



AMERICAN UNIVERSITY

WASHINGTON, DC

September 18, 2014

The Government Development Bank: At the Heart of Puerto Rico's Financial Crisis

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When the history of Puerto Rico's financial crisis which started in 2013 is finally written, the island's Government Development Bank for Puerto Rico (GDB) will surely be assigned a major role.

As fiscal agent, banker and “brain trust” to the Commonwealth, the GDB has played a central part in raising and allocating borrowed funds to cover public-sector deficits and associated current and investment outlays and debt-service commitments; receiving deposits from and making loans to, and trading and holding securities on behalf of, the government and its instrumentalities; providing economic policy advice, especially when it comes to financial strategies for the government and all its agencies; and in maintaining good relations with institutional investors and the rating agencies.²

The GDB's role has evolved significantly over time, and is now the financial heart of the Commonwealth. In the 1950s, two-thirds of the bank's total loans granted went to private companies – everything from laundries to car-repair shops, drugstores, milk-processing plants, and furniture factories.³ Starting in the 1970s, however, the GDB began to spawn a series of subsidiaries – like the Puerto Rico (PR) Municipal Finance Agency, PR Development Fund, PR Housing Finance Authority, and PR Tourism Development Fund – while successive governments were setting up other state enterprises, mainly the PR Electric Power Authority (PREPA) and the PR

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² “We serve as a bank, fiscal agent and financial advisor for the Commonwealth of Puerto Rico, and its instrumentalities,” see <http://www.gdbpr.com/about-gdb/mission.html>. The GDB is known in Spanish as the Banco Gubernamental de Fomento para Puerto Rico (BGF).

³ See http://www.gdbpr.com/about-gdb/history_03.html.

Highways and Transportation Authority (PRHTA).⁴ The GDB's financial support for these entities has been such that, by mid-2014, virtually all (99.6%) of the bank's nearly \$9 billion in loan exposure was to public-sector obligors, with the troubled PRHTA alone accounting for \$2 billion, or nearly one-quarter, of total loans. On the liability side of its ledger, virtually all (99.1%) of its \$5.6 billion in deposits belonged to state-owned enterprises, with an additional \$4.7 billion of funding provided by GDB notes placed with investors – two funding sources which are subject to rollover risk.⁵ The GDB serves as the principal source of short-term liquidity for the Commonwealth and its many entities.

The GDB facilitated the decade-long borrowing binge that paved the road to the Commonwealth's current fiscal crisis, but now that binge has also made the GDB quite vulnerable, given its large loan exposure to state entities that may soon default on their obligations, and also its extreme dependence on deposits from state entities which may need to draw down those funds parked at the GDB. If the bank's loan portfolio were to sour as a result of defaults on the part of PRHTA, PREPA or other obligors, its capital cushion of less than \$2½ billion would be seriously impaired. The GDB's precarious situation is betrayed by its low credit ratings from the two leading agencies: “B3” by Moody's Investors Service and “BB-” (Negative Outlook) by Standard & Poor's. These two ratings are one notch lower than the Commonwealth's government obligations (GOs), indicating that while the two credit-rating agencies disagree on the magnitude of default risks and on potential recovery values in a default scenario, both believe that the GDB is a step closer to default.

The true financial condition of the GDB is hard to ascertain and track on a timely basis. The reason is that the bank discloses its financial information selectively, intermittently, and generally with long delays. For example, its annual financial report is usually released with about a ten months' lag, such that the report for the fiscal year ending June 30, 2013, was only filed at the end of April of this year. The GDB does not file quarterly reports on a regular basis, providing glimpses of its financial condition from time to time, as it did this past July 17, when in the wake of

⁴ Among others sponsored by the GDB were the PR Industrial, Tourist, Educational, Medical, and Environmental Control Facilities Financing Authority (AFICA), the PR Higher Education Assistance Corporation, the PR Student Loan Association, the PR Infrastructure Financing Authority, and the José M. Berrocal Institute for Economics and Finance. See http://www.gdbpr.com/about-gdb/history_05.html, http://www.gdbpr.com/about-gdb/history_06.html,

⁵ http://www.gdb-pr.com/documents/FY15Q1_UpdateonFiscalandEconomicProgressWebcast_071714-Final.pdf, pp. 8-9.

investor nervousness, the Commonwealth released selected, unaudited, interim financial information for the GDB as of December 31, 2013 and June 30, 2014. Projected quarterly cash flows and cash balance information is likewise released intermittently by the GDB. Moreover, by tradition the GDB has not set aside any provisions for loan losses and has not changed this policy even in the wake of the steady deterioration in the economic and credit environment in Puerto Rico.

