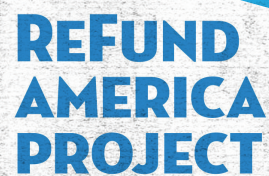


BROKEN PROMISES

**PROMESA is a Model for
Undermining Democracy and Pushing
Austerity Elsewhere in the U.S.**

SAQIB BHATTI AND CARRIE SLOAN



HEDGE CLIPPERS

BROKEN PROMISES


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 and Action Center on Race and the Economy have completed a yearlong investigation of Puerto Rico's debt. The other reports in this series can be found at acrecampaigns.org/puertorico.



HEDGECLIPPERS

The two biggest debt crises in the history of the United States have occurred over the past four years, in Detroit and Puerto Rico. What is starting to emerge is a pattern in which bankers, hedge fund managers, and other Wall Street investors intentionally prey on communities with predatory debt deals to increase their profits, and when those deals sour, right-wing politicians use that as an excuse to undermine local democracy and enact painful austerity measures that protect creditors while throwing communities under the bus. The Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), which the U.S. Congress passed in June 2016, is a potential blueprint for how this model, which was developed at the municipal level in Detroit, could be applied to states in the U.S. in the future.

People who want to see an outcome other than Wall Street's vision will need to organize against this model, and expose both the financial mechanisms that banks use to entrap government borrowers across the country into toxic debt deals that are designed to fail, and the political machinations that turn over control of local governments to ethically compromised fiscal control boards and emergency managers who are primed to put the interests of Wall Street ahead of Main Street. By ensuring that the PROMESA experiment backfires on those who have intentionally exploited Puerto Rico's hardship, it will be possible to stop them from making similar attempts to seize political power through debt elsewhere in the future.



By ensuring that the PROMESA experiment backfires on those who have intentionally exploited Puerto Rico's hardship, it will be possible to stop them from making similar attempts to seize political power through debt elsewhere in the future.


Instead of empowering unelected and unaccountable control boards and managers to implement harsh austerity measures that force working families—and communities of color in particular—to bear the costs of resolving debt crises, policymakers at every level of government should hold accountable the financial predators who have taken advantage of and profited off of these crises and force them to pay to fix what they broke.

This includes:

- ▶ Auditing debt to determine what portion is illegal or illegitimate;
- ▶ Taking legal action to invalidate all illegal debt;
- ▶ Refusing to pay excessive fees and interest on predatory deals;
- ▶ Clawing back fees from predatory lenders;
- ▶ Refusing to reward vulture capitalists with excessive profit;
- ▶ Rejecting unfair restructuring agreements;
- ▶ Starting from the premise that basic human rights are more important than bondholder rights; and
- ▶ Addressing the structural issues that led to Puerto Rico's debt crisis, including an over-reliance on corporate tax incentives.

HOUSE OF CARDS

Puerto Rico is trapped under a mountain of debt that it cannot possibly pay back, leading former Governor Alejandro García Padilla to say in June 2015, “The debt is not payable... This is not politics, this is math.”¹ Puerto Rico’s per capita debt burden of \$15,637 is more than 10 times higher than that of the average state (\$1,419) and nearly three times higher than that of the highest state (\$5,491).² However, it is important to note that Connecticut, the state with the highest debt per capita, is also the fifth richest state in the country by median household income.³ Puerto Rico, on the other hand, is poorer than any state in the U.S. In fact, its median household income of \$18,626 is less than half that of the poorest state (Mississippi, with \$40,593).⁴ This means that the burden for paying back the highest amount of debt per capita falls on some of the poorest people in the country.



The banks that underwrote Puerto Rico’s bonds did not merely enable its borrowing spree; in many cases they targeted the Commonwealth with unsustainable levels of debt that they knew it would not be able to pay back, in order to pad their profits.

