Puerto Rico’s Payday Loans

$33.5 Billion of the Island’s Debt Is Actually Interest on Payday Loans

“The debt is not payable. There is no other option. I would love to have an easier option. This is not politics, this is math.”

–Puerto Rico Governor Alejandro García Padilla, June 2015

As the debt crisis engulfs the island, the people of Puerto Rico are facing a humanitarian crisis caused by a depressed economy, astronomical unemployment and poverty rates, a high cost of living, and austerity measures that have shredded the social safety net. It is important to revisit Governor Alejandro García Padilla’s statement that the Commonwealth’s debt is not payable. It is true that Puerto Rico cannot pay back all of its debt. It is also true the Commonwealth should not pay back all of it. $33.5 billion of the island’s outstanding debt isn’t debt at all, but is unpaid interest on capital appreciation bonds—the municipal version of a payday loan. This predatory debt is not payable.

Municipal Payday Loans

A capital appreciation bond (CAB) is a long-term bond with compounding interest on which the borrower does not make any principal or interest payments for the first several years, and, in some cases, until the final maturity of the bond. In this way, it is similar to a negative amortization mortgage, in which the outstanding principal actually grows over time because the unpaid interest gets tacked on to the amount owed and compounds. Because of this structure, borrowers often end up paying extraordinarily high interest rates over the life of the bonds. In this way, a CAB is like the municipal version of a payday loan.

$33.5 billion of this debt is actually interest—an effective interest rate of 785%

Puerto Rico has $37.8 billion in outstanding CABs, accounting for a very large share of its total outstanding debt (see note at end of document).

The underlying principal on these CABs is just $4.3 billion. The remaining $33.5 billion is interest—an effective interest rate of 785%!

That means that a large portion of Puerto Rico’s outstanding debt isn’t debt at all. It is interest on a series of payday loans. Moreover, because of the way these deals are structured, most of it is interest that hasn’t even accrued yet—in other words, it is future interest on payday loans.
COFINA Bonds

Furthermore, an estimated $36.9 billion of Puerto Rico’s outstanding debt is legally dubious because it belongs to the Puerto Rico Sales Tax Financing Corporation, known popularly by its Spanish acronym, COFINA (see note at end of document). The COFINA structure was created to refinance what was considered at the time to be “extra-constitutional” debt—a term that no one has ever defined but which calls its legality into question.

♦ 63% of Puerto Rico’s total CAB debt belongs to COFINA.
♦ CABs account for $23.9 billion of Puerto Rico’s COFINA debt.
♦ The underlying principal on the COFINA bonds is just $3.3 billion. The remaining $20.6 million is interest—an effective interest rate of 614%!

Payday for Wall Street & Investors

Many of the investors who now own Puerto Rico’s CAB debt, including vulture hedge funds, never expected the island to be able to repay all of it. This is evidenced by the fact that these investors were able to buy the debt at steep discounts on the secondary market because the previous creditors had actually already written it down as bad debt.

♦ Some of Puerto Rico’s CABs are trading for as little as 5 cents on the dollar in the secondary market. That means that bondholders are hoping to make 95 cents in profit for every 5 cents they invest—a 1,900% return on investment!
♦ Based on the latest available trade price as of June 20, 2016, Puerto Rico’s COFINA CABs are trading for 14 cents on the dollar, on average.

This means that many of the investors who own Puerto Rico’s CABs are trying to reap excess profits at the expense of the Puerto Rican people. Not only are they demanding triple-digit interest rates on predatory payday loans, but they also want to be paid for the portion of the debt that has already been written down.

Moreover, the big Wall Street banks that put these predatory payday loans together also collected hundreds of millions in fees, which also got tacked onto Puerto Rico’s total outstanding debt.

♦ On the COFINA CABs alone, banks charged Puerto Rico $221 million in issuance fees.
♦ The largest category of issuance fees are underwriting fees. The lead underwriters on Puerto Rico’s CABs were Citigroup, Goldman Sachs, Lehman Brothers, Merrill Lynch (now owned by Bank of America), Morgan Stanley, Santander, Prudential, and UBS.

Some of Puerto Rico’s bonds are trading for as little as 5 cents on the dollar, giving investors a 1,900% profit

Wall Street banks charged Puerto Rico $221 million in fees for the COFINA CABs
Principles for CAB Restructuring

Puerto Rico is already in the throes of a humanitarian crisis that is likely to get worse before it gets better. Any debt restructuring must put the interests of the Puerto Rican people first and must ensure that creditors are not able to profiteer off the suffering on the island. This is particularly important with respect to the Commonwealth’s CABs, which are inherently instruments of usury and extraction. Puerto Rico’s CABs should be restructured with these principles in mind:

♦ The predatory, 785% interest on the CABs should be canceled. This would reduce Puerto Rico’s outstanding debt by $33.5 billion. This is appropriate because this $33.5 billion represents money that the Commonwealth never actually borrowed from anyone. It is merely investor profit.

♦ Creditors should not receive more than they paid to purchase the CABs. If they bought Puerto Rico’s CABs for 14 cents on the dollar, they should not get more than 14 cents. The Commonwealth cannot afford to give vulture hedge funds a return on their investment if it means closing schools and slashing public health programs during a Zika virus outbreak.

♦ Wall Street banks should be forced to return the fees they charged the island for putting together these payday loans, many of which are potentially illegal. Banks targeted Puerto Rico for these predatory deals, and they should be held accountable.

A Note About Our Numbers

According to Puerto Rico’s Financial Information and Operating Data Report from November 6, 2015, the Commonwealth has $69.9 billion in outstanding debt, of which $15.2 billion belongs to COFINA. However, one of the major obstacles in accurately assessing the Commonwealth’s financial health is that these official figures are not reliable. We used bond-level data from Bloomberg to analyze Puerto Rico’s debt in this document. According to the Bloomberg data, the Commonwealth has $36.9 billion in COFINA bonds, more than double the official number. We strongly urge a complete audit of the Commonwealth’s debt to ensure complete transparency and accountability.

About the Authors

Saqib Bhatti and Carrie Sloan are with the ReFund America Project, which tackles the structural problems in the municipal finance system that cost governments across the United States billions of dollars each year at the expense of public services. They research the role of financial deals in contributing to public budget distress and work with policy experts, community leaders, and public officials to develop, advocate for, and implement solutions to save taxpayer dollars.
Scooping and Tossing Puerto Rico’s Future

Puerto Rico Borrowed $3.2 Billion to Pay Fees & Interest to Banks & Investors

Puerto Rico is embroiled in a dire humanitarian crisis that is being compounded by its unsustainable debt load. Congress passed the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) in June, which will create a Fiscal Control Board to oversee the Commonwealth’s finances. But in order for it to do its job fairly, the Control Board must understand how Puerto Rico came to be so deeply indebted in the first place. The ReFund America Project is releasing a series of reports investigating Puerto Rico’s debt. Our previous report, Puerto Rico’s Payday Loans, can be found on our website, at www.ReFundProject.org. This report focuses on Puerto Rico’s refunding bonds.

When a struggling family hits a bump in the road, sometimes the only way to pay the bills is to take out debt. The family may even have to use one credit card to pay off another, or take out a payday loan to pay the mortgage. Stories of families having to take out new debt to make payments on old debt are all too common. Often lenders prey on borrowers’ vulnerability and charge excessive interest rates or fees on the new debt. This is a form of predatory lending.

Like poor families, financially distressed governments can also be vulnerable to predatory lending. In the case of Puerto Rico, even though its Constitution prohibits the Commonwealth from taking out debt to fill budget gaps, an examination of Puerto Rico’s finances reveals that it has been doing exactly that for the past several years, often issuing new refunding bonds to make payments on previously issued bonds. Refunding bonds and notes are intended to refinance older debt. “Refunding” is the municipal version of refinancing. Using refunding bonds to push current debt payments into the future is known as “scoop and toss” financing, because it allows public officials to “scoop” up debt payments that are due today and “toss” them many years into the future, essentially kicking the can down the road. But this came at a cost to Puerto Rican taxpayers because every time a government borrower issues a bond, it has to pay issuance fees to the financial and legal firms that helped put the deal together.

