
How UBS Spread the Pain of Puerto Rico's Debt Crisis to Clients.

The Swiss bank packed pension bonds it underwrote into mutual funds it marketed on the island with a hard sell.

UBS had a good thing going in Puerto Rico. The Swiss bank served as an adviser to the commonwealth's Employees Retirement System, led the underwriting of a $2.9 billion bond issue for the pension agency in 2008, and then stuffed half of those bonds into a family of closed-end mutual funds it sold exclusively to customers on the island. It collected fees at every step.

Now, with the U.S. territory in the downward spiral of a government debt crisis, it's all coming apart for UBS, long the biggest retail brokerage on the island. After UBS helped the government dig itself into a deeper hole and put island customers on the hook for the losses that followed, its Puerto Rico saga has become a cautionary tale of how risks can multiply.

Angry customers have filed hundreds of arbitration claims with the Financial Industry Regulatory Authority. They're seeking more than $1.1 billion in damages from UBS after huge losses in the tax-free bond funds, sold as high-income investments that would preserve their capital, and in the bonds themselves. Three of UBS Puerto Rico's five offices have closed since 2010, and nearly 60 of the unit's 140 financial advisers have departed. The bank's retail brokerage market share on the island has dropped to 33 percent from 48 percent over that period.

Retiree Juan Burgos Rosado was 66 in December 2011, when he opened an account with UBS. A month earlier, he had taken a fall from a tall ladder, ending his career rehabbing real estate. Rosado was "the quintessential conservative investor," according to the arbitration panel that heard his case. UBS advised him to move $325,000 from a maturing certificate of deposit into its high-income funds. Rosado invested a further $200,000 in 2012, when he sold a house, and $600,000 more in January 2013, when another CD matured. He tried to sell the funds later that year as they plunged in value. His statements showed they were still worth $450,000, but UBS offered him just $90,000. While most closed-end funds are listed on an exchange, these were not, so clients depended on bids and offers from UBS Puerto Rico to get in or out.

Rosado didn't sell; he went to arbitration and won. In May, the arbitrators wrote in their decision that Rosado was "grossly over-concentrated" in the bond funds, which were unsuitable for a senior with no investing experience. UBS was ordered to pay Rosado $1 million, including $602,000 in damages. With six other arbitration cases decided on the merits so far this year, one of which went in favor of the bank, UBS has been ordered to pay out a total of more than $7 million.

The bank was disappointed in the outcome of Rosado's case, says UBS spokesman Gregg Rosenberg. The claims arbitrated so far are not indicative of how other claims might be decided, says Rosenberg, who's based in New York. "For more than 20 years, investors in UBS's Puerto Rico municipal bonds and closed-end funds received excellent returns." Losses beginning in mid-2013 occurred amid general weakness in municipal bond markets and Puerto Rican debt, the bank says.

The funds, which have declined as much as 75 percent from their initial prices, have continued to pay dividends.

The UBS Puerto Rico funds were lucrative for the bank, bringing in hundreds of millions of dollars in fees and commissions. The fund family, which had as much as $8.9 billion in assets in 2009, was designed to be heavily invested in the island's municipal bonds, using borrowed money. By mid-2013, the bonds UBS had underwritten for the pension agency represented more than half of the net assets in five of the funds. The pension agency bonds lost more than 80 percent of their value from when they were issued in 2008 through August of this year. On Sept. 10, Standard & Poor's predicted with "virtual certainty" that the bonds will default.

Putting bonds UBS had underwritten into funds UBS managed would have been forbidden by the Investment Company Act of 1940—if the funds were sold on the mainland. But Congress exempted Puerto Rico when the law was enacted. Bloomberg Markets first reported on UBS's activities on the island in 2009.

"UBS made itself a ton of money at the expense of its clients, with these huge conflicts of interest," says Craig McCann, a former senior economist at the U.S. Securities and Exchange Commission who has been hired by investors' lawyers to review more than 200 of the arbitration claims.

McCann, a principal at Securities Litigation & Consulting Group in Fairfax, Virginia, says UBS Puerto Rico sold its fixed-income mutual funds and the pension debt to customers with no regard for diversification or the appropriateness of the risk. "Whether it was a $50,000 account or a $50 million account, systematically UBS put clients into the same securities," he says. "I've never seen anything like it."

The bond funds have landed UBS Puerto Rico in trouble before. In May 2012, UBS paid $26.6 million in fines and restitution and was censured by the SEC, which said the bank had manipulated the prices of the funds in 2008 and 2009. UBS didn't admit or deny wrongdoing.

While UBS settled with the regulators, Miguel Ferrer, then-chairman of UBS Puerto Rico, fought a parallel proceeding that the SEC brought against him—and got his case dismissed. In October 2013, an administrative law judge ruled the regulator had failed to prove its case. She found that the prospectuses and literature describing the funds were accurate. Ferrer, who built what eventually became UBS Puerto Rico, starting with a two-man office 50 years ago, retired in 2014.

Ferrer had championed the bond funds. "What is the problem?" he asked his brokers during a June 2011 sales meeting in San Juan that was recorded. "We have in your accounts almost $1 billion in cash that does not generate commissions," he said. He touted the high income the funds offered and argued that they were diversified. "You have current yield, and you have a history of good performance. What the f-ck do you want?" The audio recording, first reported by Reuters earlier this year, wasn't used in the SEC case; it's in the hands of lawyers handling the arbitration claims. Ferrer didn't respond to a request for comment made through his lawyers.

Retail investors aren't the only UBS clients who've suffered. So has the pension agency whose bonds the bank underwrote. The debt issue was intended to help rescue a troubled system that was, at that time, underfunded by $10 billion. It actually made things worse, according to a 2010 study prepared for the pension fund by consulting firm Conway MacKenzie. "The $3 billion transaction was inherently flawed, misconceived and speculative as a mechanism to improve the system's funded ratio," it found.

In May, Puerto Rico estimated the fund's deficit versus future obligations had tripled to $30 billion.

José J. Villamil, an economist in San Juan, said in a 2009 interview with Bloomberg Markets that the bond deal relied on unreasonable projections of future funding of the pension system to service the debt. “I don’t know what they were smoking when they put this together,” he said, referring to revenue forecasts in a report by Global Insight, a mainland U.S. consulting firm since acquired by IHS. Jim Diffley, lead author of the report, defends his work. “There were all sorts of disclaimers that these are forecasts and subject to error,” he says.

A year after settling with the SEC, UBS hired Villamil to serve as an independent director of 18 of its Puerto Rico mutual funds. So he’s now on the payroll of an affiliate of the underwriter, but Villamil still says that it was a terrible idea to issue the pension bonds in the first place. “I think it was a huge mistake.”

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