To frame this situation simply as a matter of financial mismanagement and reckless borrowing on the part of Puerto Rico is highly misleading. Puerto Rico did not come to take on record levels of debt on its own. With every bond it issued, there was a set of banks that was willing to underwrite each bond and a set of investors willing to buy each bond, knowing full well Puerto Rico’s financial situation. They knowingly built a house of cards.

The banks that underwrote Puerto Rico’s bonds did not merely enable its borrowing spree; in many cases they targeted the Commonwealth with unsustainable levels of debt that they knew it would not be able to pay back, in order to pad their profits. Puerto Rico’s bonds were 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.⁵

Wall Street banks saw an opportunity in this. They met high investor demand by selling Puerto Rico exotic and predatory financial instruments like capital appreciation bonds, scoop and toss deals, toxic swaps, and auction rate securities. This allowed banks like Santander, Wells Fargo, Goldman Sachs, and JPMorgan Chase to close more deals and collect more fees, while making Puerto Rico’s debt portfolio significantly riskier and costlier.

CAPITAL APPRECIATION BONDS

A large portion of Puerto Rico's debt isn't debt at all; it is unpaid interest on capital appreciation bonds—the municipal version of a payday loan. We discussed this issue in depth in our June 2016 report, *Puerto Rico's 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. As a result, 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 triple-digit interest rates over the life of the bonds. In this way, a CAB is like the municipal version of a payday loan.

Puerto Rico has \$37.8 billion in outstanding CABs, but the underlying principal on these bonds is just \$4.3 billion. The remaining \$33.5 billion is interest—an effective interest rate of 785%! 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.

Moreover, nearly two-thirds of Puerto Rico's CAB debt (\$23.9 billion) belongs to 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. That means that in addition to being usurious, the portion of the CAB debt held by COFINA may also be illegal. In total, \$36.9 billion of Puerto Rico's overall debt is held by COFINA and therefore legally dubious.

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.⁶ That means that bondholders are hoping to make 95 cents in profit for every 5 cents they invest—a 1,900% return on investment!

As of June 20, 2016 (when we wrote *Puerto Rico's Payday Loans*), Puerto Rico's COFINA CABs were trading on the secondary market 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.

SCOOP AND TOSS DEALS

“Scoop and toss” financing is the practice of issuing new bonds to refinance older ones in order to push current debt payments into the future. It is so called because this allows public officials to “scoop” up debt payments that are due today and “toss” them many years into the future.* Our comprehensive analysis of Puerto Rico’s scoop and toss deals can be found in our August 2016 report, *Scooping and Tossing Puerto Rico’s Future*. 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. This came at a cost to Puerto Rican taxpayers, who had to pay issuance fees to financial and legal firms every time their public officials entered into another scoop and toss deal.

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.

Furthermore, 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 remarketed since the economic crisis has been to pay capitalized interest.

While there are many financially sound reasons one may refinance debt, in the mortgage lending 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.⁷


Many of Puerto Rico’s scoop and toss deals fell into this category. Instead of helping Puerto Rico reduce its long-term indebtedness, they were structured in a way that simply pushed payments into the future and, in some cases, actually increased overall indebtedness as issuance fees and capitalized interest got tacked onto the outstanding principal.

Finally, Puerto Rico’s scoop and toss deals also raise constitutional issues. The Constitution of Puerto Rico does not allow the Commonwealth to issue loans for more than 30 years. In many cases, Puerto Rico used scoop and toss deals to extend the debt past the 30-year mark, refinancing it repeatedly in order to put off payments. This may potentially have run afoul of the Puerto Rican Constitution, and the resulting debt may therefore be unconstitutional.

VARIABLE-RATE DEBT, TOXIC SWAPS, AND AUCTION RATE SECURITIES

Adjustable-rate mortgages (ARMs) were key culprits of the foreclosure crisis in the United States. Banks and mortgage lenders convinced families to enter into ARMs with the promise of a lower interest rate on the front end, even though there was risk of significantly higher interest rates and balloon payments in the future. Similarly, 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. More than half 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). These variable-rate bonds proved problematic, and the issues that

arose from them are covered more extensively in our February 2017 report, *Beware of Bankers Bearing Gifts*.



