives, Winter 2009.

[18] Adam Davidson, "How AIG Fell Apart," Reuters, September 18, 2008.

[19] Matthew Karnitschnig, Deborah Solomon, Liam Pleven, and Jon E. Hilsenrath, "U.S. to Take Over AIG in $85 billion Bailout; Central Banks Inject Cash as Credit Dries Up," Wall Street Journal, September 16, 2008.

support. The suit made its way to the Supreme Court, which ruled against Greenberg. As of this writing, only a small proportion of the funds provided to AIG by Maiden Lane LLC are still outstanding ($1.6 billion of the original total of about $75 billion).

3.6 Commercial paper facility and purchases

During the financial crisis of 2007 and beyond, the Federal Reserve broadened significantly its interpretation of lending powers granted under Section 13(3) of the Federal Reserve Act. Funds were extended to firms that were atypical Federal Reserve borrowers, including non-bank financial firms and non-financial firms. Before the crisis, Federal Reserve lending was extended mainly to commercial banks over which the Federal Reserve had regulatory and supervisory relationships and responsibilities.

In July 2007, before full awareness of the financial crisis was unavoidable, the Federal Reserve extended credit through three traditional facilities that it had employed for decades: open market operations, discount window lending, and securities lending. By December 2008, the number of Federal Reserve facilities available to borrowers had burgeoned to 15, including: single-tranche open market operations program, term discount window program, term auction facility, primary dealer credit facility, transitional credit extensions, reciprocal currency agreements, term securities lending facility, term securities lending facility options program, asset-backed commercial paper money market fund liquidity facility, commercial paper funding facility, money market investing funding facility, and term asset-backed securities loan facility. A summary table containing detailed information about all 15 credit facilities is included in Figure 1. This information was posted on the Federal Reserve Bank of New York web site in December 2008.

In many cases, the Federal Reserve maintained confidentiality regarding the users of the new credit facilities. When the identities of some of these borrowers were subsequently revealed, they were found surprising by many observers familiar with standard Federal Reserve practices. For instance, under provisions of the 2010 Dodd-Frank Act proposed by Senator Bernard Sanders of Vermont, the Federal Reserve disclosed significant credit extensions to, among others, General Electric ($16.1 billion), Harley-Davidson ($2.3 billion), Verizon ($1.5 billion), Mitsubishi ($711 million), and the Korea Development Bank ($2.3 billion).

3.7 Two troubled municipalities

Detroit, Michigan and Jefferson County, Alabama were hit hard by the 2008 crisis. Both suffered from leadership problems, both have been struggling to pay off their debt, and both have filed for bankruptcy. Municipal bankruptcies are not common occurrences and both cities are facing great challenges and are in need of a strong financial plan that will take them to solvency. Detroit is looking into cutting pension payments, while Jefferson County has had to

stop funding many public services. Thus far, the federal government is holding fast to a decision not to provide direct assistance to either Detroit or Jefferson County.

3.8 Lessons from policy practice

From this brief survey of policy practice and more generally from actions by the Federal Reserve and the federal government in past crisis situations, we may glean a few stylized principles about what is feasible and what the federal agencies have been prepared to do. This section presents a summary of those principles.

Exercise flexibility in interpreting statutes and regulations. As noted, the Federal Reserve is subject to various laws and regulations that constrain its actions when faced with a financial crisis. Nevertheless, the Federal Reserve was founded in 1913 precisely to deal with systemic financial problems that threatened the health of the U.S. economy. Since then, statute and regulation have evolved, in part to allow the Federal Reserve greater flexibility to deal with crises. Moreover, in certain episodes of acute perceived risk, the Federal Reserve has shown an inclination to interpret it powers fairly broadly. A clear example was the development of twelve new types of credit facilities in 2008 to deal with the mounting problems that became increasingly clear as the financial crisis and economic recession deepened.

