Puerto Rican Bonds and the Liability for Investment Professionals

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ABSTRACT
This paper explores the present circumstances surrounding the collapse of Puerto Rican Municipal Bonds and consequences to the Mutual Funds, Hedge Funds and ETFs that remain invested in them. Further, the paper explores the legal consequences that exist and developing trends for financial advisors that sold these investments with the Financial Institution Regulatory Authority (FINRA). The paper explores the history leading up to the present situation, the inappropriate use of capital appreciation bonds, the position taken by the US Government and the decisions to date by the federal oversight board installed by Congress.

KEYWORDS: Capital Appreciation Bond, Puerto Rico Bankruptcy, Pensions, Sales Tax Bonds, FINRA, Federal Oversight Board
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1. Introduction

Puerto Rico is small relative to most states, having a population, according to the US Census Bureau on July 1, 2017 of only 3,337,177, less than Connecticut, ranking it 28th among the states. It has a Gross Domestic Product of $98.91 Billion in 2017 according to Statista, ranking it 37th from among the states and slightly less than Samoa, per the US Census tables. Puerto has over $74 billion in bond debt and $49 billion in unfunded pension obligations, giving it $123 billion in debt and a Credit rating of D. This debt is greater than all of the states except California's $157 billion and New York's $136 billion, according to Mary Walsh of the New York Times The debt per capita in Puerto Rico is $15,637; more than twice that of California and New York combined and more than 10 times the average for all 50 states per Casey Wilson of Money Morning. This paper explores the consequences of the use of capital appreciation bonds, Puerto Rico's intertwined use of these bonds by their various agencies and the liability to the hedge funds, ETFs, mutual funds and later the vulture capital funds that purchased the bulk of these bonds.

Capital Appreciation Bonds (CABs) are municipal securities that defy typical municipal fiscal standards and controls (Estes, Fudge, & Van Wart, 2014). The CAB delays any payment of interest until redemption, compounding and accruing all interest payments when along with the principal are due. At maturity municipalities face fiscal disaster when they are on the hook for accreted values that can be 10 to more than 100 times what was received at issue (Adelmann, 2013; Lusvardi, 2012). In the case of Puerto Rico, the maturity is 55 years. Municipal bonds normally pay interest on a semiannual basis at the same rate over their life and are issued with maturities from 10 to 30 years, paying interest semiannually and the entire bond issue is then redeemed at face value at maturity. A municipal bond is a debt security issued by a public agency for capital expenditures. Typically, the federal, state and local governments allow the interest income on municipal bonds to be exempt from income taxes in the state of issue only. In the case of Puerto Rico, its municipal bonds are exempt from all federal, state, and local income taxes throughout the US, making these appealing bonds, especially in New York City where there is a sizable city income tax.

According to the Government of Puerto Rico's web site, Puerto Rico issued CAB sales tax bonds (COFINA bonds) from 2007 through 2011. The Wall Street Journal's Andrew Scurria wrote that these bonds are backed solely by sales tax revenue and have a virtually no probability of redemption when they mature in 2062 through 2066. The Puerto Rico Pension fund is essentially broke, per Joshua Hudson (2017) CFA, with $49.5 billion in liabilities and only $777 million in net fiduciary assets, and is essentially paying current obligations from current receipts. The pension fund, purchased $163 million COFINA bonds at face value, stating in their financial report that they have increased in value to $230 million, per the Commonwealth of Puerto Rico's Government Development Bank in 2017. In in so doing it is misstating the value by 13,747 times the actual value of $16,731, per the Thompson Reuters database (2017) and bondview.com, an online bond quote service on November 17, 2017.