Add-ons that were supposed to mitigate risk often came with risks of their own. When those risks materialized in the aftermath of the financial crisis in 2008, they ended up costing taxpayers millions of dollars in excess fees and interest. That's a direct transfer of wealth from Puerto Rico to Wall Street.

As with ARMs, there was always the risk with variable-rate bonds that interest rates could shoot up in the future. Because this was not a risk that most government borrowers wanted to take on, banks developed add-on products to help them mitigate this and other related risks. These add-ons were very expensive. Given a choice between fixed-rate bonds and variable-rate bonds, Wall Street banks started aggressively pushing government borrowers like Puerto Rico toward the riskier variable-rate debt so that they could sell them these expensive add-ons and collect millions more in fees. In some cases, the money that borrowers saved in interest from lower variable rates was completely offset by the higher fees they paid for add-on products like toxic interest rate swaps and letters of credit.

However, add-ons like interest rate swaps that were supposed to mitigate risk often came with risks of their own, and when those risks materialized in the aftermath of the financial crisis in 2008, they ended up costing taxpayers millions of dollars in excess fees and interest—a direct transfer of wealth from Puerto Rico to Wall Street. 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 new bonds were the very same ones to whom Puerto Rico had to pay swap penalties. This means that those banks got to collect swap penalties and underwriter fees from the same transactions.

Furthermore, much of Puerto Rico's variable-rate debt was in the form of auction rate securities (ARS), which is a type of variable-rate bond in which the variable interest rate is determined at regularly scheduled auctions. The ARS market froze in 2008, triggering penalty interest rates on the debt and forcing Puerto Rico 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 pitched these variable-rate debt deals to Puerto Rico, which include firms like Goldman Sachs, Morgan Stanley, UBS, and Lehman Brothers, misrepresented how risky these deals were and likely broke federal securities law. Many municipal borrowers have successfully taken legal action and recovered their losses.

SCANDAL

Because a large portion of Puerto Rico's debt is illegal, predatory, or otherwise illegitimate, public officials should take steps to get some or all of that illegitimate debt invalidated in order to maximize the funds that can be put toward public services for residents. Instead, their actions thus far suggest they are more interested in ensuring investors get paid than protecting the interests of the people of Puerto Rico.

A peculiar mystery of Puerto Rico's debt crisis is that no one knows how much debt the island actually has, and it is even less clear how much of it is legitimate. For example, according to Puerto Rico's Financial Information and Operating Data Report from November 6, 2015, Puerto Rico had \$69.9 billion in outstanding debt, of which \$15.2 billion belonged to COFINA. However, the bond-level data from Bloomberg that we used to analyze Puerto Rico's debt in our reports over the past year show that Puerto Rico has \$36.9 billion in outstanding COFINA bonds, more than double the official number. There are similar inconsistencies in other portions of Puerto Rico's debt numbers as well.

Moreover, regardless of the amount, the COFINA debt itself is a bit of a puzzle because it is considered "extra-constitutional" and no court has ever ruled on its validity.⁸ This is hardly the only constitutional issue arising from Puerto Rico's debt. Puerto Rico's Commission for the Comprehensive Audit of the Public Credit, or Audit Commission for short, released a Pre-audit Survey Report in June 2016 in which it identified several other constitutional issues that could affect the validity of a significant portion of Puerto Rico's debt, including:

- ▶ Whether the Commonwealth's use of debt to finance deficit spending violated the Constitution's balanced budget requirement;
- ▶ Whether Puerto Rico violated its constitutional debt limit by spending more than 15% of its internal revenues on debt; and
- ▶ Whether the Commonwealth's use of scoop and toss deals to extend debt past 30 years violated the constitutional prohibition against taking out any debt with a term longer than 30 years.⁹