- We estimate that Wall Street firms like UBS, Citigroup, Goldman Sachs, and Barclays Capital have raked in $1.6 billion in fees on Puerto Rico’s scoop and toss deals since 2000—an amount that has been tacked onto the Commonwealth’s outstanding debt load. The largest portion of these fees, an estimated $323 million, was for scoop and toss deals in which UBS was the lead underwriter.

- Nearly half of the $134 billion in debt that the Commonwealth of Puerto Rico and its public corporations have issued or remarketed since 2000 has been refunding debt. Much of this debt could be considered a form of “loan flipping”, a predatory lending practice in which a bank refines a loan to generate fee income even though it doesn’t provide any net tangible benefit to the borrower.

- A significant number of Puerto Rico’s refunding bonds were issued to make interest payments on other debt. This practice, known as capitalizing interest, turns the interest on older debt into principal and forces taxpayers to pay interest on interest. $1.6 billion that the Commonwealth of Puerto Rico (not including its public corporations) has issued or remarkeated since the economic crisis has been to pay capitalized interest.

- These bad financial deals were enabled or exacerbated by the passage of Public Law 7 in 2009.

*In this report, we use the terms “refunding debt” and “scoop and toss deals” interchangeably because Puerto Rico’s refunding debt was used largely used to reduce or avoid current payments and extend the payoff date into the future.*
Like the $33.5 billion in predatory interest on Puerto Rico’s capital appreciation bonds that we discussed in our previous report, *Puerto Rico’s Payday Loans*, this $3.2 billion in fees and capitalized interest on Puerto Rico’s scoop and toss deals is illegitimate. Wall Street banks and wealthy investors pushed much of this refunding debt onto Puerto Rico to safeguard their own profits. They knew that Puerto Rico’s debt load was unsustainable, but they convinced public officials to borrow even more money to enable them to pay interest and fees. This had the combined effect of extracting billions of dollars out of the island and putting it in the hands of wealthy investors and big banks. *Puerto Rico’s Fiscal Control Board should cancel this $36.7 billion in illegitimate debt.*

Furthermore, the Fiscal Control Board should *fully fund the Commission for the Comprehensive Audit of the Public Credit*, so that it can perform a detailed audit of all of Puerto Rico’s debt and determine how much of it is legitimate. This audit should be made public to ensure transparency and accountability and it should serve as the basis for any restructuring plan the Control Board undertakes to protect the interests of the people of Puerto Rico.

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<tr>
<th>Running Tally of Puerto Rico’s Illegitimate Debt</th>
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<tr>
<td>Illegitimate Debt from Capital Appreciation Bonds</td>
<td>$33.5 billion</td>
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<tr>
<td>Illegitimate Debt from Scoop and Toss Deals</td>
<td>$3.2 billion</td>
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<tr>
<td>Total</td>
<td>$36.7 billion</td>
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**Predatory Refinancing Deals**

Like homeowners who refinance their mortgage when interest rates drop, it can make good economic sense for government borrowers to refund bonds to take advantage of changing economic circumstances. The *Wall Street Journal* notes that for government borrowers, “Refinancings that aim to reduce interest rates typically keep the same maturity schedule.”¹ It is problematic, however, when borrowers refinance so that they can extend the maturity (or payoff) date of the bond, because that means that they are kicking the can down the road to avoid having to make payments that are currently due. Issuing new debt to pay down old debt is known as scoop and toss financing because it allows borrowers to “scoop” up their debt and “toss” it into the future. According to the *Journal*, Puerto Rico is “[a]mong the chief practitioners of scoop and toss.”²

The Commonwealth of Puerto Rico and its public corporations issued or remarketed $134 billion in debt from January 1, 2000 through June 30, 2016 (see note at the end of this document). Nearly half of this debt ($61.5 billion) was in refunding bonds and notes. “Refunding” is the municipal version of refinancing.

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<th>Puerto Rico’s Illegitimate Debt from Scoop and Toss Deals</th>
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<tr>
<td>Issuance Fees on Refunding Bonds of the Commonwealth and Public Corporations</td>
<td>$1.6 billion</td>
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<tr>
<td>Refunding Bonds to Pay Capitalized Interest on Commonwealth Bonds</td>
<td>$1.6 billion</td>
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<tr>
<td><strong>Illegitimate Debt from Scoop and Toss Deals</strong></td>
<td><strong>$3.2 billion</strong></td>
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**This $3.2 billion in fees and capitalized interest on Puerto Rico’s scoop and toss deals is illegitimate.**
Puerto Rico’s bonds are highly desirable to investors because they are “triple tax exempt”, which means the interest that bondholders collect on the bonds is exempt from local, state, and federal taxes. Additionally, Puerto Rico’s Constitution guarantees that bondholders of the general obligation debt of the Commonwealth (but not the public corporations) will be paid before the Commonwealth makes any other expenditure. As Puerto Rico’s financial situation deteriorated, its bonds also started fetching higher interest rates for investors. The tax exemptions, higher rates, and the fact that the general obligation debt is backed by the full faith and credit of the Commonwealth made Puerto Rico’s debt very attractive to investors. Many of the Commonwealth’s bonds were oversubscribed over the years, which meant that investors wanted to buy more bonds than were available. In order to close more deals and collect more fees, Wall Street banks began pitching scoop and toss deals so that they could make money off the same underlying debt multiple times.

Banks peddled refunding schemes that allowed Puerto Rico to pay off old bonds by issuing new bonds, but not in a way that helped reduce long-term indebtedness. Instead, Puerto Rico could keep up with its debt service payments by pushing the payoff of the debt farther into the future. At the same time, this allowed Wall Street banks to keep issuing new debt and collecting massive fees on underwriting services and other issuance costs as they issued the same debt multiple times. Each time, Puerto Rico’s overall debt actually grew because the issuance fees, and in some cases the interest on older bonds (see section on Capitalized Interest) got added onto the bond principal.

In the consumer world, refinancing schemes that do not benefit the borrower are known as “loan flipping” and they are considered a form of predatory lending. According to the National Association of Consumer Advocates (NACA), loan flipping is when:

“A lender ‘flips’ a borrower by refinancing a loan to generate fee income without providing any net tangible benefit to the borrower. Every time a loan is refinanced the consumer has to pay out fees. These fees can amount to thousands of dollars. Flipping can quickly drain borrower equity and increase monthly payments -- sometimes on homes that had previously been owned free of debt.”

This predatory behavior on the part of banks helped crashed the US economy in 2008 and is similar to the scoop and toss deals that banks put together for Puerto Rico. Because of booming investor demand for mortgage-backed securities, Wall Street banks pushed mortgage lenders to sell more and more mortgages to homeowners, including predatory refinancing loans. Banks and lenders were not overly concerned about the borrowers’ ability to repay the loans because they got their profits from the fees they charged for making the loans and packaging them into mortgage-backed securities. Banks took a similar approach with Puerto Rico. They made their profit based on deal volume, so they were happy to refinance the same debt over and over and collect hefty fees as a result.

Public Law 7

A lot of these predatory debt practices were enabled or exacerbated by Public Law 7, the “Special Act to Declare a State of Fiscal Emergency and to Establish a Comprehensive Financial Stabilization Plan to Salvage the Credit of Puerto Rico”, which Puerto Rico passed in 2009 to help address its deteriorating fiscal health in the wake of the economic crisis. Although the law is best known for having led to the mass layoffs of tens of thousands of public sector workers and a sharp cutback in public services, it also had significant ramifications for Puerto Rico’s financial deals by doing away with many of the previous limitations that protected Puerto Rican taxpayers against Wall Street predation.