2. Puerto Rico's Debt Issue

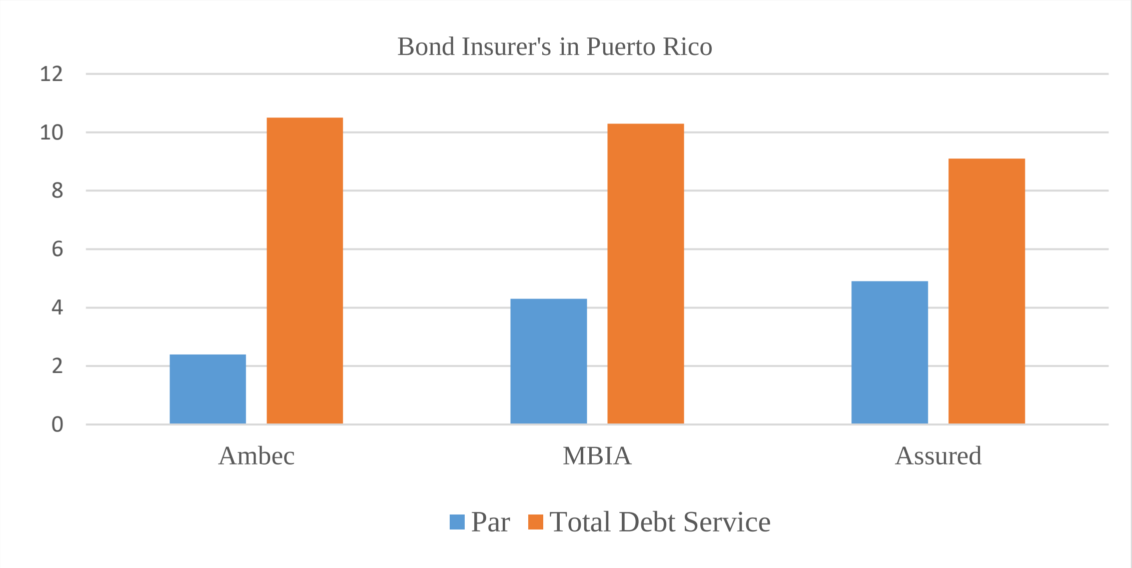
Puerto Rico has a history of economic issues. According to the United States Treasury report entitled "Puerto Rico's Fiscal Challenges" (2015), "Puerto Rico has experienced a record of poor fiscal performance due to unrealistic budget and revenue estimates, lack of fiscal discipline, and opaque reporting and disclosure". Despite these challenges, Puerto Rico had historically been able to rely on the municipal bond markets for relatively low-cost financing. According to Wirtz, Timiraos, and Kiriloff of the Wall Street Journal (2015), the popularity of these bonds, due to their tax-free nature, led to the amassing of over $74 billion in total bond indebtedness and when added to the pension debt constitutes over 119% of its GDP.

A significant portion of Puerto Rico's debt stems from its sales tax bonds, originally issued to "plug budget gaps and repay other lenders" (Kuriloff, 2015). After a sales tax was introduced in 2006, the Puerto Rico Urgent Interest Fund Corporation (also known as the Puerto Rico Sales Tax Financing Corporation the Corporación del Fondo de Interés Apremiante (COFINA) in Spanish), issued bonds backed by Puerto Rico's future sales tax revenues. These bonds were called COFINA bonds and issued in 2007, 2008, 2009 and 2011. The Corporation is a subsidiary of the Government Development Bank and was created by Law No. 291 of 2006, taken from Wikipedia. Thus, this corporation is effectively a government subsidiary which would normally make its bonds General Obligation Bonds backed by the full faith, credit and taxing ability of Puerto Rico. However, the corporation feels that the bonds are only backed by the sales tax revenue of Puerto Rico pointing to a very important future issue to be decided by Federal District Court Judge Laura Taylor Swaina.

These bonds, according to the Commonwealth of Puerto Rico's Government Development Bank (2015), total over $15.2 billion and are structured to be repaid from future dedicated sales-tax revenue. The COFINA CABs, per the Thompson Reuters database in 2017, have a face amount of $3.565 billion with a repayment amount of $4.489 billion. However, Puerto Rico received only $173.5 million at issue, a discount of 96.1% and a payback of 25.9 times the amount borrowed, per the same Thompson Reuters database. In a check using Fidelity Investments Bond Quotes on October 21, 2017, the latest trade price of these outstanding bonds represents a total value of $6,955. All are in default.