Take actions that are not prohibited, as well as actions that are expressly allowed by law. The Federal Reserve Act guides the behavior of the central bank in various ways. In most cases, the Act specifies what the Federal Reserve must do or what the Federal Reserve is allowed to do. For example, Section 2A compels the Federal Reserve to conduct monetary policy in a manner commensurate with certain economic objectives. In contrast, Section 14 allows the Federal Reserve to conduct certain purchase and sale transactions in the open market, but does not compel it to do so. Occasionally, the Federal Reserve Act prohibits the Federal Reserve from taking certain actions, as the recent amendment to Section 13 that states that the Federal Reserve may not establish certain facilities without prior approval from the Treasury. As a practical matter, no piece of legislation can substantively cover every possible permissible, required, or prohibited action and the Federal Reserve Act, like any law, remains silent with regard to certain actions or behavior. "Nothing compels Congress to act comprehensively when it legislates on a subject. It is not safe to assume that Congress intends to address all ancillary issues directly whenever it acts."[20] In some cases, silence in the law may actually prove as helpful when seeking solutions to a crisis as explicit commands or sanctions. The record shows that this was the case during the recent financial crisis.

Work with Congress to pass legislation that allows federal agencies to act. The basic legal framework that guides the Treasury when it takes action to deal with specific crises is less

[20] Larry M. Eig, op. cit., p. 17.

specific than that of the Federal Reserve, so it tends to rely to a greater extent on legislation explicitly directed at management of specific crises. When dangers arise, the Treasury has collaborated with Congress to design bills that provide the legal capacity it needs to assist various sectors of the economy. Those sectors may be domestic or global, as in the cases of the 2008 financial crisis and the developing country debt crisis of the 1980s.

Act with discretion to reduce delays and to preserve confidentiality. There has been a push over the last few decades to increase the level of transparency of government operations. Advances in information technology have provided the means to accomplish this goal in many areas. The Federal Reserve in particular has injected a much greater level of transparency in monetary policy decisions by developing a much more open approach to communication, especially since the 1990s. Nevertheless, there is still a valid need for confidentiality in some types of activities such as financial supervision by federal and local agencies and discount window lending by the Federal Reserve. This level of discretion has also been applied in Federal Reserve lending to nonfinancial firms, as during the recent financial crisis.

When there's a will there's a way. The case studies of this section have shown that there is no single way of addressing the problems encountered in financial crises and that the existing laws and regulations do not always provide the means to deal effectively with those problems. When the problems are sufficiently serious, the federal government has shown a willingness to try all the means at its disposal, including the use of the current legal framework, perhaps interpreted broadly, going beyond explicit powers when no prohibition exists, and working with Congress to pass new legislation. When the situation warrants it, standard practices are supplemented with ingenuity and improvisation.

4 Possible federal actions with respect to Puerto Rico debt

4.1 General considerations

In light of the foregoing analysis, we come back to the basic question raised by New York Federal Reserve Bank President William Dudley in his offer of help to Puerto Rico, what can the Federal Reserve – and more generally the federal government – do to assist the Commonwealth and the people of Puerto Rico in these trying times? The fact that Puerto Rico is generally designated in Federal Reserve regulation as a state and as part of the Second Federal Reserve District opens the door to certain types of actions that federal authorities may take in the case of domestic financial crises. Moreover, the proven capacity of federal authorities to come to the aid of troubled sectors of the economy in past situations and their ability to work effectively within the legal framework or to change it if necessary should be a source of comfort.

Before identifying possible courses of action, it is helpful to review some general principles for government intervention offered by Terrence Checki, a veteran crisis manager at the Federal Reserve Bank of New York, and Ernest Stern of J.P. Morgan. Before his retirement earlier this year, Mr. Checki was head of the Emerging Markets and International Affairs Group, the chief international troubleshooting unit within the Bank. In an article from the Bank's "Current Issues" series, Checki and Stern argued that the solution to a financial crisis "is neither a single piece of financial engineering nor a compact between the official lenders and the innumerable private creditors. Rather, it is a process incorporating a number of elements."[21] Consider those six elements, how they relate to the case studies of the previous section, and how they might be applied to the case of Puerto Rico.