The GDB's corporate governance and image have deteriorated over time. The bank historically has been able to attract well-educated, highly competent investment and loan professionals to its ranks. For a long time, the GDB was considered to be a technocratic institution relatively insulated from the political world, so much so that neither its top appointed officials nor its seven-member board of directors has been subject to Senate confirmation hearings. In more recent times, in contrast, the GDB has had very short-lived chief executives and an abundance of interim leadership. Indeed, the administration of Governor Sila María Calderón (Jan. 2001-Jan. 2005) marked a turning point for the GDB, when she and the Puerto Rican legislature at the time enacted laws to force the GDB to pay a large portion of its capital (\$500 million) as a one-time dividend to the government's coffers, and to provide a \$500 million loan to fund a perpetual trust to attack poverty in the Commonwealth.⁶ That event marked an important change in the way the political class and society at large began to view the GDB: **it came to be regarded as the government's "piggy bank."**

The GDB is by far the largest bank in the United States which is neither a member of the Federal Reserve System nor overseen by the FDIC. Puerto Rico's commercial banks are supervised by both the Federal Reserve Bank and FDIC, and two of them (Banco Popular and First BanCorp.) received TARP monies in the wake of the mainland's financial crisis. The GDB, in contrast, is regulated only by the Office of the Commissioner of Financial Institutions of Puerto Rico (OCFI) – and OCFI's oversight has not been strong. The GDB is audited by the island's Office of the Comptroller and by its external auditors (currently KPMG). The Comptroller has authorized external audits over the years, but these have been limited to general operations and procedural matters. **Since the GDB is vulnerable to a deepening of the crisis in the Commonwealth, and it does not have recourse to a lender of last resort, it poses a systemic risk to the financial system and economy of Puerto Rico.**

⁶ For more background on this episode, see Carlos Romero Barceló, "\$1 billion: Where is most of the money?," *Caribbean Business*, September 5, 2011, http://www.caribbeanbusinesspr.com/news02_free.php?nw_id=5896&cl_id=1

Two Scenarios for the GDB and Puerto Rico

Investor and rating-agency concerns about Puerto Rico and the GDB have been exacerbated by passage of the Puerto Rico Public Corporation Debt Enforcement and Recovery Act this past June,⁷ because it allows for the restructuring of debts of troubled public companies while attempting to ring-fence the creditors of the Commonwealth (GOs and guaranteed debts), COFINA, and the GDB, among others.⁸ And yet, there remains substantial uncertainty about whether restructurings of the debt of public corporations that are borrowers of the GDB will take place and, if they do, how large will be the impact of such restructurings on the GDB's capitalization and financial condition.

As Standard & Poor's has explained it, "the enactment of the bill is indicative of the mounting economic and fiscal challenges for the Commonwealth as a whole, which could lead to additional liquidity pressures in the long term. While the Commonwealth's GO debt is excluded from the act, we also believe enactment of the legislation itself signals a potential shift in the Commonwealth's historically strong willingness to continue to meet its obligations to bondholders, particularly in the event of constrained market access. ... As a result, we are lowering our long-term issuer credit rating on the Government Development Bank for Puerto Rico to 'BB-' from 'BB' and affirming our short-term issuer credit rating at 'B'."⁹

The outlook is far dimmer according to Moody's Investors Service: "The enactment of a debt-restructuring law is in our view a declaration of intent to allow default by highly leveraged public corporations, primarily those providing the island's essential electric, highway and water and sewer services. As a result, the law ends Puerto Rico's long history of taking the actions needed to support debt repayment. Several days after the law passed, we downgraded Puerto Rico's GO bonds to B2, the lowest rating we have ever assigned to the commonwealth. ... We lowered the rating on GDB debt one notch below the GO rating to indicate GDB's exposure to the default-eligible