†This should not be confused with “bond flipping”, which is a different practice.
Prior to the passage of Public Law 7, the Laws of Puerto Rico Annotated (LPRA) prohibited the use of refunding bonds to create new debt. The Commonwealth could only use refunding bonds to refinance the outstanding principal, premium, interest, issuance fees, and other related payments for existing debt, and it was only permitted to do so if it would save money. Furthermore, Puerto Rican law limited issuance fees or refunding bonds to 2% of bond principal.⁵

Public Law 7 did away with these provisions.⁶ Notably, refunding bonds were no longer required to provide savings to the Commonwealth. Furthermore, the law allowed the Commonwealth to issue refunding bonds to make interest payments on other bonds without paying down the principal (see section on Capitalized Interest). Most provisions of Public Law 7 expired in 2011.

**Issuance Fees**

Issuing a bond is a multi-step process that involves several different financial and legal actors, like bond underwriters, municipal advisors, credit rating agencies, bond counsel, and bond insurers, among others.⁷ Each of these actors charges a fee. Collectively, these fees are called the cost of issuance, or issuance fees. Bond underwriting fees make up the largest portion of issuance fees. When a bond is issued, the underwriters buy the entire issuance from government borrowers and then sell the bonds to other investors. The lead underwriter typically buys the largest share and plays a key role in structuring the entire bond deal, often serving as a *de facto* advisor to the borrower.

Issuance fees get added to the principal of the bond, which means that they become a part of the debt itself and must be repaid with interest. On a traditional 30-year, fixed-interest rate bond, the interest is roughly equal to the principal, which means that the true cost of issuance fees can actually double after accounting for interest.

Because of the large volume of bonds issued or remarkedeted by the Commonwealth of Puerto Rico and its public corporations since 2000 ($61.5 billion), it was not feasible for us to calculate the issuance fees for all of Puerto Rico's scoop and toss deals in that time period. Instead, we closely analyzed the issuance fees for the refunding debt of just the Commonwealth itself (not including the public corporations), and used that to estimate the overall total. The Commonwealth accounts for 30% ($18.3 billion) of Puerto Rico's outstanding refunding debt since 2000, making it by far the largest issuer of refunding debt on the island.

**Case Study of Just the Commonwealth’s Refunding Debt**

In our case study of the Commonwealth's refunding bonds and notes, we found:

♦ The Commonwealth of Puerto Rico has paid $405 million in issuance fees on the refunding debt it has taken out since 2000.

♦ Nearly 60% of these issuance fees were for bonds on which Barclays Capital was the lead underwriter. Refunding bonds that Barclays has taken the lead in underwriting have incurred $232 million in issuance fees in just the last five years, since 2011.

♦ The lead underwriters of the Commonwealth's other refunding bonds and notes since 2000 are UBS, Goldman Sachs, Morgan Stanley, Lehman Brothers, and Banco Popular.
Projections About the Total Refunding Debt of the Commonwealth and Its Public Corporations

We estimated the issuance fees for the refunding debt of Puerto Rico’s public corporations based on the figures of the Commonwealth and found that:

- **Together, the Commonwealth and its public corporations have paid $1.6 billion in total issuance fees** for their $61.5 billion in refunding debt since 2000.

- UBS, Citigroup, and Goldman Sachs (and firms they have since acquired) were the lead underwriters on 52% ($31.8 billion) of this debt, which accounts for an estimated $852 million in issuance fees.

- Lead underwriters for other portions of this debt included banks like Barclays, Morgan Stanley, JPMorgan Chase, Santander, and Bank of America, among others.

<table>
<thead>
<tr>
<th>Lead Underwriter</th>
<th>Total Debt</th>
<th>Estimated Issuance Fees‡</th>
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<tbody>
<tr>
<td>UBS</td>
<td>$12.1 billion</td>
<td>$323 million</td>
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<tr>
<td>Citigroup</td>
<td>$11.3 billion</td>
<td>$302 million</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>$8.4 billion</td>
<td>$226 million</td>
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<tr>
<td><strong>Total for Top Three</strong></td>
<td><strong>$31.8 billion</strong></td>
<td><strong>$852 million</strong></td>
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Astronomical Issuance Fees

A 2015 study by the Haas Institute for a Fair and Inclusive Society at UC Berkeley (HIFIS) and the ReFund America Project (RAP) that looked at issuance fees for 812 bond issuances from around the United States found that the weighted average for issuance fees as a percentage of total bond in the sample was 1.02%. That means that on an $100 million bond, the average issuance fees for the sample would have been $1.02 million.

- The weighted average issuance fees for the Commonwealth’s refunding bonds since 2000 was 2.68%, which is 162% higher than the national weighted average based on the HIFIS/RAP study (see note at the end of the document).

- The weighted average issuance fees for refunding bonds with Barclays as the lead underwriter was 3.76%.

- For the Commonwealth’s 2011A Refunding Bonds, for which Barclays was the lead underwriter, Puerto Rico had to pay 9.01% in issuance fees, nearly nine times the national weighted average from the HIFIS/RAP study.

It is interesting to note that these exorbitant issuance fees would not have been possible prior to the passage of Public Law 7. Previously, Puerto Rican law had capped issuance fees at 2%.

Puerto Rico's weak credit rating did not justify such high fees. In 2013 Wall Street Journal study found that banks charged Puerto Rico higher bond underwriting fees than financially troubled cities and states, including Detroit. Underwriting fees are a major component of issuance fees.

The Journal found that between 2006 and 2013, the fees that bond underwriters charged Puerto Rico were, on average, 31% higher than those for Detroit, even though Puerto Rico's general obligation debt was rated higher than Detroit’s at the time.

‡This represents the total cost of issuance for the entire bond issuance. The lead underwriter gets the largest share of these fees, but not all of them. We estimated these fees based on an average cost of issuance of 2.68%, based on our case study of the Commonwealth’s refunding bonds.
Capitalized Interest

Since the economic crisis, Puerto Rico has issued hundreds of millions of dollars in bonds to pay interest on older debt. When a government borrows money to pay interest, that interest becomes capitalized, which means it gets converted to principal. By taking out new debt to pay interest on old, Puerto Rico converted the interest on older bonds into the principal on newer ones. This is problematic for two reasons:

- The principal on a bond is debt that is owed to creditors, whereas the interest is the creditors' profit. By borrowing new money to pay interest on older bonds, Puerto Rico borrowed money to pay profits to its other creditors. It did not borrow to build infrastructure or provide services for residents; it borrowed to pay investor profit and is backing that with the full faith and credit of the Commonwealth in many cases.

- It is like using one credit card to pay the interest on another. Because capitalized interest gets converted to principal, the borrower ends up paying interest on the interest. This drives up borrowing costs and pushes the ultimate payoff of the debt farther into the future while generating fee income for banks.

As with issuance fees, we only analyzed the refunding debt of the Commonwealth itself (not the public corporations) to understand the scope of Puerto Rico’s capitalized interest. We found that:

- **$1.6 billion** of the refunding debt that the Commonwealth has issued or remarketed since the economic crisis has been to pay capitalized interest.

- Just three banks—Morgan Stanley ($992 million), Barclays ($327 million), and UBS ($262 million)—were the lead underwriters on the refunding bonds that account for 98% of this capitalized interest.

By issuing bonds to pay fees and interest, the Commonwealth turned bank and investor profit into debt that it has to pay back with interest.

We did not use these figures to extrapolate capitalized interest for Puerto Rico’s public corporations.

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§Public Law 7, which Puerto Rico passed in 2009, provided the legal authority that allowed Puerto Rico to issue bonds with capitalized interest. Two of the bonds that we identified with capitalized interest were issued in 2008, prior to the passage of Public Law 7. We have not researched the legal authority for those bonds. The remainder of the bonds with capitalized interest that we identified have all been issued since 2009.