Break problems down into manageable pieces. Financial crises are never simple. Moreover, the situation is further complicated and dimensions magnified when publicly issued and traded securities are involved. In past crises, federal authorities have employed various specific solutions to well-defined individual problems, such as in the case of the dozen new credit facilities offered by the Federal Reserve in 2008. In the case of Puerto Rico, it may be helpful to examine separately the various types of government debt and to deal separately with issues of credit quality and liquidity.

Articulate the public sector's objectives clearly and transparently. Federal authorities should be clear and transparent regarding their views about the nature and magnitude of the risks in the current financial crisis of Puerto Rico. The Federal Reserve Bank of New York has made an excellent start with its recent studies and with statements by President Dudley, but more information is needed about the level of priority ascribed to the crisis and about specific actions that the Federal Reserve and other agencies are willing to pursue.

Emphasize working with the grain of the situation. The objective of this principle is to find solutions that address the incentives of all economic participants involved. It is important not to think of the situation as a zero sum game, but to realize that Puerto Rico's financial and economic well-being is in the best interests of everyone involved including local communities, bondholders, investors, and taxpayers. Any effective assistance provided could ultimately redound to the benefit of residents of the continental United States as well as Puerto Rico.

Explore creative ways to stretch public sector support. Creativity is one of the major themes that were identified in the case studies of crisis management examined in the previous section. The Federal Reserve and the Treasury have shown initiative and imagination in previous crises,

[21] "Financial Crises in the Emerging Markets: The Roles of the Public and Private Sectors" Federal Reserve Bank of New York Current Issues in Economics and Finance, Nov 2000.

and it is important for them to bring to bear the same tenacity to address the problems of Puerto Rico.

Allow different forms of participation, recognizing that relevant parties' interests may diverge. Puerto Rico government bonds are central to the current financial problems. In looking for solutions, it is important to bear in mind that bondholders are not some homogeneous block of hedge fund managers but include many classes of stakeholders from large institutional investors to small retail investors who depend on coupon payments for their income. Their different perspectives must be aligned by finding common ground in a solution.

Restore and revitalize the IMF's role as guardian of policy and crisis mitigator. This final element proposed by Checki and Stern is dictated by their focus on problems of countries like Mexico and Argentina, and it may seem misdirected in the case of Puerto Rico. In fact, this element highlights one of the major obstacles in finding a solution to the case of Puerto Rico. If Puerto Rico were a sovereign nation, it would have access to the World Bank and the International Monetary Fund and could elicit their financial and planning assistance as many Latin American countries have over the year. However, Puerto Rico is not a nation and neither is it a state, so who within the world order is responsible for providing assistance? It seems that the U.S. federal government has a serious responsibility to address this question and to help find a reasonable solution.

Having reviewed the Checki-Stern general principles, we turn now to specific ideas informed by the present analysis. Two points should be made at the outset. First, there is no claim of originality here. Some, though perhaps not all, of these ideas have been floated in Puerto Rico and the United States for some time. The present contribution is to consider them against the backdrop of the foregoing analysis of statutes, regulations, and policy practice so that perhaps they may be seen in a new light. The second point is that it would be presumptuous to expect that this list is in any way exhaustive, but the intention is to help find a way forward in the discussion of specific solutions to the financial problems of Puerto Rico.

4.2 The Federal Reserve could purchase Puerto Rico debt as a U.S. municipality

Designation of Puerto Rico as a state and as part of the Second Federal Reserve District for the purposes of most Federal Reserve regulations suggests that Puerto Rico may be treated as a municipality for the purposes of Section 14(2) of the Federal Reserve Act. Such treatment would allow the Federal Reserve to purchase Puerto Rico debt obligations with maturity up to six months.[22]

[22] Economist José Antonio Herrero has advocated the purchase of Puerto Rico bonds by the Federal Reserve as part of the "quantitative easing" operations conducted in recent years. See, for example, Wilda Rodríguez,

4.3 The Federal Reserve could purchase Puerto Rico debt as a "foreign country"

Designation of Puerto Rico as a foreign country for the purposes of Federal Reserve Regulation K suggests that Puerto Rico may also be treated as a foreign country for the purposes of Section 14(2) of the Federal Reserve Act. Such treatment would allow the Federal Reserve to purchase Puerto Rico debt obligations with no limitation as to maturity.