⁷ For the text of the Debt Restructuring Act, see

http://www.oslpr.org/legislatura/tl2013/tl_busca_avanzada.asp?rcs=P%20S1164

⁸ COFINA stands for the Puerto Rico Sales Tax Financing Corporation, established in 2006 in the wake of enactment of sales and use taxes and the creation of a Dedicated Sales Tax Fund, to be held and owned by COFINA, separate and apart from the central government's General Fund. It provided that each fiscal year the first receipts of the Commonwealth's sales tax, in the amount specified by law, be deposited in this special Dedicated Fund and applied to the payment of Sales Tax Revenue Bonds.

⁹ See Standard & Poor's, "Government Development Bank for Puerto Rico Long-Term Issuer Credit Rating Lowered To 'BB-'; Outlook Negative," July 11, 2014.

authorities (including \$2 billion of loans to PRHTA) and potentially higher loss severity in the event of default compared with GO bonds.”¹⁰

At present, there are only two realistic scenarios that describe how the financial situation in Puerto Rico is likely to develop. Both scenarios involve a debt restructuring with investor losses. The first scenario assumes the successful sheltering of government entities not subject to the Recovery Act, namely the Commonwealth (GO), COFINA, and the GDB, though as explained the GDB’s large exposure to loan and deposit losses illustrates the interconnections among state-owned entities. The second scenario is one in which the ring-fencing strategy fails and a more generalized debt restructuring becomes necessary because of lack of access to the capital markets.

In the first scenario, investors believe that the debt-restructuring process can be contained at the likes of PREPA and PRHTA, and skepticism is placated by the commitment of the Ad Hoc Group of creditors to backstop the ring-fenced entities. The medium-term thrust of fiscal policy, and an economic contraction that finds a bottom, support the payment capacities of the Commonwealth and of its protected entities, including the GDB. In this scenario, debt restructurings by problematic utilities liberate the fiscal balance sheet from future support needs, and the holistic restructuring of the enterprises’ activities and operations helps place Puerto Rico on a sounder, more competitive footing. These conditions support renewed investor confidence and set the basis for a pick-up in economic growth, employment, and tax revenues critical to fiscal solvency.

For this scenario to come to pass, the GDB’s asset-quality issues must be addressed. The GDB’s most immediate problem is that nearly one-fourth of its loan book is accounted for by PRHTA, as previously noted. A bill currently in the Senate, if passed into law, would channel PRHTA revenues to the PR Infrastructure Financing Authority (PRIFA) for it to issue new bonds whose proceeds would pay off the GDB loans. If this bill were to become law, it would immunize the GDB from taking a (large) haircut; indeed, its passage is essential for the credibility of the ring-fencing effort.

The successful sheltering of excluded government entities by definition also reduces significantly the GDB’s transfer risk. This refers to the risk that the GDB would be rendered insolvent because Recovery Act-exempted entities – namely, the Commonwealth – would either fail or be at risk of failing. Transfer risks for the GDB

¹⁰ See Moody’s Investors Service, “Puerto Rico Restructuring Law Drives Ratings Deeper Into Speculative Territory,” July 21, 2014.

rose last year and earlier this year, with loan payments to it delayed because of crisis conditions in entities like PREPA.¹¹

In the most benign scenario of a successful ring-fencing, there is no large-scale drawdown of GDB deposits, and liquidity is available to allow the government to function and the GDB to stay afloat. COFINA remains exempted from any “clawback” to use its funds to keep GOs current, though the risk remains that the Commonwealth eventually passes a law to change its exemption from clawbacks.