All of these issues point to one clear solution: Puerto Rico's debt must be audited to determine how much debt it has and what portion of it is legal and valid. For one, the Commonwealth cannot come up with a sound debt restructuring plan unless it knows the total amount of the debt. But more importantly, Puerto Rico should demand that any illegitimate debt be canceled as part of debt restructuring. The people of Puerto Rico should not have to endure cuts to essential public services to pay illegitimate debt. However, Governor Ricardo Rosselló has dismantled, defunded, and repealed the Audit Commission that was charged with carrying out an audit of Puerto Rico's debt.¹⁰

The dismantling of the Audit Commission is not the only action that Governor Rosselló has taken that puts the interests of creditors ahead of that of the Puerto Rican people. In April 2017, his administration doubled down on a deal to restructure the debt of the Puerto Rico Electric

Power Authority (PREPA) in a way that is overly generous to bondholders but will likely result in skyrocketing rate increases for residents. In late 2015, then Governor Alejandro García Padilla's administration oversaw a debt restructuring agreement for PREPA that allowed investors to collect 85% of the face value of the debt, even if they had bought the debt on the secondary market for less than that and even if the legal validity of the debt was in doubt. This would have allowed many investors to make a profit under the 2015 restructuring agreement.

Meanwhile, to guarantee that PREPA had enough money to make these lavish payouts to bondholders, the 2015 restructuring agreement put in place a feature called "rate securitization", which allowed PREPA to automatically raise electric rates on customers in order to pay bondholders. As a result, as usage decreases because people are leaving the island or are having their power turned off because they cannot afford to pay their electric bills, the customers who remain will see automatic rate hikes to make sure that bondholders get paid.



Puerto Rico's debt must be audited to determine how much debt it has and what portion of it is legal and valid. Puerto Rico should demand that any illegitimate debt be canceled as part of debt restructuring. The people of Puerto Rico should not have to endure cuts to essential public services to pay illegitimate debt.


Rather than reject the disastrous 2015 restructuring agreement to get a better deal for PREPA ratepayers, Governor Rosselló largely affirmed it in April 2017. With minor tweaks to the original RSA, PREPA's new deal was also terrible for residents and businesses on the island. Even though, according to Roselló's own budget plan, Puerto Ricans cannot afford to pay more than about 25% of Puerto Rico's existing public debt, the revised RSA rewarded PREPA's creditors with an effective repayment rate close to 90%.¹¹ In late June, however, the Fiscal Control Board rejected the 2017 RSA in a 4-3 vote, opening the possibility for a restructuring deal that is more just and sustainable for Puerto Rico and Puerto Ricans.¹²

In June 2016, Congress passed the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) to help Puerto Rico address its debt crisis. Among other things, PROMESA created a seven-member Fiscal Control Board (known locally as "La Junta") to oversee the island's finances. Two of the seven members of the board are

former executives with Santander who held top positions in the bank while it sold predatory debt deals to Puerto Rico. They are now charged with making decisions about whether to cut services or play hardball with investors, including investors in bonds that their former bank helped underwrite on their watch. This creates the potential for a major conflict of interest that could prove highly detrimental to the people of Puerto Rico.

HOW TO GET AWAY WITH MURDER

What is happening in Puerto Rico is not happening in a vacuum. The Puerto Rican debt crisis follows closely in the footsteps of the Detroit bankruptcy, and the precedents from both Detroit and Puerto Rico will likely become the blueprint for how public officials and Wall Street can use debt crises to undermine local democracy, push forth harsh and unpopular austerity measures, and ultimately displace people of color from the communities they have lived in for generations. Using debt to dictate public policy is not new. In developing countries, the International Monetary Fund (IMF) and World Bank have long required financially distressed governments to enact painful cuts in order to obtain financing. During New York City's fiscal crisis in the 1970s, banks refused to continue extending credit to the city and then forced harsh austerity measures.¹³ Detroit and Puerto Rico are the latest test cases for what this model can look like in the United States.