Although not the primary focus of this paper, the analysis of section 2.4 above points to an apparent inconsistency in the treatment of Puerto Rico in Federal Reserve regulations. Beyond resolving the issue of Puerto Rico's status in federal regulation for the present purposes, the Federal Reserve may wish to undertake a review of the treatment Puerto Rico generally and to consider developing a more consistent approach.

4.4 Puerto Rico government corporations as "corporations" under section 13(3) of the Federal Reserve Act

The past flexible interpretations of Section 13(3) by the Federal Reserve, especially during the recent financial crisis, suggest that some public corporations in Puerto Rico may be eligible for extension of Federal Reserve credit under the appropriate conditions. Those corporations would include:

- Government Development Bank
- Puerto Rico Electric Power Authority
- Puerto Rico Highways and Transportation Authority.

Such extensions of credit would have to meet the conditions required by law, outlined in section 2.2 above.

4.5 Assistance in planning from Federal Reserve and the Treasury Department

As in various crises examined in section 3 of the present paper, the Federal Reserve and the Treasury could assist the Commonwealth of Puerto Rico in the development of a plan to emerge from the current crisis. In the past, plans of this type have also been accompanied by debt guarantees provided by the federal government, which could have significant positive effects on the pricing and placement of Puerto Rico debt.

The recent formation of a new Office of State and Local Finance at the Treasury Department is an encouraging development. Kent Hiteshew, director of the office, has made

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"Perdidos en el bosque," El Nuevo Día, August 12, 2013.This idea could have a legal basis whether Puerto Rico is considered a U.S. municipality or a foreign country, as alternative Federal Reserve regulations currently do.

constructive public remarks with regard to Puerto Rico and has signaled that the island's problems are being closely monitored.[23]

4.6 Steps may be taken singly or jointly

The ideas listed above, and other ideas that may be brought forward, are generally not mutually exclusive and could be undertaken jointly. Such a strategy would be very consistent with the Checki-Stern approach mentioned earlier, which warns of the improbability of a single big solution and advocates instead looking at specific pieces of the puzzle and applying creativity to the solutions. Examples of joint approaches would be:

- Short-term purchase of debt coupled with a financial plan, perhaps with IMF-like conditions
- A financial plan coupled with debt guarantees.

5 Conclusions

Discussion of the debt crisis in Puerto Rico has been ongoing for years. Substantive progress has been made by the government of Puerto Rico in addressing fiscal imbalances and by the investing public in an attempt to stabilize the situation and forestall further deterioration. The intent of this paper is to contribute to that discussion, but to contribute in a very specific way by providing detailed analysis of the legal and regulatory framework for Puerto Rico and the federal authorities as well as a review of past policy practice to gauge the feasibility of the ideas discussed, at least on a preliminary basis.

The analysis shows that there are various possible ways in which the federal government could assist Puerto Rico, and that in fact it is important that there be various elements to deal with different facets of the problem. These possible solutions should enter the public discussion and should be considered seriously by the local and federal authorities.

Just as important is the need to clarify the situation of Puerto Rico as a Commonwealth in the overall global financial structure and in the internal administrative structure of the United States. The paper has identified some important questions that should be addressed by federal authorities in the search for solutions.

Most importantly, the federal government and its agencies need to demonstrate the same will to find solutions that has been applied in the past to so many cases, domestic and foreign, a sample of which has been considered here. History shows that when the will is there and the situation is deemed sufficiently important, effective solutions have been found either

[23] Kasia Kaimasinska, "Puerto Rico Faces 'Difficult Choices Ahead,' U.S. Treasury Says," Bloomberg News August 4, 2014.

within the existing legal structure or by advancing that structure further to tackle new problems.