Compounding the problem, only three of the seven issues of these COFINA bonds are insured. These three, according to data from the Thompson Reuters database, were issued with a face amount of $5.675 billion and an amount due of $7.163 billion, but only received a tiny $105.8 million on issue. As can be seen from Figure 1 below, the exposure to the insurance companies is large, though it is thought by those same carriers that their reserves are sufficient in the event of a Puerto Rico default. However, the insured portion represents only 51.6% of the outstanding bonds, 39% of which are the senior bonds; with Puerto Rico left with the balance of liability in a default.

Figure 1, Bond Insurer's Exposure to Puerto Rican Bonds



Source: Bloomberg: http://www.bloomberg.com/news/articles/2015-09-04/puerto-rico-balloon-payments-seen-as-risk-for-some-bond-insurers

As quoted in Bloomberg (Chappatta, 2015), Bill Bonawitz, director of municipal research in Philadelphia at PNC Capital Advisors explains, "The biggest risk for National and

Ambac is COFINA. Because of the CABs, they would ultimately owe enormous numbers." The issue at hand is the large accreted values and the lack of funding reserves to date by Puerto Rico. Since there are no current interest payments there is no immediate risk of default, thus the risk is a long term one and it is substantial. Ambac discloses its exposure to Puerto Rico interest payments on its web site, though it's December 2017 quarterly filing includes only a tally based on the amount of bonds outstanding.

These high levels of debt and historical poor fiscal performance have been exasperated by the 11.5% unemployment rate vs. 4.4 % in the US, a negative GDP annual growth rate that declined annually from +2.8 in 2000 to -2.8% in 2017 and a population that has fallen from 3.92 million in 2000 to 3.35 million in 2017 (a decline of 14.5%) per Index Muni (6/25/18). Julia Horowitz with CNN Money quotes conservative estimates from Chuck Watson, an analyst with the disaster research group Enki Research, who believes that "Puerto Rico will face $30 billion in total damages. $20 billion in physical damages (both insured and uninsured) and $10 billion in lost economic productivity". These numbers represent roughly 30% pf Puerto Rico's $103 billion economy, again according to Watson. This combination of catastrophic hurricane damage, economic decline and government debt issues have effectively closed financing to Puerto Rico. The Commonwealth has begun to run of cash, utilizing emergency liquidity measures (Krueger, Teja, and Wolfe, 2015). Payments to vendors are stretched, tax refunds are delayed, pension assets have been liquidated early, and debt service has been withheld. Puerto Rico is effectively out of liquidity.

The US Congress has refused to allow Puerto Rico to declare Chapter 9 bankruptcy and the appointed of a federal oversight board which placed Puerto Rico under court protection on May 1st, 2017. Under United States law, there is currently no bankruptcy protection for American states or territories and a US bailout has proven to be unfavorable among voters and taxpayers. The size of the undertaking dwarfs that taken by Detroit, $9 billion vs. Puerto Rico's $74 billion. Congress and the oversight board cannot officially allow bankruptcy as it would open the door to similar filings by states. Illinois for instance, per Heather Gillers of the Wall Street Journal, "is on the verge of becoming the first U.S. state with a junk bond rating". At the present time, per the Government of Puerto Rico's web site, under credit ratings, virtually all government bonds are rated as junk. The best probable outcome for Puerto Rico's future was the appointment by U.S. Supreme Court Chief Justice John Roberts of The Federal District Court judge in the case, Laura Taylor Swaina, a Federal District Judge from the Southern District of New York to deal with the crisis. This restructure of Puerto Rican debt will be done under Title III of the Puerto Rico Oversight, Management and Economic Stability Act. This process will be different than a Chapter 9 Bankruptcy, as the process is not run by elected officials as in the Detroit filing, (removing politics from the mix) but Judge Swaina will have a great deal of power of the disposition of the proceedings. Already moving swiftly she froze a $16.3 million COFINA bond interest on May 30th, 2017. This will be a slow process, creditors have to wait 120 days before attempting to get the bankruptcy dismissed. Detroit, for example, spent 16 months under a courts protection and Puerto is much more complex. This restructure/ bankruptcy process will cover about 50% Puerto Rico's debt and its pension fund. While the other 50% of debt represented by other public agencies, not subject to the administration of the court, are restructuring; although many may proceed into bankruptcy, including the highway authority (PRHTA) and Puerto Rico's utility company the Electric Power Authority (PREPA). Part of Judge Swain's responsibility will be to decide whether or not creditors, such as Vulture funds, may receive these entities in lieu of repayment.