**In this report, the term “capitalized interest” is used to describe all new debt that was taken out to pay interest on older debt, including debt used to repay lines of credit that had been used to make payments on interest but not principal on older bonds.**
Principles for Restructuring Scoop and Toss Financing Deals

Puerto Rico is already in the throes of a humanitarian crisis that is likely to get worse before it gets better. Any debt restructuring must put the interests of the Puerto Rican people first and must ensure that banks and creditors are not able to profiteer off the suffering on the island. To achieve this, Puerto Rico’s Fiscal Control Board must draw a distinction between debt that was used to pay for services and capital projects for Puerto Ricans, and debt that was used to pay fees, penalties, and capitalized interest to bankers and bondholders. Puerto Rico’s scoop and toss deals should be restructured with these principles in mind:

♦ The Control Board should cancel the $1.6 billion in debt that Puerto Rico has accrued to pay issuance fees on scoop and toss financing deals and demand that the Wall Street firms that collected those fees return that money to taxpayers.

♦ The Control Board should cancel the $1.6 billion in capitalized interest issued by the Commonwealth since the economic crisis. Interest should not be treated as debt.

♦ The Control Board should fully fund the Commission for the Comprehensive Audit of the Public Credit, so that it can perform a detailed audit of all of Puerto Rico’s debt and determine how much of it is legitimate. This includes assessing the amount of capitalized interest and issuance fees that Puerto Rico’s public corporations are paying on scoop and toss deals.

A Note About Our Numbers

This report focuses on refunding bonds that have been issued or remarkedeted by the Commonwealth of Puerto Rico and its public corporations since 2000. Our figures about the size of bond issuances throughout this report refer to the original principal when the bonds were issued. Because of the number of public corporations and the large volume of their debt, we were unable to closely analyze all of Puerto Rico’s debt. Instead, we focused on the debt of the refunding bonds and notes of the Commonwealth itself as a case study and used that to estimate the total issuance fees for the refunding debt issued or remarketed by the public corporations. We did not similarly estimate the amount of capitalized interest issued by the public corporations because there was no reasonable way for us to make that extrapolation. The Commonwealth accounted for 30% ($18.3 billion) of Puerto Rico’s $61.5 billion in overall refunding debt since 2000.

We relied on the offering statements for the Commonwealth’s refunding bonds and notes to calculate issuance fees. Even though the Commonwealth issued $18.3 billion in refunding debt during the time period we examined, we were only able to obtain offering statements accounting for $15.1 billion in refunding debt. The $405 million in issuance fees we attributed to the Commonwealth’s refunding debt is a conservative estimate because it is derived only from this $15.1 billion in debt for which we were able to obtain data. We did not extrapolate this figure to apply to the full $18.3 billion.

We used bond-level data from Bloomberg and bond offering statements from EMMA to analyze Puerto Rico’s debt in this document. Because of limitations in the data (such as the fact that we were not able to obtain the offering statements for every single bond), we were unable to determine in every case which records were for new bond issuances and which were for remarketings of older bonds. As a result, the aggregate figures about total debt issuance and remarketing may include some double-counting. However, the data on cost of issuance fees, toxic swap penalties, and capitalized interest is accurate and was not affected by those shortcomings in the data.
Because many of the bonds and notes included in this study have been refinanced into newer ones, the Commonwealth is still paying the fees and penalties from that debt even though the original bonds and notes themselves are no longer outstanding. As a result, the figures in this report are not a direct reflection on the official figures about Puerto Rico’s total outstanding debt. Nothing in this report confirms or disputes the claims of the government of Puerto Rico that it had $69.9 billion of outstanding debt as of November 2015. However, it should be noted that in our previous report, *Puerto Rico’s Payday Loans*, we found that data from Bloomberg showed that the Commonwealth had more than twice as much outstanding COFINA debt as the government’s official number. **As such, we strongly urge a complete audit of the Commonwealth’s debt to ensure complete transparency and accountability.**

**About the Authors**

Saqib Bhatti and Carrie Sloan are with the ReFund America Project, which tackles the structural problems in the municipal finance system that cost governments across the United States billions of dollars each year at the expense of public services. They research the role of financial deals in contributing to public budget distress and work with policy experts, community leaders, and public officials to develop, advocate for, and implement solutions to save taxpayer dollars.

**Endnotes**


2 Ibid.


5 13LPRA §141f&h


8 Ibid., 12.


11 Ibid.

12 Puerto Rico’s Financial Information and Operating Data Report from November 6, 2015.
Beware of Bankers Bearing Gifts

Wall Street Sold Puerto Rico Billions in Predatory Loans Disguised as Gifts

Puerto Rico is embroiled in a dire humanitarian crisis that is being compounded by its unsustainable debt load. Congress passed the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) in June 2016, which created a Fiscal Control Board to oversee the Commonwealth’s finances. But in order for it to do its job fairly, the Control Board must understand how Puerto Rico came to be so deeply indebted in the first place. The ReFund America Project is releasing a series of reports investigating Puerto Rico’s debt. Our previous reports can be found on our website, at refundproject.org/#puerto-rico.

Just like Wall Street banks caused the foreclosure crisis in the United States by targeting homeowners with predatory loans, they similarly played a critical role in causing Puerto Rico’s debt crisis by targeting the Commonwealth with predatory municipal loans. They pushed Puerto Rico into increasingly complex financing structures involving variable-rate bonds, auction rate securities, and toxic interest rate swaps. These deals were highly risky and eventually ended up costing taxpayers millions of dollars in excess fees and interest—a direct transfer of wealth from Puerto Rico to Wall Street. Now the people of Puerto Rico are being asked to bear unconscionable cuts and harsh austerity measures to guarantee the bankers and investors their profits.

In many cases, the bankers that marketed these deals to public officials likely broke federal securities law by misrepresenting how volatile these financial instruments truly were, and the Commonwealth may have legal recourse to recover its losses from the banks. Puerto Rico’s Fiscal Control Board should aggressively pursue all legal options to hold banks accountable and recover the millions the banks have drained out of the island. Furthermore, the Control Board should reinstate and fully fund the Commission for the Comprehensive Audit of the Public Credit (Puerto Rico’s Debt Audit Commission) so that it can determine how much of the island’s debt was predatory and therefore illegitimate.

Key Findings

♦ **Predatory Lending by Another Name:** As Puerto Rico’s financial health deteriorated, banks targeted it with more and more complex debt deals that generated millions in fee income for Wall Street, at the expense of Puerto Rican taxpayers.

♦ **Risky Business:** Starting in the early 2000s, banks convinced Puerto Rico to refinance a lot of its debt into new variable-rate structures to take advantage of historically low interest rates.

  ◊ 52% of the refunding bonds that the Commonwealth issued or remarkeat from 2002 through 2008 had variable interest rates, compared with just 11% in the seven-year period before that (1995-2001).

  ◊ Wall Street banks aggressively pushed borrowers toward risky variable-rate debt so that they could sell them expensive add-on products to manage the heightened risk and collect millions in fees. However, these products had risks of their own, which in many cases cost taxpayers hundreds of millions of dollars down the road.

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Toxic Swaps: As Puerto Rico became increasingly reliant on variable-rate debt, it entered into interest rate swaps with banks in order to limit its exposure to fluctuating interest rates, but these deals backfired after the 2008 financial crash.

- The Commonwealth and Puerto Rican agencies were forced to pay at least $780 million in termination penalties to get out of their costly toxic swap deals.
- Puerto Rico was forced to issue new bonds to pay many of these penalties and, in several cases, the banks that underwrote these bonds were the very same ones to whom Puerto Rico had to pay swap penalties. This means they got to collect swap penalties and underwriter fees from the same transactions.

Failed Auctions: Puerto Rico took out hundreds of millions of dollars in debt using auction rate securities (ARS), which is a type of variable-rate bond. However, when the ARS market froze in 2008, triggering penalty interest rates on the debt, Puerto Rico had to unwind $634 million in outstanding ARS debt.