In the second scenario, creditors do not have confidence in the ring-fencing story and the Commonwealth and its entities have trouble refinancing obligations falling due and placing new bonds at coupons regarded as affordable in the medium run. Perhaps the Ad Hoc Group of creditors disbands, and confidence is undermined by a combination of destabilizing events such as:

1. The GDB experiences an abrupt drawdown of deposits. It maintains a 20% reserve requirement on demand deposits but this is insufficient against cash demands, and thus the GDB becomes illiquid.
2. The vast bulk of GDB loans becomes nonperforming, with solvency risks making its own, and the Commonwealth’s, already acute liquidity risks even more apparent.
3. The GDB falls victim to transfer risks. The constitutional guarantee on GOs means that all resources on the island are mobilized in order to follow the intent of applicable laws. Appropriations to the GDB are cancelled or reversed. Taxes dedicated to COFINA are “clawed back” through legislative action, and the constitutional guarantee on GO debts breaks down.
4. With more than \$70 billion in debts outstanding and payment assurances failing, retail investors stampede out of Puerto Rico bonds, and the hedge-fund community cannot absorb the avalanche of sell orders.

¹¹ According to Fitch Ratings, “a restructuring of PREPA’s debt obligations remains probable despite recent forbearance agreements between PREPA and certain of its creditors (including bondholders). The agreements, signed on Aug. 14 2014, provide only temporary relief related to the scheduled maturity of PREPA’s bank lines of credit, and minimal comfort that long-term financial compliance is sustainable.” See “Fitch Maintains Negative Watch on Puerto Rico Electric Power Authority’s Revenue Bonds,” September 15, 2014, https://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=872694

5. Political instability breaks out, creating policy unpredictability in the Commonwealth at the worst possible moment.
6. The authorities in Washington are confronted with a “too politically important to fail” situation in Puerto Rico, leading to emergency interventions to put a floor of support under the municipal bond market.

In this scenario of cascading and destabilizing default, the GDB is likely to be perceived as having systemic importance to Puerto Rico – and for Puerto Rico to have systemic, political importance to the mainland United States. While there is no evidence or suggestion that the U.S. government currently has an intention to bail out Puerto Rico, the ability of an out-of-control debt crisis in the island’s bond market could well rattle the whole municipal bond market to such an extent that federal intervention is precipitated. Indeed, a default on GOs would give rise to serious doubts in the financial markets about the stability of other state-like governments, in a legal space where there is no Bankruptcy Code Chapter 9 mechanism to deal with restructurings at anything but the local, municipal level.

The Bigger Picture in Puerto Rico

Puerto Rico has been in a slump since 2006, and economic activity has continued to contract and remains generally depressed, with no signs that a bottom has been reached – never mind that a meaningful recovery has started. While the island’s economy has historically paralleled the U.S. mainland’s cycles, the latest downturn started earlier, was much steeper, and is proving to be protracted. For example, the GDB’s economic activity index (EAI), which correlates closely to measures of GDP, fell 0.7% year-on-year in July, bringing the level of the index back to 125.1 (on a Jan. 1980=100 basis) – the lowest figure since 1994.¹² This is the unfortunate backdrop that has rendered the Commonwealth’s fiscal situation increasingly vulnerable to downward changes in rating-agency judgments and to shifts in investor sentiment.

Recent legislative and policy initiatives, in particular the Fiscal Emergency Law, are well-intentioned attempts to stabilize the fiscal situation in Puerto Rico.¹³ The budgets passed since FY 2013 and plans to eliminate the General Fund deficit during the current fiscal year are also bold. **However, in the absence of an economic stabilization in the months ahead and an economic upturn in 2015 and beyond,**

¹² “Puerto Rico Economic Activity Drops to 20-Year Low,” Reuters, September 2, 2014, <http://www.reuters.com/article/2014/09/02/usa-puertorico-economy-idUSL1N0R31FA20140902>

¹³ Fiscal Emergency Law, http://www.oslpr.org/legislatura/tl2013/tl_busca_avanzada.asp?rcs=P%20C1922

government revenues are unlikely to meet their targets and the authorities' credibility in the eyes of rating agencies and investors will continue to be fragile. The recently released tax haul results confirm the persistence of this problem.¹⁴ The creditworthiness of the Commonwealth and of its leading bank – the GDB – will thus likely remain quite shaky for many months to come.