The complex nature of Puerto Rico's bonds, issued by 18 different debt issuing entities all with different legal protections and financial obligations, creates challenges on a scale never seen before in municipal bonds. No U.S. state has ever restructured its general obligation debt before. In the past, Puerto Rico has looked to its public pension fund to aid with fiscal shortages.

In fact, according the US Treasury report on Puerto Rico's fiscal troubles, early sales of fund assets have recently provided a significant means of short-term financing pushing Puerto Rico's public pension funds to the lowest funded ratio of any state or territory, effectively zero. This however, has come to an end. Puerto Rico's Employees Retirement System, covering 119,975 employees, has a debt of $49 billion and fiduciary assets of $777 million according to Joshua Hudson, CFA (2017). In 2008, according to the Thompson Reuters database, the pension fund issued three different tiers of zero coupon Pension obligation bonds (rated at issue BBB-) with a value of $2.947 billion in order to strengthen the pension fund**.** Moody's rates these bonds Ca, according to bondview.com on November 17 2017. The bonds are to be repaid from contributions that the commonwealth and municipalities make to the retirement system with absolutely no guarantee from the Commonwealth of Puerto Rico. At maturity, in 2058, these bonds call for a payment of $3.841 billion. The pension fund received only $71.3 million on the CABs as shown in Table 3 below. The value of these bonds today is $10,853 based on values taken from bondview.com on November 17, 2017 (Table 1).

Table 1. Value of Bonds Issued by Puerto Rico's Pension Fund

Sale Date	Issuer	Amount	Amount	Amount	Value on
		of Issue	at Maturity	Received	24-Dec-15
		($ Million)	($ Million)	($ Million)	
1/29/2008	Puerto Rico Employee Retirement System	1,588,811	1,700,450	12.948	$ 4,020.00
5/8/2008	Puerto Rico Employee Retirement System	1,058,635	1,833,660	57.808	$ 5,954.20
6/26/2008	Puerto Rico Employee Retirement System	300.203	307.09	0.539	$ 878.90
Totals		2,647,746	3,534,417	71.295	$10,853.10

Sources: Thompson-Reuters Database; http://www.bondview.com/price-check/bond

During the fiscal year ended June 30, 2011, the Pension System received a special contribution of approximately $163 million from the Puerto Rico Infrastructure Financing Authority, an instrumentality of the Commonwealth. The entire contribution of $163 million was invested in COFINA Bonds with maturity dates between 2043 and 2048. These sales tax bonds are carried on the asset side of the Pension Fund at an accreted value of $270 million per the Thompson-Reuters database. According to Fidelity Investments Bond site the current trading value of these bonds is $896.00 as of October 21, 2017, representing only .00003% of the stated value on the balance sheet. On May 31st, 2017 the Governor of Puerto agreed to pay some $2 billion per year to insure that the pensioners continue to receive their money. While this is good news for the pensioners, it reduces the funds available to repay bondholders and may well face a challenge by Judge Swaina.

3. Recent Developments

According to Bloomberg's Michelle Kaske defaulted Puerto Rican bonds fell to a low in December of 2017 of 20.8 cents on the dollar rose sharply rallied in the first part of 2018 reaching a high of 45 cents on the dollar in late March 2018. Much of the rally seems to be attributed to "Governor Ricardo Rossello's revised fiscal plan projection of a $6 billion surplus before debt payment through 2023". Exploiting this "bottom fishing are the hedge funds led by "Vulture Funds" who buy distressed debt hoping to cash in on settlements; having purchased the debt for a few cents on the dollar, Three of these vulture funds: Aurelius Capital, Monarch Alternative Capital, and Canyon Capital, have been involved in Greece, Argentina, and Detroit and now Puerto Rico. In many cases these funds are able to avoid regulation and are only focused on profits regardless of the consequences of their greed to the issuer of any debt. They can stop settlements seeking concessions and in the case of Puerto Rico may be looking at universities or airports as payment to cease attempting to block any settlement.

