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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 remarketed 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]

Wall Street sold Puerto Rico toxic swaps that cost taxpayers more than $780 million.

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.

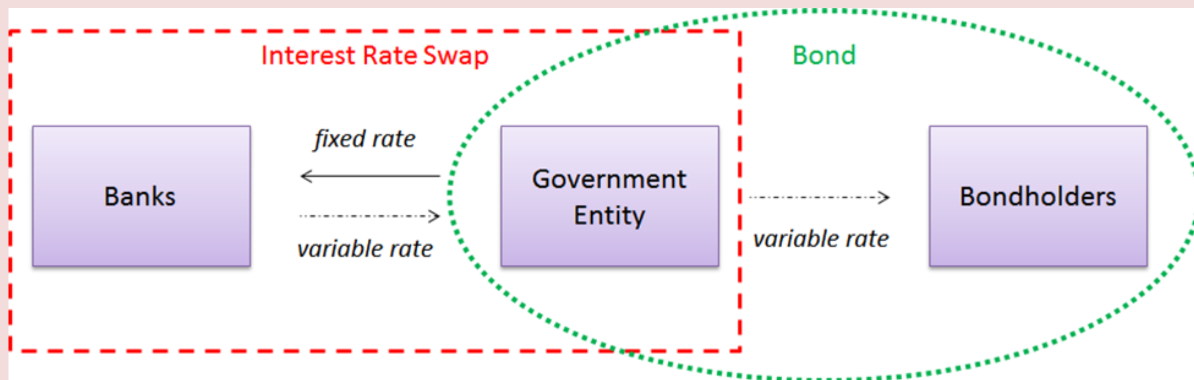
Puerto Rico was forced to issue new bonds to pay these toxic swap penalties. By doing this, the island turned these payments into new debt, which now has to be paid back with interest. At least $319 million of the refunding bonds that the Commonwealth of Puerto Rico issued from 2008 through 2014 went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

Failed Auctions

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.[6] 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.[7] 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.[8] 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.[9]

The underwriters that misrepresented how risky these deals were likely broke federal securities law.

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.[10] 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.[11]

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.

Parts of the 2004 B bonds and its associated interest and fees were refunded at least six times.

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.

That journey took it through the hands of numerous bankers, and each one squeezed money out of Puerto Rican taxpayers.

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.[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 mispresented 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%.[13] 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 a 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.

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