Table 1. Geographical coverage under the Federal Reserve and Federal Home Loan Bank Acts

Federal Reserve Act of 1913
"Sec. 2. As soon as practicable, the Secretary of the Treasury, the Secretary of Agriculture and the Comptroller of the Currency, acting as 'The Reserve Bank Organization Committee,' shall designate not less than eight nor more than twelve cities to be known as Federal reserve cities, and shall divide the continental United States, excluding Alaska, into districts, each district to contain only one of such Federal reserve cities. The determination of said organization committee shall not be subject to review except by the Federal Reserve Board when organized: *Provided*, That the districts shall be apportioned with due regard to the convenience and customary course of business and shall not necessarily be coterminous with any State or States. The districts thus created may be readjusted and new districts may from time to time be created by the Federal Reserve Board, not to exceed twelve in all. Such districts shall be known as Federal reserve districts and may be designated by number."
Federal Home Loan Bank Act of 1932
"Sec. 3. As soon as possible the board [Federal Home Loan Bank Board] shall divide the continental United States, Puerto Rico, the Virgin Islands, and the Territories of Alaska and Hawaii into not less than eight nor more than twelve districts. Such districts shall be apportioned with due regard to the convenience and customary course of business of the institutions eligible to and likely to subscribe for stock of a Federal Home Loan Bank to be formed under this Act, but no such district shall contain a fractional part of any State. The districts thus created may be readjusted and new districts may from time to time be created by the board, not to exceed twelve in all. Such districts shall be known as Federal Home Loan Bank districts and may be designated by number. As soon as practicable the board shall establish, in each district, a Federal Home Loan Bank at such city as may be designated by the board. Its title shall include the name of the city at which it is established."

Table 2. Historical Federal Reserve regulations designating Puerto Rico as a State or as part of the Second District

For the purposes of Regulation*	Date of circular	Puerto Rico designated as
F Trust powers of national banks (obs)	7/7/1961	State
G Collection of noncash items (obs)	12/2/1957	Second District
G Collection of noncash items (obs)	2/5/1959	Second District
G Collection of noncash items (obs)	1/23/1961	Second District
G Securities credit by persons other than banks, brokers, or dealers (obs)	7/30/1969	State
J Check clearing and collection (title)	12/2/1957	Second District
J Check clearing and collection (title)	2/5/1959	Second District
J Check clearing and collection (title)	1/23/1961	Second District
J Collection of checks and other items (title)	8/14/1967	Second District, State
J Collection of cash items (title)	7/18/1969	Second District
J Collection of checks and other items (title)	11/24/1970	Second District, State
J Collection of checks and other items (title)	11/4/1971	Second District
K Corporations doing foreign banking or other foreign financing under the Federal Reserve Act (title)	10/7/1963	Foreign
M Foreign branches of national banks (obs)	9/9/1963	Foreign
M Foreign activities of national banks (obs)	4/12/1967	Foreign
T Credit by brokers and dealers	7/30/1969	State
U Credit by banks for the purpose of purchasing or carrying margin stocks	7/30/1969	State
Z Truth in lending	3/19/1969	State

* Information appears in Federal Reserve Bank of New York circular issued on the date listed; "obs" indicates an obsolete regulation that no longer exists, although a different current regulation may be designated by the same letter; "title" indicates that the current title of the regulation is different but that some or all of the same functions remain

Table 3. Current Federal Reserve and federal agency regulations designating Puerto Rico as a State or as part of the Second District

Regulation	12 U.S.C. §	Section heading	Puerto Rico designated as
B	202	Equal credit opportunity act	State
H	208	App. A Capital adequacy guidelines state member banks	State
J	210	Collection of checks and other items, fedwire	Second District, State
K	211	International banking operations	Foreign
M	213	Consumer leasing	State
Y	225	Bank holding companies	State
Z	226	Truth in lending	State
GG	233	Prohibition of funding unlawful internet gambling	State
QQ	243	Resolution plans	State
VV	248	Proprietary trading	State
YY	252	Enhanced prudential standards	State
(OCC)	167	Capital; B Regulatory capital requirements	State
(FDIC)	390	Regulations transferred from the OTS; Z Capital	State
(OTS)	567	Capital; B Regulatory capital requirements	State

Notes: (OCC) regulation issued by the Office of the Comptroller of the Currency, (FDIC) regulation issued by the Federal Deposit Insurance Corporation, (OTS) regulation issued by the Office of Thrift Supervision.