However there seems to be some doubt about both the optimism and the ultimate resolution. According to Joe Rosenblum of Alliance Bernstein in the same Bloomberg article the numbers "are still pretty ugly". Much of the issue seems to be in an argument, presently in front of Federal Judge Laura Swain, over who has first right to sales tax revenue in Puerto Rico. "The general obligation bondholders, including a number of U.S. hedge funds, say the sales tax receipts, an important source of cash, are legally theirs first under the commonwealth's constitution. Opposing them are bondholders of Puerto Rico's Sales Tax Financing Corporation (or "COFINA," for its acronym in Spanish), who say they have the first claim" according to CNBC's Down Giel (2018). The Judge, in May, ordered any further payments held in escrow until a decision is reached. This issue is critical as the losing party will have significantly less funds available for recovery in the bankruptcy process.

The issue takes on increasing importance since the government of Puerto Rico has not guaranteed the COFINA bonds as a GO Bond, but has rather pledged the sales tax revenue to the bonds. Complicating Judge Swain's decision is the issue of the insurers. "AMBAC has insured some $7.3 billion and MBIA some $4.2 billion of COFINA bonds representing 75% of AMBAC's and 49% of MBIA's total exposure in Puerto Rico" according to Richard Lehmann of Investing. He states "a ruling that favors the GO bondholders could be devastating to AMBAC and windfall to Assured Guaranty (AGO) which has greater GO bond exposure. Some $26.3 billion of Puerto Rico's $73 billion in bonds carry monoline bond insurance, so all the carriers face serious write offs no matter who wins, however, the AMBAC exposure appears the most crippling. The total exposures are $8.5 billion for AGO, $9.7 for AMBAC and $8.5 billion for MBIA. While this battle takes shape COFINA has also gone into court to obtain relief from its $17 billion bond obligation through a mandatory reduction of the principal amount."

4. Liability Issues for Investment Professionals

Puerto Rico's debt crisis has received significant attention in recent years but recognition of the Commonwealth's dependence on high-risk CAB municipal bonds has been limited. The COFINA CABs issued in recent years drastically increase the liability of Puerto Rico due to the delay, magnitude of repayment and the lack of debt service required. According to Aaron Kuriloff of the Wall Street Journal (2015), Puerto Rico may be looking at nonexistent sales tax revenue as a source of funds for looming interest payments. This would only serve to compound the problems for these failed bonds to which those sales taxes are pledged, reducing the price even further. Holders of these bonds have already told the government that they will sue to block any action to divert sales tax revenue from the bonds. This will make the debt service issue more complicated and difficult to resolve by the due date. To intensify Puerto Rico's problems, the Commonwealth's pension system issued its own expensive pension CABs and used the proceeds to purchase significant portions of the high-risk COFINA CABs, carrying them on their balance sheet at more than 77,000 times their value, according to the Thompson-Reuters Database.