- In order to unwind the debt, the Commonwealth had to either convert or refinance the ARS into different debt structures that required even more add-on products, like standby purchase agreements and letters of credit.
- The underwriters who sold these deals to Puerto Rico, which include firms like Goldman Sachs, Morgan Stanley, UBS, and Lehman Brothers, misrepresented how risky ARS were and likely broke federal securities law. Many municipal borrowers have successfully taken legal action in connection with ARS and recovered their losses.

Anatomy of a Deal: The example of the 2004 B Series Public Improvement Refunding Bonds provides a cautionary tale of how variable-rate debt structures can become overly complex and drain millions out of public coffers.

- The $448 million of variable-rate debt and associated fees and interest payments stemming from the 2004 B bonds had to be refunded at least six times over the next eight years into at least nine different series of bonds.
- The issuance fees for the new bonds that contained portions of the 2004 B debt added up to more than $56 million.
- The Commonwealth had to pay another $69 million in termination penalties for the toxic swaps that were connected to the 2004 B bonds.
- This $125 million in combined fees and penalties does not include fees that were not publicly disclosed.

Puerto Rico’s Gift Receipts: Banks like Goldman Sachs and Wachovia (now owned by Wells Fargo) that sold these risky variable-rate deals to Puerto Rico by painting them as gifts that would save the island money likely broke federal securities law. Puerto Rico should take the following steps to recover its losses from these predatory deals:

- Petition the Securities and Exchange Commission to bring disgorgement actions against the banks that misled public officials about how risky these deals were;
- Reinstate and fully fund the Debt Audit Commission so that it can calculate the true cost of these deals and determine which of them were predatory and therefore illegitimate; and
- Refuse to pay any debts deemed illegitimate by the Debt Audit Commission.
Predatory Lending by Another Name

There are striking parallels between Puerto Rico’s debt crisis and the foreclosure crisis in the United States. Just as Wall Street banks fueled the housing bubble by encouraging mortgage lenders to make more and more loans to homeowners, they also inflated Puerto Rico’s debt bubble by selling more and more debt to the island.

Often marketed as a lifeline that could save governments money, these complex deals were no gifts... They were predatory loans.

Because mortgage lenders immediately sold the loans they originated to big Wall Street banks, they were not concerned with borrowers’ ability to pay them back. Neither were the banks who bought the loans, because they packaged these loans into mortgage-backed securities and sold them again to investors in the secondary market. Banks and lenders cared first and foremost about the fees they could charge for doing the deals, packaging them, and selling them. Consequently they targeted communities of color and low-income families with loans that were overpriced, highly risky, and that they knew the borrowers would not be able to pay back. In other words, they sold these families predatory mortgages.¹

They did the same thing to Puerto Rico. As Puerto Rico’s financial health deteriorated, banks targeted it with more and more complex debt deals that generated millions in fee income for Wall Street. Often marketed as a lifeline that could save governments money, these complex financing deals were no gifts. They were overpriced, highly risky, and structured in a way that would protect the banks even if the Commonwealth were unable to pay the bondholders. They were predatory loans, designed to enrich Wall Street while draining millions out of Puerto Rico.

Risky Business

Starting in the early 2000s, banks started aggressively pushing variable-rate bonds to municipal borrowers like Puerto Rico. Variable-rate bonds are similar to adjustable-rate mortgages. Because borrowers’ interest rates can fluctuate based on market conditions, they can allow borrowers to take advantage of lower interest rates on the front end, but expose them to the risk of rising rates in the future. Conventional fixed-rate bonds, on the other hand, allow borrowers to lock in interest rates in advance.

Banks marketed variable-rate debt to Puerto Rico and other borrowers as a way to save money, even though these bonds were much riskier than conventional bonds. Wall Street encouraged the move toward variable-rate debt because banks could sell borrowers add-on products to manage this additional risk, like interest rate swaps and credit enhancements. Banks collect millions in fees for these add-ons. In fact, the fees can be so high that they sometimes eat up all or most of the cost savings that the variable-rate debt structures were supposed to provide in the first place. Instead, the interest payments that would have gone to bondholders get redirected in the form of fees to the banks that provide these add-on products.

Just like homeowners can refinance their mortgages to lower their monthly payments, municipal borrowers can issue refunding bonds to save money on debt service. The Federal Reserve slashed interest rates following the Dotcom Crash in 2001 to help revive the economy.² Over the next several years, the Commonwealth of Puerto Rico refinanced its debt to take advantage of these low rates by issuing variable-rate refunding bonds. According to data from Bloomberg, 52% of the refunding bonds that the Commonwealth issued or remarketed from 2002 through 2008 had variable interest rates, compared with just 11% in the seven-year period before that (1995-2001). Nearly all of Puerto Rico’s bonds that were refunded into variable-rate structures from 2002...
through 2008 had originally been fixed-rate bonds (the market for new variable-rate debt mostly dried up in 2008 in light of the financial crisis). This means that the Commonwealth refinanced safer fixed-rate bonds with riskier variable-rate bonds in order to save money.

Products like interest rate swaps and credit enhancements were supposed to help Puerto Rico mitigate this added risk, but they actually came with risks of their own. When deals like Puerto Rico’s toxic swaps backfired in light of the financial crisis in 2008, in many cases they actually wiped out all of the modest savings that banks had promised the complex variable-rate structures would provide.

**Toxic Swaps**

Perhaps the costliest add-on products that Wall Street sold to Puerto Rico were toxic interest rate swaps, which cost taxpayers more than $780 million. As Puerto Rico became increasingly reliant on variable-rate debt, it started entering into interest rate swaps with banks in order to limit its exposure to fluctuating interest rates.

Interest rate swaps are a type of derivative instrument that banks pitch to municipal borrowers as a way to protect against rising interest rates on variable-rate bonds. Banks sold these complicated, risky deals to governments by convincing them they would help them save money on borrowing costs. However, these deals were laden with a whole host of risks. Perhaps the biggest risk was posed by the egregious termination clauses embedded in the swap agreements. Because these clauses are typically triggered when borrowers fall under financial distress, they serve to compound financial woes by hitting governments with stiff penalties when they can least afford them.³

Puerto Rico’s swaps backfired in the wake of the financial crisis in 2008. In 2013, the *Wall Street Journal* reported that the Commonwealth of Puerto Rico and other Puerto Rican agencies had paid at least $690 million in swap termination penalties.⁴ Subsequently, in fiscal year 2014, the Commonwealth paid another $90 million in toxic swap penalties, bringing the total to a whopping $780 million.⁵

This is not money that banks had ever lent to Puerto Rico. Swap termination penalties are based on the net present value of all future payments over the remaining life of the deals, which can often extend for more than 25 years. This $780 million represented future bank profit. The only reason that the penalties were so high was because when Wall Street had crashed the economy in 2008, the Federal Reserve was forced to slash interest rates in order to get the economy going again, which had caused the net present value of future payments to balloon. In other words, banks got to profiteer off the crisis that they had caused, and Puerto Ricans got left with a $780 million bill.

Puerto Rico was forced to issue new bonds to pay these toxic swap penalties. By doing this, the island turned these payments into new debt, which now has to be paid back with interest. At least $319 million of the refunding bonds that the Commonwealth of Puerto Rico issued from 2008 through 2014 went toward paying toxic swap penalties.

In many cases, the banks that underwrote this new debt were the very same banks that were demanding swap penalties from the Commonwealth. Banks like Barclays, Morgan Stanley, JPMorgan Chase, Bank of America, Bank of New York Mellon, Santander, Oriental Financial, Goldman Sachs, UBS, and the Royal Bank of Canada were on both sides of these deals. They underwrote bonds that were used in part to pay toxic swap penalties to themselves. This means they got to collect swap penalties and underwriter fees from the same transactions.
What Is an Interest Rate Swap?