Figure 1. Summary of Federal Reserve Lending Facilities
Source: Federal Reserve Bank of New York

Forms of Federal Reserve Lending to Financial Institutions

	Regular OMOs	Single-Tranche OMO Program (announced March 7, 2008)	Discount Window[1]	Term Discount Window Program (announced August 17, 2007)	Term Auction Facility (announced December 12, 2007)	Primary Dealer Credit Facility (announced March 16, 2008)[2]	Transitional Credit Extensions (announced September 21, 2008)	Reciprocal Currency Arrangements (first announced December 12, 2007)[3]
Who can participate?	Primary dealers	Primary dealers	Depository institutions	Primary credit-eligible depository institutions	Primary credit-eligible depository institutions	Primary dealers	U.S. and London broker-dealer subsidiaries of Goldman Sachs, Morgan Stanley, Merrill Lynch	Select central banks to lend on to banks in their jurisdiction[3]
What are they borrowing?	Funds	Funds	Funds	Funds	Funds	Funds	Funds	U.S. Dollars
What collateral can be pledged?	U.S. Treasuries, agencies, agency MBS[8]	U.S. Treasuries, agencies, agency MBS, but typically agency MBS	Full range of Discount Window collateral	Full range of Discount Window collateral	Full range of Discount Window collateral	Full range of tri-party repo system collateral[9,10]	Full range of Discount Window collateral and tri-party repo system collateral[10]	Central banks pledge foreign currency and lend against eligible collateral in their jurisdiction
Is there a reserve impact?	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
What is the term of loan?	Typically, term is overnight–14 days[12]	28 days[13]	Typically overnight, but up to several weeks[14]	Up to 90 days[15]	28 days or 84 days[13,16]	Overnight	Overnight	Overnight to 3 months
Is prepayment allowed if term is greater than overnight?	No	No	Yes	Yes	No	N/A	N/A	No
Which Reserve Banks conduct operations?	FRBNY	FRBNY	All	All	All	FRBNY	FRBNY	FRBNY
How frequently is the program accessed?	Typically once or more daily	Typically weekly	As requested (standing facility)	As requested (standing facility)	Every other week, or as necessary[16]	As requested (standing facility)	As requested (standing facility)	Typically on schedule with FRBNY TAF auctions or as requested by central banks
Where are statistics reported publicly?	Temporary OMO activity[19]	Temporary OMO activity[19]	H.4.1 - Factors Affecting Reserve Balances[20]	H.4.1 - Factors Affecting Reserve Balances[20]	TAF Activity[19]	H.4.1 - Factors Affecting Reserve Balances[20]	H.4.1 - Factors Affecting Reserve Balances[20]	H.4.1 - Factors Affecting Reserve Balances[20]

