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‘Safe’ Puerto Rican Debt Stirs Worries.

Investors uneasy that island will redirect money from Cofina bonds to pay off general-obligation debt

As Puerto Rico runs out of cash and approaches a Jan. 1 due date for about $1 billion in debt payments, investors increasingly are uneasy about the fate of bonds sold with a near guarantee.

The bonds, backed by sales taxes and known by the Spanish acronym Cofina, were issued starting a decade ago to plug budget gaps and repay other lenders. The debt at the time was considered the island’s safest offering, and Cofina bonds soon became the biggest chunk of Puerto Rico’s debt outstanding.

Now, as the struggling commonwealth redirects money intended for some debt to pay bonds with better legal protections, some analysts are predicting it will soon target Cofina bonds to avoid defaulting on its constitutionally protected general-obligation debt. Such a move would spark a showdown over its two most-sacrosanct obligations.

A spokeswoman for Puerto Rico declined to comment on Cofina.

As a sign of the concern, many of the Cofina bonds already trade below 60 cents on the dollar, less than benchmark debt from the island.

Some Cofina creditors aren’t waiting for the government to act, saying in a public statement last month that any effort to use the money for other purposes without their permission would violate the U.S. and Puerto Rico constitutions. “As one of the very few secured creditors in the Puerto Rico debt structure, we expect that our property rights will be protected,” the statement said.

“If the commonwealth defaults on its general-obligation debt, then bondholders are going to sue Puerto Rico to raid the sales taxes that back Cofina,” said Matt Fabian, partner at the research firm Municipal Market Analytics. “And if they don’t pay Cofina, those bondholders will sue, saying they have a property right to that revenue above all stakeholders.”

The looming conflict highlights the interconnectedness of Puerto Rico’s debt, the complexity of the island’s effort to negotiate competing legal claims on its dwindling cash and the nationwide breadth of creditor exposure to the fiscal crisis on the island.

Puerto Rico owes investors about $70 billion and has struggled with a decadelong recession and declining population, leading Gov. Alejandro García Padilla to call its debts unpayable. The commonwealth defaulted on bond payments in August and is in restructuring talks with creditors. It has also has turned to the U.S. Congress for access to bankruptcy protections.

Investors in Cofina range from mutual funds to hedge funds to individual retirees, an array of interests that characterizes Puerto Rico bondholders. About 130 municipal-bond mutual funds had Cofina holdings at the end of September, according to data from investment researcher Morningstar Inc. Many creditors own general-obligation debt, too. Bond insurers also back billions of dollars of Cofina debt, along with other Puerto Rico bonds.

About $4 billion of the Cofina debt was sold as zero-coupon bonds, which function like savings bonds. Investors buy the debt for less than face value and receive no interest payments—instead collecting a larger amount when the bonds mature, often decades in the future. The setup allows the issuer to avoid interest payments until the debt matures much later.

Some analysts say that structure enabled the island to dodge hard choices, piling a long-term financial problem atop Puerto Rico's immediate crisis.

"This is a classic example of how Puerto Rico got into this mess," said Sergio Marxuach, public-policy director at the Center for a New Economy, a think tank in San Juan.

Those zero-coupon bonds make it hard to say exactly how much Puerto Rico owes Cofina investors, which the island says in different disclosures is either $15.2 billion or $16.6 billion. Municipal Market Analytics puts the figure closer to $17.5 billion, saying the bonds increase in value as time goes by.

In 40 years, when the last zero-coupon bonds mature, the full payment to bondholders is scheduled to be about $25 billion—about one-quarter of the money borrowed through Cofina and two-thirds of the amount owed, that research firm found.

Some say negotiations ultimately will, and should, ensue over the Cofina bonds, as untangling legal claims between general-obligation and Cofina debt is likely to result in delay and uncertainty. Puerto Rico's power authority reached a consensus restructuring deal with creditors last week after more than a year of talks.

"Gridlock will be complicated, time consuming, expensive, uncertain and result in less for investors rather than more," said James Spiotto, managing director at the municipal-bond consulting firm Chapman Strategic Advisors, which consults on financial restructuring.

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