An interest rate swap is a type of financial derivative that is intended to protect borrowers of variable-rate debt against rising interest rates. Municipal borrowers typically entered into interest rate swaps concurrently with the issuance of variable-rate debt. When governments and other public entities issued variable-rate bonds to borrow large sums of money, banks offered them a deal. The banks said that if the governments would pay them a steady, fixed interest rate, then the banks would pay them back a variable rate that could be used to pay the bondholders. Banks sold these swaps as insurance policies that would give borrowers a “synthetic” fixed rate that would let them lock in lower interest rates without having to worry about those rates shooting up in the future.

Structure of a Variable-Rate Bond with an Interest Rate Swap

The diagram above shows the structure of a synthetic fixed-rate deal, which includes an interest rate swap. The government's payments on the variable-rate bond are on the right side, and the swap is on the left side. The idea is that the variable rate that the bank pays the government on the swap should approximate the variable rate that the government pays the bondholders, which means the two should effectively cancel each other out. As a result, the government’s only actual payment should be the fixed rate it pays to the bank on the swap.

However, these deals actually turned out to be more of a gamble than an insurance policy. If variable rates fell really low, then the banks could take millions of dollars from the government entities. That is exactly what happened when the banks crashed the economy in 2008 and the Federal Reserve slashed interest rates in response. Not only did the net payments on the swaps rise as variable interest rates plummeted, but many municipal borrowers were unable to take advantage of the low interest rate environment to refinance because they could not get out of their 30- or 40-year interest rate swaps without paying harsh termination penalties.

Furthermore, the sharp decline in variable interest rates actually caused the termination penalties on these deals to balloon, because the penalties are based on the net present value of all future payments on the deals. Because the low variable rates caused government entities' net swap payments to go up, as interest rates dropped, the net present value of the future payments that governments had to make to banks rose in tandem. So at precisely the time that it would have been most advantageous for municipal borrowers to refinance their bonds, the penalties to get out of the corresponding swap deals were higher than ever before. In essence, the swaps trapped public entities into deals that became immensely profitable for the banks at taxpayers’ expense.
Puerto Rico relied heavily on one particular type of variable-rate debt: auction rate securities. Auction rate securities (ARS) are a type of variable-rate bond whose interest rate is set at regularly scheduled auctions. The market for ARS froze in the spring of 2008, which triggered double-digit penalty interest rates on the debt. Municipal borrowers like the Commonwealth had to restructure this debt to avoid paying millions in unexpected interest. Puerto Rico had to unwind $634 million in outstanding ARS debt. It did so by either converting or refinancing its ARS into different debt structures that required even more add-on products like standby purchase agreements and letters of credit. As a result, Puerto Rico had to pay millions in additional fees to various financial actors for services like underwriting and remarketing bonds and providing credit enhancements.

The problems within the ARS market were not simply a matter of bad luck. The underwriters that sold ARS to municipal borrowers misrepresented how risky these deals were to make them seem more attractive. For example, they overstated bondholder demand for ARS. In reality, banks had been systematically propping up the ARS market by buying bonds during auctions themselves in order to create a market for these products so that they could keep underwriting them. However, as the banks' own health started to deteriorate in 2008, they stopped submitting bids at the auctions, freezing up the market. The underwriters that misrepresented how risky these deals were likely broke federal securities law. Many municipal borrowers have successfully taken legal action and recovered their losses stemming from ARS deals. The lead underwriters on Puerto Rico's ARS included banks like Goldman Sachs, Morgan Stanley, UBS, and Lehman Brothers. These are the Wall Street firms that targeted Puerto Rico with these predatory loans.

**What Are Auction Rate Securities?**

Auction rate securities (ARS) are a type of variable-rate bond whose interest rates typically reset on a regular interval. At the end of every reset period, bondholders who want to sell their ARS may auction them off. At the auctions, potential investors bid the lowest interest rate they are willing to accept for the bond. The interest rate therefore resets at every auction. Banks collect exorbitant fees for conducting these auctions.

However, if no investors submit bids at an auction, then the municipal borrowers that issued the debt could be forced to pay double-digit penalty interest rates to the bondholders that are unable to sell. That is precisely what happened in 2008 during the financial crisis. Furthermore, because ARS are often linked to interest rate swaps, the collapse of the ARS market in 2008 caused related swaps to go haywire, triggering termination penalties in many cases.
Anatomy of a Deal

The saga of the 2004 Public Improvement Refunding Bonds serves as an illustrative example of how banks were able to make more and more money as Puerto Rico’s debt got more and more complex. The Commonwealth of Puerto Rico issued $727 million in refunding bonds in 2004 to refinance a series of older fixed-rate bonds dating as far back as 1999. The bond was split into two series: the 2004 A series, which consisted of $279 million in conventional fixed-rate bonds, and the 2004 B series, which consisted of $448 million in variable-rate auction rate securities.

Over the next eight years, all of the variable-rate debt in the 2004 B series was eventually refinanced into fixed-rate debt. However, that journey took it through the hands of numerous bankers, and each one squeezed money out of Puerto Rican taxpayers. Parts of that debt (which itself had refunded several older bonds that were issued from 1999 through 2004) and its associated interest and fees were refunded at least six times, with the 2008 B bonds, 2009 A and C bonds, the 2011 A, B, D, and E bonds, and finally the 2012 A and B bonds (see Appendix for details). The Commonwealth paid more than $56 million in issuance fees for these bonds. Additionally, Puerto Rico paid bond insurers, remarketing agents, auction agents, credit enhancement providers, and other financial and legal firms at every twist and turn.

Moreover, because this was variable-rate debt, the Commonwealth had also taken out interest rate swaps to protect against spikes in interest rates. As these toxic swaps were gradually unwound from 2008 through 2012, Puerto Rican taxpayers had to pay $69 million in termination penalties on just the swaps that trace back to this one bond deal. This $125 million in fees and swap penalties is all money that came out of the pockets of Puerto Ricans and went straight to Wall Street. None of it represents the principal or interest on any money that the Commonwealth ever borrowed. Instead, it was pure profit for the banks, and money that the banks were able to collect because they had convinced public officials to use a variable-rate debt structure for the 2004 B series bonds. Moreover, this estimate is very conservative because it does not include the fees that have not been publicly disclosed.

Finally, it is important to remember that these are only the fees and penalties that trace back to this one particular bond deal. In total, the Commonwealth and other Puerto Rican agencies have paid approximately $780 million in toxic swap penalties, in addition to the annual swap payments they made prior to termination. We do not even know how many millions they have poured into other fees related to variable-rate debt because that data is not publicly available. Even though banks held these variable-rate debt structures out to be gifts that could help struggling public officials reduce their debt payments, each of these gifts was actually a Pandora’s Box.

Puerto Rico’s Gift Receipts

Banks pushed Puerto Rico into increasingly complex variable-rate debt structures because this allowed them to sell add-on products and milk more money out of Puerto Rican taxpayers. However, banks like Goldman Sachs and Wachovia (which is now owned by Wells Fargo) that marketed these deals to Puerto Rico misrepresented how risky they were. They emphasized the potential savings and downplayed the risks. They did not mention that the toxic swaps they were
selling to the Commonwealth that locked Puerto Ricans into the deals for up to 25 years would have been radically off-market in the private sector, where corporate interest rate swaps typically last no longer than five to seven years because most corporations do not want to assume the risk of the exorbitant termination fees that can accompany swaps with longer terms. They failed to disclose the fact that they themselves were creating artificial demand for auction rate securities by propping up the market. In short, the banks engaged in predatory sales tactics.

The federal “fair dealing” rule prohibits financial institutions from misrepresenting or omitting “facts, risks, potential benefits, or other material information” when doing business with municipal borrowers like Puerto Rico.\textsuperscript{12} It was standard industry practice for bond underwriters that pitched variable-rate debt deals to violate this rule.