Puerto Rico has had a growing competitiveness problem, which is explained very well in a report published by the Federal Reserve Bank of New York two years ago, updated this summer.¹⁵ The island maintains the same minimum wage structure as in the mainland United States, while skill levels, labor productivity, and key costs like electricity compare unfavorably in Puerto Rico, rendering the economy uncompetitive for low-value-added production relative to cheaper neighbors in the Caribbean, Central America and beyond. The Jones Act also hurts Puerto Rico's competitiveness, by affecting the cost of shipping to and from the island.¹⁶ The Federal Reserve rightly emphasizes the need for structural reforms to improve labor market opportunities, develop human capital, reduce the costs of doing business, mobilize finance for new-business development, and move away from dependence on a shrinking industrial base.

The island's overreliance on an unsustainable growth model – attracting mainly pharmaceutical companies through the tax benefits of Law 936 – created artificial jobs which have tended to disappear since the full phase-out of this tax advantage in 2006. While the pharmaceutical sector is still a major contributor to economic activity, the consolidation of the sector, rapid expiry of patents, and increasing automation – with capital-intensive modes of production – have reduced local employment in the sector markedly.¹⁷ Federal tax reform from Washington, DC, under debate, is another threat to the viability of this sector in the economy, as it still enjoys tax loopholes, even though they are more restrictive.

¹⁴ The tax haul in August 2014 was a net \$440.6 million for Puerto Rico's general fund, nearly 6% shy of the government's expectation. See "Puerto Rico's August Tax Revenue Misses Target – Treasury," Reuters, September 11, 2014, <http://www.reuters.com/article/2014/09/11/usa-puertorico-tax-idUSL1N0RC2IO20140911>

¹⁵ See "Report on the Competitiveness of Puerto Rico's Economy," Federal Reserve Bank of New York, 2012, <http://www.newyorkfed.org/regional/puertorico/report.pdf> and "An Update on the Competitiveness of Puerto Rico's Economy, Federal Reserve Bank of New York, July 31, 2014, <http://www.ny.frb.org/outreach-and-education/puerto-rico/2014/Puerto-Rico-Report-2014.pdf>

¹⁶ See http://en.wikipedia.org/wiki/Jones-Shafroth_Act

¹⁷ US firms still enjoy a tax advantage under Law 154 as long as they do not repatriate capital to the mainland. This arrangement has often been referred to as a back-door bailout of Puerto Rico, see "Backdoor Bailout' Boosts Puerto Rico's Revenues," Reuters, February 10, 2014, <http://www.reuters.com/article/2014/02/10/usa-puertorico-tax-idUSL2N0LF1BE20140210>

The financially troubled state-owned firms are a big part of the fiscal and competitiveness problems, because high utility rates but insufficient earnings (or operating losses) account for a major share of the buildup in public debt over time. For example, PREPA's overreliance on expensive imported crude oil and other high costs have made electricity charges roughly double those in the mainland, at around \$25¢/KWH.¹⁸ Factors like these stymie private investment and economic growth – in addition to making the utility insolvent and dragging down the Commonwealth's finances.

Despite the bold agenda over the past year, question marks still linger over the willingness of the authorities to embark on growth-promoting structural reforms. While political opposition to reform has been subdued (in terms of strikes and protests) thus far, many biting reforms of the public sector have yet to occur mainly because of resistance from enterprise managers and organized labor percolating up through the political process. The Recovery Act, which facilitates the restructuring and reduction of liabilities without ensuring the adoption of new business models, came at the urging of the labor unions in the public sector because they were clamoring for a shared sacrifice with creditors – meaning, bondholders. While the current crisis should be providing an opportunity for economic reform, the current administration appears timid and is busier playing defense rather than offense.

The time has come for Puerto Rico to start addressing its economic growth and competitiveness challenges in order to regain fiscal and financial stability – and avoid the worst-case scenarios, for the sake of the Government Development Bank and the Commonwealth at large.

¹⁸ Michelle Kaske, "Puerto Rico Electric Must Cut Power Costs, Governor Says," Bloomberg News, June 23, 2014, <http://www.bloomberg.com/news/2014-06-23/puerto-rico-electric-must-cut-power-costs-governor-says.html>