	Securities Lending	Term Securities Lending Facility (announced March 11, 2008)[2]	Term Securities Lending Facility Options Program[4] (announced July 30, 2008)	ABCP Money Market Fund Liquidity Facility (announced September 19, 2008)[2]	Commercial Paper Funding Facility (announced October 7, 2008)	Money Market Investing Funding Facility (announced October 21, 2008)	Term Asset-Backed Securities Loan Facility[5] (announced November 25, 2008)
Who can participate?	Primary dealers	Primary dealers	Primary dealers	Despository institutions, bank holding companies, U.S. branches and agencies of foreign banks	Eligible CP issuers[6]	Eligible Money Market Mutual Funds[7]	All U.S. persons that own eligible collateral
What are they borrowing?	U.S. Treasuries	U.S. Treasuries	U.S. Treasuries	Funds	Funds	Funds and subordinated note	Funds
What collateral can be pledged?	U.S. Treasuries	Schedule 1: U.S. Treasuries, agencies, agency MBS Schedule 2: Schedule 1 plus all invesment grade debt securities[9]	Schedule 2 TSLF collateral	First-tier ABCP	Newly issued 3-month unsecured and asset-backed CP from eligible U.S. issuers	U.S. dollar-denominated certificates of deposit, bank notes and commercial paper issued by highly rated financial institutions	Recently originated U.S. dollar-denominated AAA ABS[11]
Is there a reserve impact?	No (loans are bond-for-bond)	No (loans are bond-for-bond)	No (loans are bond-for-bond)	Yes	Yes	Yes	Yes
What is the term of loan?	Overnight	28 days[13]	Typically 2 weeks or less[17]	ABCP maturity date (270-day maximum)	3 months	N/A	At least one year
Is prepayment allowed if term is greater than overnight?	N/A	No	No	No	N/A	N/A	Yes
Which Reserve Banks conduct operations?	FRBNY	FRBNY	FRBNY	FRB Boston	FRBNY	FRBNY	FRBNY
How frequently is the program accessed?	Daily	Schedule 1: Every other week Schedule 2: Weekly	As necessary[18]	As requested (standing facility)	As requested (standing facility)	As requested (standing facility)	Monthly
Where are statistics reported publicly?	Securities lending activity	Term securities lending facility activity[19]	Term securities lending facilty options program activity[19]	H.4.1 - Factors Affecting Reserve Balances[20]	H.4.1 - Factors Affecting Reserve Balances[20]	H.4.1 - Factors Affecting Reserve Balances[20]	TALF activity[19]

[1] Discount Window includes primary, secondary and seasonal credit programs.
[2] The PDCF, TSLF and AMLF will remain in operation through April 30, 2009 as announced on December 2, 2008.
[3] ECB and SNB created December 12, 2007; BOC, BOE, and BOJ created September 18, 2008; RBA, Sveriges Riksbank, DNB, and Norges Bank created September 24, 2008; Reserve Bank of New Zealand created October 28, 2008; Banco Central do Brazil, Banco de Mexico, Bank of Korea, and Monetary Authority of Singapore created October 29, 2008
[4] TOP auctions are sales of options granting the right to enter into TSLF borrowing.
[5] The TALF is expected to go live around February 2009. The Federal Reserve reserves the right to review and make adjustments to these terms and conditions – including size of program, pricing, loan maturity, and asset and borrower eligibility requirements – consistent with the policy objectives of the TALF.
[6] Through the CPFF the FRBNY provides financing to an SPV that purchases eligible three-month unsecured and asset-backed commercial paper from eligible issuers.
[7] Through the MMIFF the FRBNY will provide senior secured funding to a series of private sector SPVs to finance the purchase of certain money market instruments from eligible investors.
[8] Reverse repos are collateralized with U.S. Treasuries.
[9] PDCF and TSLF collateral expanded on September 14, 2008.
[10] Includes non-U.S. dollar denominated securities.
[11] Includes auto loans, student loans, credit card loans, or small business loans guaranteed by the U.S. SBA
[12] Open market operations are authorized for terms of up to 65 business days.
[13] 28-day and 84-day terms may vary slightly to account for maturity dates that fall on Bank holidays.
[14] Primary credit loans are generally overnight. Loans may be granted for term beyond a few weeks to small banks, subject to additional administration.
[15] Maximum maturity of term increased from overnight to 30 days on August 17, 2007, and to 90 days on March 16, 2008.
[16] Foward selling TAF auctions announced on September 29, 2008 will be conducted in November with terms targeted to provide funding over year-end.
[17] Loans are targeted to span potentially stressed financing dates, such as quarter-ends.
[18] TOP auctions may be conducted on multiple dates for a single loan and may be conducted well in advance of a loan period.
[19] Data only available on days when operations are conducted.
[20] Data published on Thursday, as of close of business on Wednesday.