Borrowers like Puerto Rico have recourse against these predatory deals. A full audit of Puerto Rico’s debt is necessary to determine how much of it is predatory and therefore illegitimate. This is precisely the wrong time for Governor Ricardo Rosselló to dismantle the Commission for the Comprehensive Audit of the Public Credit (Puerto Rico’s Debt Audit Commission). He should reinstate the commission and allow it to do its job. We recommend the following steps for recovering Puerto Rico’s money from predatory debt deals:

- **Puerto Rico’s Fiscal Control Board should petition the Securities and Exchange Commission (SEC) to bring a disgorgement action against the banks to make them return their ill-gotten gains** from variable-rate debt deals where they misrepresented the risks. The SEC has already taken similar action on behalf of bondholders who were harmed by banks that misled them about variable-rate municipal finance deals. The Control Board should request that the SEC similarly take action to make Puerto Rican taxpayers whole.

- **Governor Rosselló should reinstate the Debt Audit Commission and ensure that it is fully funded** so that it can perform a detailed audit of all of Puerto Rico’s debt, calculate the true cost of these variable-rate deals, and determine how much of Puerto Rico’s outstanding debt is predatory and therefore illegitimate.

- **The Control Board should cancel any debt deemed illegitimate by the Debt Audit Commission**, so that Puerto Rico’s scarce funds can go toward mitigating the humanitarian crisis that is unfolding on the island and improving the lives of the people of Puerto Rico.

**About the Authors**

Saqib Bhatti and Carrie Sloan are with the ReFund America Project, which tackles the structural problems in the municipal finance system that cost governments across the United States billions of dollars each year at the expense of public services. They research the role of financial deals in contributing to public budget distress and work with policy experts, community leaders, and public officials to develop, advocate for, and implement solutions to save taxpayer dollars.
APPENDIX: The Twists and Turns of the
2004 Public Improvement Refunding Bonds

Overview of the Original Bonds. The Commonwealth of Puerto Rico issued $727 million in refunding bonds in 2004 to refinance a series of older fixed-rate bonds dating as far back as 1999. The bond was split into two series: the 2004 A series, which consisted of $279 million in conventional fixed-rate bonds, and the 2004 B series, which consisted of $448 million in variable-rate auction rate securities. The 2004 B series was further subdivided into eight subseries. Lehman Brothers was the lead underwriter for 2004 B1-B4 subseries, and Goldman Sachs was the lead underwriter for the 2004 B5-B8 subseries.

Fees on the 2004 A and B Series Bonds. The total issuance fees for the 2004 A and B series bonds came to $24 million, or 3.27% of bond principal. That was an extraordinarily high rate. A 2015 study by the Haas Institute for a Fair and Inclusive Society at UC Berkeley (HIFIS) and the ReFund America Project (RAP) that looked at issuance fees for 812 bond issuances from around the United States found that the weighted average for issuance fees as a percentage of total bond principal in the sample was 1.02%.

The fees paid by Puerto Rico for the 2004 bonds were more than three times higher.

All of the 2004 bonds had to be insured, so the Commonwealth had to pay fees to bond insurers for both the A and B series. Puerto Rico hired Goldman Sachs as the remarketing agent for the 2004 A series and Bank of New York Mellon as the auction agent for the 2004 B series. These banks also got to collect additional fees from Puerto Rico that are not reflected in the issuance fees.

♦ Issuance Fees: $24 million

The 2004 A and B Swaps. Because the 2004B series bonds had variable rates, Puerto Rico also had to enter into interest rate swaps to protect against the risk of rising interest rates. It took out swaps with Goldman Sachs and Lehman Brothers. These swaps later became an albatross around the Commonwealth's neck. Following the financial crash in 2008, the payments on these swap deals shot up to $12 million a year. As Puerto Rico slowly unwound these toxic swaps, it eventually paid an estimated $69 million in termination penalties, above and beyond its annual payments on these deals.

Because the swap counterparties were the same banks that were also the lead underwriters for the bonds, this presents a potential conflict of interest. The lead underwriters on any given bond deal are the architects of the entire deal and serve as de facto advisers to the borrower. When the lead underwriter steers a borrower toward a more complex debt structure that requires the borrower to buy add-on products and then the same bank ends up providing those products, it is important to ask whether that structure was really in the borrower's best interest. In this case, Goldman Sachs, one of the lead underwriters, was the remarketing agent for the 2004 A series and the swap counterparty for the 2004 B series. The other lead underwriter, Lehman Brothers, was also a swap counterparty.

The Aftermath of 2008's Failed Auctions. After the ARS market collapsed in 2008, the Commonwealth was forced to restructure its 2004 B bonds. The 2004 B1-B4 subseries had a provision that allowed the Commonwealth to convert the bonds from ARS to another form of variable-rate debt, so it exercised that option. This was accomplished by remarketing the bonds, and remarketing agents played the role that underwriters play in a traditional bond issuance. For the 2004 B1-B4 conversion, Wachovia (now owned by Wells Fargo) and Lehman Brothers were chosen as the new remarketing agents. The related swaps were transferred to other banks after the collapse of Lehman Brothers in September 2008. Under the terms of the new debt, the Commonwealth was also forced to enter into a standby purchase agreement, which is a form of credit enhancement, with Dexia, a European financial firm.

Unlike the 2004 B1-B4 subseries, the 2004 B5-B8 subseries bonds did not contain any provisions allowing them to be converted. Instead the Commonwealth was forced to issue new variable-rate bonds to refund the original ARS. This refunding was accomplished through the 2008 B series, which refinanced several different bonds. The 2008 B series consisted of variable-rate bonds and was issued alongside the 2008 A series, which consisted of
fixed-rate bonds. The lead underwriters on the joint-issuance were UBS, Lehman Brothers, and Wachovia, and the issuance fees were an estimated $12 million.

As part of this deal, Puerto Rico terminated the two swaps that were associated with the 2004 B6 subseries bonds and paid approximately $10 million in termination penalties, which got rolled into the principal of the new bond. The other swaps, which were held by Goldman Sachs, were left in place. Wachovia was also selected as the remarketing agent for the 2008 bonds and it provided the Commonwealth with a letter of credit (a form of credit enhancement). Once again, one of the lead underwriters was able to sell additional products to Puerto Rico because of the way the deal was structured, posing questions about potential conflicts of interest.

- **Issuance Fees**: $12 million
- **Toxic Swap Penalties**: $10 million

### The 2009 B and C Series Bonds

In 2009, the Commonwealth issued the 2009 B and 2009 C series bonds, which had a fixed interest rate. These bonds were issued in part to make $7.6 million in interest payments on the 2004 B1-B4 bonds. This means that the interest on the 2004 B1-B4 bonds was capitalized and turned into the principal of another set of bonds. Puerto Ricans will now have to pay interest on the interest, as they pay back the 2009 B and C bonds. Morgan Stanley and JPMorgan Chase were the lead underwriters on the 2009 bonds, and the issuance fees for the deals were $5 million.

- **Issuance Fees**: $5 million

### The 2011 Refinancing Deals

When Puerto Rico issued the 2011 A series bonds, it used part of the $357 million in proceeds to refinance the 2004 B4 subseries into a fixed rate. In doing that, the Commonwealth paid an estimated $11 million in termination penalties on the related swap. The cost of the swap penalty was rolled into the bond, which means that Puerto Rico borrowed the money to pay the bank. Barclays and the Jefferies Company were the lead underwriters for the 2011 A bonds, and the issuance fees were $8 million.

