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.

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

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.

- 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.***

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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 bonds are trading for as little as 5 cents on the dollar, giving investors a 1,900% profit

- 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.

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

- 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.

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.