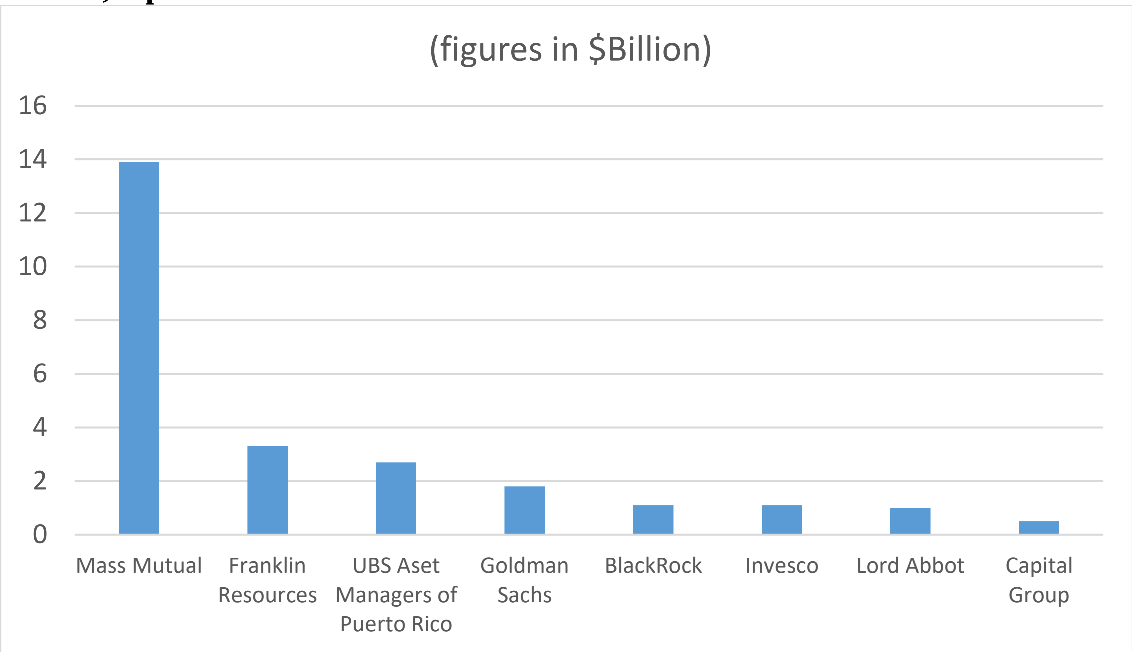
Even with the recent announcement by the Governor to fund up to $2 billion per year for the pensioners there is no guarantee that this will continue past the restructuring that will be overseen by Federal District Court judge in the case, Laura Taylor Swaina. Should this system collapse and existing employees and retired employees lose their pension benefits, the chaos stemming from this could be disastrous for Puerto Rico. Imagine, if you would, utilities, street maintenance and trash pickup, in combination with law enforcement and the judicial system all ceasing activities for any significant period of time.

Compounding these many issues is the number of arbitrations facing FINRA as losses mount and the mutual funds reprice with those losses. As of January 31, 2017, nearly 1900 cases involving Puerto Rican bonds have been filed; of these, more than 1100 cases are pending and over 30 have been decided by award. Unfortunately FINRA cases are confidential until after a decision has been rendered and the time for an appeal to the US Appellate court has passed. Following the two hurricanes, FINRA postponed the continence of hearings until a more suitable location, outside Puerto Rico, can be established. FINRA has set up a series of special rules and procedures to expedite what they believe will be an increasing amount of litigations stemming from the Puerto Rico bond defaults. This process resumed in late 2017 on a limited basis and is now processing smoothly. UBS has already been ordered to pay extensive fines and restitution stemming from the sale of Puerto Rico's municipal bonds: more than $2.9 million to investors for losses tied to Puerto Rico's municipal bonds (Prior, 2015). Further on February 16th, 2017 a FINRA panel awarded Mr. Luis R. Romero Lopez $7.983 million in compensatory damages and $1 million in punitive damages from UBS Financial Services and on June 17th 2017 a FINRA panel awarded $793,078 to Madeleine Carrero, finding UBS guilty of misrepresentation, negligence, breach of contract, breach of fiduciary duty, unsuitability and unauthorized trading. This is in addition to a loss on the bonds themselves posted by UBS in December 2016 of $18.58 million, per the NASDAQ global newswire.

Further, the SEC has informed FINRA that they may take action against brokers from Barclays and Morgan Stanley for fraud, deception, misdealing and misrepresentation during their sale of Puerto's municipal bonds according to Reuters on June 28th, 2017. These types of awards will only serve to attract a large number of litigators seeking clients who have lost money on these bonds. A check of Google under "Suing Brokers on Puerto Rico Bonds" turned up 435,000 responses in .91 seconds. This is a clear indication of what is facing financial professionals who may have placed clients assets in Puerto Rico Municipal Bonds or even in the many mutual funds, hedge funds or ETF's that hold these bonds. According to McCann, Qin and Yanl of the Securities Litigation and Consulting Group the arbitration filings in 2014 and 2015 represent over 33% of the total filings with FINRA in the mainland. They go on to point out that the "arbitrations are filed against brokerage firms, not individual brokers. Yet, FINRA forces individual brokers who are not being sued to report the arbitration filings and settlements as black marks on their records while leaving the brokerage firms' public disclosures largely unscathed." As Jake Zamansky with Forbes points out, compounding this entire process is the simple fact that Under Puerto Rican law, financial advisors owe a "fiduciary duty" to act in their customers' best interests, clearly establishing a case of absolute liability as these bonds continue to default. That "fiduciary duty" standard could in the end result in record awards against professional advisors in FINRA hearings. This exposure may be somewhat unexpected since most of the accounts holding the municipal bonds are after tax accounts and as such are not subject to the Fiduciary duty laid out in the department of labor fiduciary rule. While CFP designees are required to assume a fiduciary stance, many other financial advisors were not following this standard in after tax account management.

