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Goldman's Strong Man in Puerto Rico

Trump's Puerto Rico Policy Is a Back Door Bailout for Goldman Sachs

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.

Donald Trump took to Twitter on April 26-27, 2017 to deride an alleged bailout of Puerto Rico. However, his tweets belie the uncomfortable truth that his Administration's position on Puerto Rico actually amounts to a back door bailout of Wall Street firms like Goldman Sachs, whose alumni now run his White House.

Trump's chief economic advisor and his choice to run the National Economic Council is Gary Cohn, who was the President and Chief Operating Officer of Goldman Sachs until he resigned to assume his post in Trump's Administration. His Treasury Secretary is Steven Mnuchin, another Goldman alum who later went on to run OneWest Bank, the bank whose foreclosure practices earned him the moniker, "Foreclosure King". His nominee to run the Securities and Exchange Commission (SEC) is Jay Clayton, a partner at the law firm Sullivan & Cromwell, whose clients included Goldman Sachs and whose wife still works for Goldman Sachs. This is just a sampling of the Goldman alumni who hold high posts in the Trump White House.

Goldman Sachs played an important role in causing Puerto Rico's debt crisis by targeting the Commonwealth with predatory debt deals like capital appreciation bonds, auction rate securities, and toxic swap deals that have cost Puerto Rico billions of dollars.

- Goldman Sachs helped underwrite $2.5 billion in capital appreciation bonds, for which Puerto Rico will pay $18.8 billion in interest—an effective interest rate of 746%.
- Goldman Sachs was the lead underwriter on $224 million of auction rate securities for the Commonwealth, which had to be restructured at great cost to Puerto Rico when the market for these types of bonds froze in 2008.
- Goldman Sachs sold Puerto Rico interest rate swaps that were supposed to save the Commonwealth money on the auction rate securities, but that backfired when the banks crashed the economy in 2008. Puerto Rico had to pay $40 million in penalties to get out of these toxic swap deals.
- Goldman Sachs likely broke federal law when it sold Puerto Rico auction rate securities and toxic swaps. The SEC can bring a disgorgement action to force Goldman Sachs to return its ill-gotten gains to the people of Puerto Rico, but Trump's nominee to run the SEC is Jay Clayton, an attorney who represented Goldman Sachs and whose wife works for the bank, creating a potential conflict of interest.

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Capital Appreciation Bonds

Goldman Sachs helped underwrite six issuances of capital appreciation bonds (CABs) to Puerto Rico. A 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.

...an effective interest rate of 746%!

The payday loans that Goldman helped sell Puerto Rico have an outstanding balance of $21.3 billion. However, the underlying principal on these bonds is just $2.5 billion. The remaining $18.8 billion is interest—an effective interest rate of 746%!

Capital Appreciation Bonds that Goldman Sachs Helped Underwrite

Bond	Initial Principal	Total Interest	Effective Interest Rate
2011A COFINA Bonds	$380 million	$3.5 billion	913%
2011C COFINA Bonds	$102 million	$434 million	427%
2010A COFINA Bonds	$130 million	$535 million	412%
2010C COFINA Bonds	$98 million	$517 million	529%
2009A COFINA Bonds	$139 million	$591 million	425%
2007A COFINA Bonds	$1.7 billion	$13.2 billion	793%
Total	**$2.5 billion**	**$18.8 billion**	**746%**

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.

Auction Rate Securities

Goldman Sachs was the lead underwriter for the 2004 B5-B8 Public Improvement Refunding Bonds for Puerto Rico, which were auction rate securities (ARS) that had a principal of $224 million. 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, and forced borrowers to restructure this debt to avoid paying millions in unexpected interest. Underwriters like Goldman Sachs that sold ARS to municipal borrowers misrepresented how risky these deals were to make them seem more attractive to government officials. This was against the law. 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.

The Securities and Exchange Commission (SEC) has the power to bring a disgorgement action against Goldman Sachs to make the bank return its ill-gotten gains from these predatory bonds to Puerto Rico. However, Trump's choice to run the SEC is Jay Clayton, an attorney whose clients included Goldman Sachs and whose wife works for the bank. By nominating a fox to guard the henhouse, Trump is creating a conflict of interest that could cost the people of Puerto Rico millions of dollars.

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Toxic Swaps

Goldman Sachs also sold interest rate swaps to Puerto Rico in connection with the 2004 B5-B8 bonds. These toxic swaps became an albatross around the Commonwealth's neck following the financial crash in 2008, as payments on these deals spiked. As Puerto Rico slowly unwound these toxic swaps, it eventually paid an estimated $40 million in termination penalties to Goldman Sachs, above and beyond its annual payments on the swaps. Puerto Rico paid these penalties by issuing new bonds. Goldman Sachs was actually one of the underwriters on two of those new bonds, which means that Puerto Rico in effect borrowed money from Goldman Sachs in order to pay swap penalties to the very same bank.

Because Goldman Sachs was both the swap counterparty and the lead underwriter for the underlying 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.

Because the toxic swaps were part of the 2004 B5-B8 deal that Goldman Sachs put together, the SEC can also force the bank to refund Puerto Rico's swap losses through a disgorgement action. However, the biggest obstacle standing in the way of Puerto Ricans trying to recover their money may well be Trump's nominee to run the SEC.

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Back Door Bailout for Goldman Sachs

Trump should use all tools at his disposal to help the American citizens living in Puerto Rico shed the predatory debt that Goldman Sachs and other Wall Street firms sold them. Instead, he is giving the banks a free pass and using the bully pulpit to shift the blame the people of Puerto Rico. The Securities and Exchange Commission has the legal authority to force Goldman Sachs to return millions of dollars to Puerto Rico but Trump has nominated a man with very close ties to the bank to run the SEC, potentially stifling any legal action. This amounts to a back door bailout of Goldman Sachs. This is disappointing but not surprising, given that Goldman Sachs alumni run the Trump White House.

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 inconsistences 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. 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.