In both Detroit and Puerto Rico, local communities of color have been scapegoated as irresponsible deadbeats living beyond their means and this has been used as an excuse to justify dismantling local democracy and taking decision making power out of the hands of local residents.

Both Detroit and Puerto Rico faced structural issues that they did not have the legal authority to address themselves, which put them into an economic tailspin. While Detroit's economic crisis was originally rooted in the decline of the U.S. auto industry amid trends of globalization and deindustrialization, which caused the city to hemorrhage 60% of its population, the debt crisis that led to the city's bankruptcy in 2013 was triggered by a set of actions undertaken by the State of Michigan in the aftermath of the 2008 financial crisis to cut state revenue sharing with the city and limit its ability to raise taxes at the local level. This was a political intervention that predictably tipped the city into crisis.¹⁴ Governor Rick Snyder was elected alongside sweeping Republican majorities in both houses of the Michigan Legislature in the Tea Party wave of 2010, and the state set out to weaken the overwhelmingly African-American, Democratic base in the City of Detroit.

Similarly, the structural roots of Puerto Rico's economic crisis trace all the way back to 1898, when the island became a colony of the U.S. Since then, it has been subject to laws enacted by the federal government in Washington, DC, which Puerto Ricans have practically no say in electing. * For example, the Jones Act, a federal law passed in 1917, requires all imports to Puerto Rico to come on American ships that were built in the United States and have an American crew, driving up costs and choking the economy.¹⁵ Puerto Rico's inability to determine its own economic policy or access financing from international organizations like the IMF have left it vulnerable to predatory Wall Street schemes.

In both Detroit and Puerto Rico, local communities of color have been scapegoated as irresponsible deadbeats living beyond their means and this has been used as an excuse to justify dismantling local democracy and taking decision making power out of the hands of local residents. In Detroit, an emergency manager was installed by the governor who could override the elected city council and rule by decree.¹⁶ The person chosen for that task, Kevyn Orr, was a lawyer who had previously worked at Jones Day, a law firm that represents Bank of America and other Wall Street banks that had been involved with selling Detroit predatory financial deals.¹⁷

* Residents of Puerto Rico can vote in the Presidential primaries, but not the general election, and their only representation in Congress is by a non-voting member of the House of Representatives.

In Puerto Rico, the federal government has appointed a fiscal control board that will run Puerto Rico indefinitely. Two of the seven members of the Puerto Rico's Control Board are former executives of Santander, one of the banks that had sold predatory financial deals to the island. In both cases, decision making power was usurped from local elected officials and handed over to unelected and unaccountable emergency managers and fiscal control board members with ties to Wall Street.

In both places, the emergency management regime was put in place to oversee a restructuring of the debt, in Detroit through bankruptcy under Chapter 9 of the U.S. Bankruptcy Code and in Puerto Rico under Title III of PROMESA. In both cases, the emergency manager and control board have chosen to protect the interests of creditors by instituting painful austerity measures that elected officials might have had a hard time enacting because of broad popular opposition. Just as Puerto Rico's Fiscal Control Board has thus far refused to challenge the validity of any of the Commonwealth's debt despite obvious legal issues, so too did Detroit's Emergency Manager have to be pressured by the federal bankruptcy judge to challenge the legality of the debt underlying Detroit's toxic swap deals.¹⁸ In that case, the judge's intervention ultimately saved the city hundreds of millions of dollars that would have otherwise been given to banks for predatory deals.¹⁹ Similarly, the judge in Puerto Rico's bankruptcy case can push the Fiscal Control Board to challenge the legality of the debt.

