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Scooping and Tossing Puerto Rico's Future

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

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

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

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

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

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

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

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

* In this report, we use the terms "refunding debt" and "scoop and toss deals" interchangeably because Puerto Rico's refunding debt was used largely used to reduce or avoid current payments and extend the payoff date into the future.

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ReFund America Project

Puerto Rico's Illegitimate Debt from Scoop and Toss Deals	
Issuance Fees on Refunding Bonds of the Commonwealth and Public Corporations	$1.6 billion
Refunding Bonds to Pay Capitalized Interest on Commonwealth Bonds	$1.6 billion
Illegitimate Debt from Scoop and Toss Deals	**$3.2 billion**

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

Running Tally of Puerto Rico's Illegitimate Debt	
Illegitimate Debt from Capital Appreciation Bonds	$33.5 billion
Illegitimate Debt from Scoop and Toss Deals	$3.2 billion
Total	**$36.7 billion**

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

Predatory Refinancing Deals

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

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

This $3.2 billion in fees and capitalized interest on Puerto Rico's scoop and toss deals is illegitimate.

Puerto Rico's bonds are highly desirable to investors because they are "triple tax exempt", which means the interest that bondholders collect on the bonds is exempt from local, state, and federal taxes. Additionally, Puerto Rico's Constitution guarantees that bondholders of the general obligation debt of the Commonwealth (but not the public corporations) will be paid before the Commonwealth makes any other expenditure. As Puerto Rico's financial situation deteriorated, its bonds also started fetching higher interest rates for investors. The tax exemptions, higher rates, and the fact that the general obligation debt is backed by the full faith and credit of the Commonwealth made Puerto Rico's debt very attractive to investors. Many of the Commonwealth's bonds were oversubscribed over the years, which meant that investors wanted to buy more bonds than were available.[3] In order to close more deals and collect more fees, Wall Street banks began pitching scoop and toss deals so that they could make money off the same underlying debt multiple times.

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

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

> "A lender 'flips' a borrower by refinancing a loan to generate fee income without providing any net tangible benefit to the borrower. Every time a loan is refinanced the consumer has to pay out fees. These fees can amount to thousands of dollars. Flipping can quickly drain borrower equity and increase monthly payments -- sometimes on homes that had previously been owned free of debt."[4]

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

Public Law 7

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

† This should not be confused with "bond flipping", which is a different practice.

Prior to the passage of Public Law 7, the Laws of Puerto Rico Annotated (LPRA) prohibited the use of refunding bonds to create new debt. The Commonwealth could only use refunding bonds to refinance the outstanding principal, premium, interest, issuance fees, and other related payments for existing debt, and it was only permitted to do so if it would save money. Furthermore, Puerto Rican law limited issuance fees or refunding bonds to 2% of bond principal.[5]

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

Issuance Fees

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

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

Issuance fees get added to the principal of the bond and become a part of the debt itself and must be repaid with interest.

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

Case Study of Just the Commonwealth's Refunding Debt

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

- The Commonwealth of Puerto Rico has paid $405 million in issuance fees on the refunding debt it has taken out since 2000.
- Nearly 60% of these issuance fees were for bonds on which Barclays Capital was the lead underwriter. Refunding bonds that Barclays has taken the lead in underwriting have incurred $232 million in issuance fees in just the last five years, since 2011.
- The lead underwriters of the Commonwealth's other refunding bonds and notes since 2000 are UBS, Goldman Sachs, Morgan Stanley, Lehman Brothers, and Banco Popular.

Projections About the Total Refunding Debt of the Commonwealth and Its Public Corporations

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

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

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

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

Lead Underwriters of Puerto Rico's Scoop & Toss Deals (2000-2016)

Lead Underwriter	Total Debt	Estimated Issuance Fees‡
UBS	$12.1 billion	$323 million
Citigroup	$11.3 billion	$302 million
Goldman Sachs	$8.4 billion	$226 million
Total for Top Three	**$31.8 billion**	**$852 million**

Astronomical Issuance Fees

A 2015 study by the Haas Institute for a Fair and Inclusive Society at UC Berkeley (HIFIS) and the ReFund America Project (RAP) that looked at issuance fees for 812 bond issuances from around the United States found that the weighted average for issuance fees as a percentage of total bond in the sample was 1.02%.[8] That means that on an $100 million bond, the average issuance fees for the sample would have been $1.02 million.

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

Puerto Rico's weak credit rating did not justify such high fees.

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

- For the Commonwealth's 2011A Refunding Bonds, for which Barclays was the lead underwriter, Puerto Rico had to pay 9.01% in issuance fees, nearly nine times the national weighted average from the HIFIS/RAP study.[9]

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

Puerto Rico's weak credit rating did not justify such high fees. In 2013 *Wall Street Journal* study found that banks charged Puerto Rico higher bond underwriting fees than financially troubled cities and states, including Detroit.[10] Underwriting fees are a major component of issuance fees.

The *Journal* found that between 2006 and 2013, the fees that bond underwriters charged Puerto Rico were, on average, 31% higher than those for Detroit, even though Puerto Rico's general obligation debt was rated higher than Detroit's at the time.[11]

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

Capitalized Interest

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

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

It is like using one credit card to pay the interest on another...

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

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

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

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

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

We did <u>not</u> use these figures to extrapolate capitalized interest for Puerto Rico's public corporations.

...the borrower ends up paying interest on the interest.

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

[**] In this report, the term "capitalized interest" is used to describe all new debt that was taken out to pay interest on older debt, including debt used to repay lines of credit that had been used to make payments on interest but not principal on older bonds.

Principles for Restructuring Scoop and Toss Financing Deals

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

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

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

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

A Note About Our Numbers

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

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

We used bond-level data from Bloomberg and bond offering statements from EMMA to analyze Puerto Rico's debt in this document. Because of limitations in the data (such as the fact that we were not able to obtain the offering statements for every single bond), we were unable to determine in every case which records were for new bond issuances and which were for remarketings of older bonds. As a result, the aggregate figures about total debt issuance and remarketing may include some double-counting. However, the data on cost of issuance fees, toxic swap penalties, and capitalized interest is accurate and was not affected by those shortcomings in the data.

Because many of the bonds and notes included in this study have been refinanced into newer ones, the Commonwealth is still paying the fees and penalties from that debt even though the original bonds and notes themselves are no longer outstanding. As a result, the figures in this report are not a direct reflection on the official figures about Puerto Rico's total outstanding debt. Nothing in this report confirms or disputes the claims of the government of Puerto Rico that it had $69.9 billion of outstanding debt as of November 2015.[12] However, it should be noted that in our previous report, *Puerto Rico's Payday Loans*, we found that data from Bloomberg showed that the Commonwealth had more than twice as much outstanding COFINA debt as the government's official number. **As such, we strongly urge a complete audit of the Commonwealth's debt to ensure complete transparency and accountability**.

About the Authors

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

Endnotes

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11 *Ibid.*

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