In March 2011, the Commonwealth also refunded 2008 B series bonds with the 2011 B series variable-rate bonds, which were purchased directly by an institutional investor. Four months later, the 2011 B series was refunded with the 2011 D and 2011 E series fixed-rate bonds. The swaps that Puerto Rico had taken out with Goldman Sachs that had originally been linked to the 2004 B5, B7, and B8 subseries had been passed down to the 2011 B series. When the Commonwealth refunded that bond with fixed-rate debt, it also terminated those swaps and paid $30 million in termination penalties to Goldman Sachs, using the proceeds from the new bonds to make the payment. Goldman Sachs was actually one of the underwriters of the new 2011 D and E series, which means that Puerto Rico in effect borrowed money from Goldman Sachs in order to pay swap penalties to the very same bank. The lead underwriters for the 2011 D and E series bonds were JPMorgan Chase and Barclays, and the Commonwealth paid $3 million in issuance fees.

- **Issuance Fees**: $11 million
- **Toxic Swap Penalties**: $41 million

### The 2012 Bonds

Finally, in 2012, Puerto Rico refunded the 2004 B1-B3 bonds with the 2012 A and B series fixed-rate bonds. The Commonwealth paid $19 million to terminate the related swaps out of the proceeds of the new bonds. The lead underwriters for the 2012 bonds were Barclays, JPMorgan Chase, and UBS. The issuance fees for the 2012 B series bonds were an estimated $4 million. The standalone cost of issuance for the 2012 A series bonds is not broken out in the bonds’ offering statements.

- **Issuance Fees**: More than $4 million
- **Toxic Swap Penalties**: $19 million
Conclusion. All of the variable-rate debt in the 2004 B series was eventually refinanced into fixed-rate debt. However, that journey took it through the hands of numerous bankers, and each one squeezed money out of the Commonwealth, costing Puerto Rican taxpayers hundreds of millions of dollars in excess fees and interest. All told, the Commonwealth paid more than $56 million in issuance fees on bonds that contained portions of the principal, interest, and fees from the original 2004 A and B series bonds. Puerto Rican taxpayers also had to pay $69 million in toxic swap termination penalties. This was in addition to Puerto Rico’s annual payments on the swap deals, which topped out at an estimated $12 million a year. Finally, the Commonwealth had to pay undisclosed millions in remarketing fees, auction fees, credit enhancement fees, and other expenses in connection with the 2004 B bonds’ variable-rate structure.

♦ Total Issuance Fees for Related Bonds: More than $56 million
♦ Total Toxic Swap Penalties: $69 million

A Note About Our Sources

In researching this report, we reviewed the offering statements of the variable-rate bonds issued and remarketed by the Commonwealth of Puerto Rico from 2002 through 2014, the Commonwealth’s comprehensive annual financial reports from 2008 through 2012, and its basic financial statements for 2013 and 2014. Together, these documents show the history of the Commonwealth’s individual bond issuances, and name the financial firms involved in each deal. Our figures for issuance fees and swap termination penalties in this report are also based on these documents.

Endnotes

1 From Foreclosure to Re-Redlining. California Reinvestment Coalition. 2010. 11-12.
5 Basic Financial Statements and Required Supplementary Information for the Commonwealth of Puerto Rico for Fiscal Year Ended June 30, 2014. Puerto Rico Department of the Treasury. 2014. 43
8 Gillers, Heather. “Some have recouped millions from risky type of debt that plagues CPS.” Chicago Tribune. 26 Dec 2014.
10 Gillers, Heather. “Some have recouped millions from risky type of debt that plagues CPS.” Chicago Tribune. 26 Dec 2014.
Puerto Rico is embroiled in a dire humanitarian crisis that is being compounded by its unsustainable debt load. Congress passed the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) in June 2016, which created a Fiscal Control Board to oversee the Commonwealth’s finances. But in order for it to do its job fairly, the Control Board must understand how Puerto Rico came to be so deeply indebted in the first place. The ReFund America Project is releasing a series of reports investigating Puerto Rico’s debt. Our previous reports can be found on our website, at refundproject.org/#puerto-rico.

Wells Fargo played a critical role in pushing Puerto Rico to take on unsustainable levels of debt, contributing to the financial crisis that engulfs the island today. Wells Fargo and Wachovia (which Wells Fargo acquired in 2008) targeted the Commonwealth with predatory payday loans that have left Puerto Rico billions of dollars in the hole.

Wells Fargo and Wachovia were one of the underwriters on seven different issuances of capital appreciation bonds to Puerto Rico. A capital appreciation bond (CAB) is a long-term bond with compounding interest on which the borrower does not make any principal or interest payments for the first several years, and, in some cases, until the final maturity of the bond. As a result, the outstanding principal actually grows over time because the unpaid interest gets tacked on to the amount owed, and then the borrower has to pay interest on the interest. Because of this structure, borrowers often end up paying extraordinarily high interest rates over the life of the bonds. In this way, a CAB is like the municipal version of a payday loan.

Wells Fargo and Wachovia helped underwrite seven issuances of these payday loans to Puerto Rico, which have an outstanding balance of $21.5 billion. However the underlying principal on these bonds is just $2.6 billion. The remaining $18.9 billion is interest—an effective interest rate of 734%!

### Capital Appreciation Bonds that Wells Fargo & Wachovia Helped Underwrite

<table>
<thead>
<tr>
<th>Bond</th>
<th>Initial Principal</th>
<th>Total Interest</th>
<th>Effective Interest Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011A COFINA Bonds</td>
<td>$380 million</td>
<td>$3.5 billion</td>
<td>913%</td>
</tr>
<tr>
<td>2011C COFINA Bonds</td>
<td>$102 million</td>
<td>$434 million</td>
<td>427%</td>
</tr>
<tr>
<td>2010A COFINA Bonds</td>
<td>$130 million</td>
<td>$535 million</td>
<td>412%</td>
</tr>
<tr>
<td>2010C COFINA Bonds</td>
<td>$98 million</td>
<td>$517 million</td>
<td>529%</td>
</tr>
<tr>
<td>2009B COFINA Bonds</td>
<td>$54 million</td>
<td>$291 million</td>
<td>543%</td>
</tr>
<tr>
<td>2007A COFINA Bonds</td>
<td>$1.7 billion</td>
<td>$13.2 billion</td>
<td>793%</td>
</tr>
<tr>
<td>2007B COFINA Bonds</td>
<td>$147 million</td>
<td>$450 million</td>
<td>306%</td>
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<tr>
<td>Total</td>
<td>$2.6 billion</td>
<td>$18.9 billion</td>
<td>734%</td>
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Each of these CABs is legally dubious because it was issued by the Puerto Rico Sales Tax Financing Corporation, known popularly by its Spanish acronym, COFINA. The COFINA structure was created to refinance what was considered at the time to be “extra-constitutional” debt—a term that no one has ever defined but which calls its legality into question.

This is illegitimate debt that Wells Fargo and other banks sold to Puerto Rico. In fact, most of it is not even debt. 88% of it is interest! **Puerto Ricans should not be forced to pay for these payday loans. Furthermore, Wells Fargo should pay back the fees it charged Puerto Rico for these predatory deals.**

**A Note About Our Numbers**

We used bond-level data from Bloomberg to analyze Puerto Rico’s debt in this document. However, there are significant inconsistencies in the data from Bloomberg and the official debt numbers being put forth by the Puerto Rican government. For example, in November 2015, the Commonwealth reported only $15.2 billion in total COFINA debt in its Financial Information and Operating Data Report. However, according to the Bloomberg data, the Commonwealth has $36.9 billion in COFINA bonds—more than double the official number. We strongly urge a complete audit of the Commonwealth’s debt to ensure complete transparency and accountability.

**About the Authors**

**Saqib Bhatti** and **Carrie Sloan** are with the **ReFund America Project** (RAP) of the **Action Center on Race & the Economy** (ACRE). RAP tackles the structural problems in the municipal finance system that cost governments across the United States billions of dollars each year at the expense of public services. ACRE also helps lead the **Forgo Wells** Coalition, which seeks to hold Wells Fargo accountable for its predatory and racist business practices that harm communities around the globe. Bhatti and Sloan research the role of financial deals in contributing to public budget distress and work with policy experts, community leaders, and public officials to develop, advocate for, and implement solutions to save taxpayer dollars.