THE RULING

And finally, in Detroit we have seen the post-bankruptcy period marked with a period of gentrification that has displaced large swaths of the African-American community that has lived there for decades and replaced them with wealthier white people.²⁰ Puerto Rico appears to be headed in a similar direction, with a planeload of Puerto Ricans leaving the island every day because the economic conditions have made it impossible for them to remain there between the lack of good jobs, the high cost of living, and the cuts to public services like education, healthcare, and public utilities. Meanwhile, Puerto Rico has been offering tax incentives to entice stateside billionaires to move there. Hedge fund manager John Paulson, who has bought more than a billion dollars in real estate on the island, has even said that the island has "the potential to become the Singapore of the Caribbean".²¹

Prior to the Detroit bankruptcy in 2013, municipal bankruptcy within the United States was seen primarily as a way for governments to get debt relief so that they could maintain public services at a level needed to spur economic recovery and get the municipality back on its feet in the long run. It was believed that bankruptcy gave public officials the leverage they needed to force creditors to take haircuts, so that the city could get back to its core purpose of serving residents. Detroit created a different kind of precedent, with federal bankruptcy law being used as a way to get around state constitutional protections for city workers' and retirees' pensions and for the state to wrest control of city assets like the Detroit Water and Sewerage System and Belle Isle Park away from the people of Detroit. Governor Snyder appeared to be more interested in forcing workers and retirees to take haircuts than creditors.

Since then, municipal bankruptcy has been invoked in cities across the country by public officials looking to get out of union contracts and constitutionally protected pensions as part of an austerity regime. Perhaps the city most often cited as "the next Detroit" is Chicago, where both the city and the school district are under severe financial distress, and both have had their credit ratings downgraded to junk.²² They are mentioned as candidates for bankruptcy even though Illinois state law does not actually permit municipalities to file bankruptcy. Chapter 9 of the U.S. Bankruptcy Code allows municipalities to file bankruptcy, but only with state authorization. Like about half of all states,

Illinois does not currently permit municipal bankruptcy (the only exception is for the Illinois Power Agency, which is allowed to file bankruptcy).²³

Like Governor Snyder in Michigan, Illinois Governor Bruce Rauner—who made his millions managing a private equity firm before seeking political office—is pushing policies that would specifically exacerbate the financial distress of both the City of Chicago and Chicago Public Schools (CPS).²⁴ Meanwhile, he has supported changing state law to allow municipal bankruptcy in order to abrogate union contracts and pensions.²⁵ He even proposed a state emergency management panel that would run CPS prior to a bankruptcy filing.²⁶ In other words, he is trying to apply the Detroit formula to Chicago.

Similarly, the restructuring of Puerto Rico’s debt could become the model for a modified version of bankruptcy at the state level. The U.S. Bankruptcy Code does not permit states or territories like Puerto Rico to file for bankruptcy. That is partly why Congress had to create a process for restructuring Puerto Rico’s debt through PROMESA. Title III of the law creates a bankruptcy-like process for restructuring the Commonwealth’s debt.

Just as Chicago is often cited in the press as “the next Detroit”, Illinois is often mentioned as “the next Puerto Rico”. The state went two years without a budget, with a backlog of billions in unpaid bills. Republican Governor Rauner refused to sign a budget unless the Democratic-controlled General Assembly passed his anti-union “Turnaround Agenda”, which state Democrats refused to do, causing the budget stalemate. In July 2017, Illinois produced a budget just in time to avoid a credit rating downgrade to junk, but the state could still be downgraded, and its financial problems are far from over. Right-wing politicians have been openly discussing the possibility of state level bankruptcy since at least the aftermath of the Great Recession, but the political will for it has not previously existed. However, it is conceivable that the current neoliberal Republican Congress might act on a request from Governor Rauner or another right-wing governor of a financially troubled state for a PROMESA-like bill that would allow distressed states like Illinois to restructure their debt following the Puerto Rico blueprint.