Clearly Puerto is a dire debt crisis in which everyone involved will be hurt with the pain lasting for years. It will involve significant reductions in services, pensions and lifestyle for the residents of Puerto Rico and increasing numbers of FINRA arbitrations against the firms and their employees involved and eventually the mutual funds, hedge funds and ETF's who bought the bonds alongside the individual investors. While Federal Judge Laura Taylor Swaina may be able to protect Puerto Rico from lawsuits, she lacks the power to deny due process to the investors that will increasingly turn to FINRA for relief. This is a very serious threat to financial professionals who may not have realized that in placing funds with the mutual funds, ETF's and hedge funds pointed out in this paper that they have significant exposure to Puerto Rican municipal bonds and corresponding litigation. The top firms of Puerto Rico's bonds hold $21.8 billion in debt according to Bloomberg's Business week in October 2017 (Table 2). These holders include mutual funds, hedge funds as well as vulture capital firms.

Table 2, top 8 holders of Puerto Rico Bonds



Source: Bloomberg Business Week, https://www.bloomberg.com/news/articles/2017-10-04/here-are-the-top-eight-holders-of-puerto-rican-debt,

As the press on this topic continues to grow and the litigation becomes more widespread and acknowledged in the media, the consequences continue to increase both in severity and probability of occurrence to all financial professionals who may have exposure to these bonds.

5. Conclusion

Clearly, Puerto's troubles have no immediate resolution. While the Commonwealth has had serious, even potentially catastrophic financial issues prior to the hurricanes, that tragedy has compounded the difficulties taking them to a whole new level. There is fierce competition by various individual, mutual fund and hedge fund debt holders for what funds are available to pay off bondholders whose investments are in default and mitigate liabilities to their investors. Add to that a government that is desperate for assistance and capital to begin rebuilding the island nation and bring it back from disaster add to that a single Judge, Laura Swain, attempting to bring the competing parties together. Then, just for amusement, throw in the insurance companies who may be facing even larger losses with any ruling tendered. According to Yahoo Finance, MBIA lost $1.6 billion in 2017 while AMBAC lost $328.7 million. The potential losses arising from an adverse ruling could be catastrophic as these same insurers provide coverage for many of the municipal bonds across the US. This is in all probability the most complex financial unravelling and reformation ever faced by a single judge.

Puerto Rico's woes may well spill over into the entire municipal bond market, cause an increasing backlog in FINRA litigation and continue to create large liabilities for brokerage firms, mutual funds and hedge funds. The vulture funds appear to be impeding any settlement, hoping for the acquisition of asses such as power companies, water companies or public institutions in lieu of payments. However, this author doubts that it will work in their favor since a judge will rule on the disposition of funds and any restructure. Hopefully their delaying arguments will fall on deaf ears in favor of the Commonwealth's efforts to rebuild. While some of the mutual funds and brokerages did buy the bonds at a higher price, the hedge funds and vulture funds bought in at the bottom, hoping for a quick turnaround in profit. FINRA has always ruled as a matter of policy that the professionals (brokerage firms, mutual funds, banks, hedge funds and even vulture funds), are experts and as such should have been aware of the deteriorating risks and acted in the best interests of their investors, selling long before the bonds fell to their present level. Even those individual bondholders that relied on the expertise of their advisors, the majority of the FINRA cases to date, have recourse and to date have not lost an arbitration seeking both general and punitive damages. It is hoped that the judge will see through the ethical and morally dubious claims of the professional bond holders and work on a restructure that will allow Puerto Rico to reclaim its rightful place in the US orbit.

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