BREAKING BAD

If the political right is hoping Puerto Rico will be the next model for how to undermine local democracy, push austerity, and displace local communities of color, then it is imperative to flip the script and instead make it a model of how to effectively resist Wall Street's austerity agenda. We recommend the following steps for restructuring Puerto Rico's debt in a way that puts the interests of local communities first:

AUDIT THE DEBT. The government of Puerto Rico and its Fiscal Control Board should reinstate and fully fund the Audit Commission so that it can perform a detailed audit of all of Puerto Rico's debt and determine how much of the debt is valid and how much is illegal or otherwise illegitimate.

TAKE LEGAL ACTION TO INVALIDATE ALL ILLEGAL DEBT. The people of Puerto Rico should not have to endure painful cuts to pay illegal debt. The Fiscal Control Board should take legal action to have illegal debt canceled.

REFUSE TO PAY EXCESSIVE FEES AND INTEREST ON PREDATORY DEALS. Puerto Rico should not have to pay 785% interest on payday loans or billions of dollars in fees and capitalized interest on scoop and toss deals. Banks targeted the Commonwealth with predatory loans. These deals are illegitimate. The Fiscal Control Board should refuse to pay them, and instead prioritize that money for services.

CLAW BACK FEES FROM PREDATORY LENDERS. The banks that sold Puerto Rico predatory loans should be forced to refund their fees.


REFUSE TO REWARD VULTURE CAPITALISTS WITH EXCESSIVE PROFIT. In a crisis situation like Puerto Rico's, creditors who bought bonds in the secondary market for pennies on the dollar should not be able to collect more than they paid for the debt. In other words, if a bondholder bought a bond for 14 cents on the dollar, the Fiscal Control Board should refuse to pay them back more than 14 cents on the dollar.

START FROM THE PREMISE THAT THE BASIC HUMAN RIGHTS OF THE PUERTO RICAN PEOPLE ARE MORE IMPORTANT THAN BONDHOLDER RIGHTS. Puerto Ricans should not have to endure a humanitarian crisis to pay \$33.5 billion in interest to bondholders. No law allows creditors to kill people, which is what they will be doing if Puerto Rico has to shutter hospitals to make bond payments. The Fiscal Control Board should consider the human impacts of its actions in any decision it makes going forward.

ADDRESS THE STRUCTURAL ISSUES THAT BROUGHT PUERTO RICO TO THIS JUNCTURE SO THAT IT MAY RECOVER. Puerto Rico must be put on a pathway to recovery that will benefit native Puerto Ricans, through economic development policies that invest in Puerto Ricans rather than sending the lion's share of profits offshore. This will ultimately prove beneficial to residents and creditors alike. However, there is no long-term solution to the crisis in Puerto Rico without full democratic rights for Puerto Ricans. The people who make the laws that govern Puerto Rico must be accountable to Puerto Ricans at the ballot box.

If investors who see Puerto Rico as a laboratory and PROMESA as an experiment to see what debt restructuring could look like at the state level in the United States succeed in getting what they want, PROMESA will serve as the formula for using debt to push a harsh austerity regime that crushes local communities in order to reward Wall Street.

We cannot let that happen. Those who care about a sustainable future for Puerto Rico must push for policies that ensure that the island's resources are used to invest in economic growth for the Puerto Rican people rather than padding the profits of Wall Street predators. Any debt restructuring deal should force creditors to take significant haircuts and hold banks accountable for their role in creating this crisis. It is important that Wall Street investors and creditors emerge worse off than they would have absent debt restructuring, so that they never attempt the PROMESA experiment again.



If the political right is hoping Puerto Rico will be the next model for how to undermine local democracy, push austerity, and displace local communities of color, then it is imperative to flip the script and instead make it a model of how to effectively resist Wall Street's austerity agenda.

A NOTE ABOUT OUR NUMBERS

Most of the numbers in this report are gleaned from our previous reports, which can be found at acrecampaigns.org/puertorico. For methodology and sources, please refer back to those reports.

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. 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.

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