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Puerto Rico's Development Bank on Brink as Debt Gambit Goes Bad.

Puerto Rico’s Government Development Bank, which was set up after the Great Depression to chart a course out of poverty, is on the verge of a collapse that would deepen the Caribbean island’s $70 billion debt crisis.
The lender was designed to promote business investment with a long-term horizon, but in recent years politicians turned it into a piggy-bank that lent to the government and its agencies, helping keep them afloat as the island’s economy shrunk. Now it’s rapidly running out of cash and poised to default on a $422 million debt payment due in May — raising the risk that it may be pushed into receivership or broken up.

The bank’s failure would undermine one of the last sources of cash that Puerto Rican authorities are counting on to pay teachers, firefighters and other employees, in a territory where almost half the population lives in poverty. Hedge funds are also laying claim to the money, filing a lawsuit against the lender this week, while in Washington lawmakers are mulling steps to put the island government under federal oversight and give it legal powers to restructure its debt.

“It’s going to be a day of reckoning for a lot of municipalities,” said Marcos Rodríguez-Ema, who served as the bank’s president from 1993 through 1998. “Few of them know how to manage their budgets. Few of them understand the financing world. They will have to live within the means of the tax collections and that’s it.”

Puerto Rico Governor Alejandro Garcia Padilla on Wednesday signed legislation giving the government authority to temporarily halt payments on a wide swath of its debt, step that may buy the bank more time, even though it threatens to complicate negotiations with Wall Street and Congress.

Puerto Rico’s crisis has been building for almost a year as lawmakers cope with years of borrowing that allowed the government to pay its bills as the economy contracted. Since August, it’s defaulted on bonds sold by two of its agencies and is negotiating with hedge funds and other investors in an effort to reduce what it owes. The governor has said it may not be able to cover payments due in July on its general-obligation debt, which is given first claim on the island’s funds under its constitution.

Restructuring the development bank may exacerbate Puerto Rico’s troubles and put an economic recovery further out of reach, said Jose Villamil, an economist at Estudios Tecnicos Inc. an economic strategy and planning firm in San Juan. The 11.7 percent unemployment rate is more than twice what it is in the U.S., helping to fuel a population exodus that’s contributed to the government’s strains.

“If it were to go into receivership, it would increase the sense of uncertainty and in certain ways hopelessness that has been generated by this situation,” said Villamil, who about 10 years ago provided the GDB with a strategic plan that urged the bank to curb its lending to the island. “It would probably make it more difficult for the economy to recover, there’s no question about it.”

Barbara Morgan, a spokeswoman at SKDKnickerbocker in New York who represents the GDB, and Betsy Nazario, a spokeswoman at the GDB in San Juan, didn't have an immediate comment. On Friday, Garcia Padilla said the bank will remain open and that his administration is doing "all we can to avoid a receivership."

Melba Acosta, the GDB's president, told a local radio station last week that the bank's liquidity stood at about $700 million, while the moratorium legislation said it had slipped to $562 million by April 1, according to a copy of the legislation.

The island's commission of financial institutions, the bank's regulator, concluded in its most recent review in November that the GDB is insolvent, a determination that allows the administration to place the bank in receivership. It faces a potential $1.3 billion shortfall in June. Hedge funds that hold the bank's bonds sued it Monday to stop it from returning deposits to public agencies and municipalities, which had about $3.9 billion in the bank as of Sept. 30.

"As the economic conditions in Puerto Rico continue to deteriorate without any relief in sight, GDB – like all agencies of the commonwealth – is faced with extremely difficult choices, and it is our responsibility to evaluate all options that may protect creditors' ability to be repaid while ensuring that GDB keeps its doors open," Acosta said in a statement Monday.

The declining liquidity has caused the price of bonds that mature next month to tumble as investors anticipate a default. Taxable securities due May 1 last traded March 11 at an average 31.9 cents on the dollar, less than half the price from a year ago. The commonwealth's benchmark general obligations fell Wednesday, changing hands at an average 63.8 cents on the dollar, the lowest since the debt was first sold in 2014, Bloomberg data show.

The bank's debt "has been dragged down with the commonwealth's GOs and deteriorated as the severity of the stress in Puerto Rico became clearer and clearer," said Ted Hampton, an analyst at Moody's Investors Service.

The bank was created in 1942, with the help of Franklin D. Roosevelt's administration, to bring manufacturing to an agrarian economy.

It helped to finance government-owned factories, as well as roads, bridges, housing and water and electricity systems. By the 1950s, the bank was extending loans to private companies to build factories and create jobs. A $3.5 million loan helped construct the Caribe Hilton in San Juan, the island's first modern tourism hotel, which opened in 1949 and still operates today.

After federal tax incentives that lured manufacturers and drug companies were phased out from 1996 to 2006, Puerto Rico relied on the bank to help fund operating expenses by extending it loans or selling bonds on its behalf. That left it owed about $6.8 billion by the Puerto Rico government and its agencies as of June 30, 2015, according to financial documents.

"When you're looking at the GDB about 2000 and on, you're looking at a very weakened GDB," said Jose Bolivar, a Puerto Rico historian and author of a book about the bank. "As time went by there was less money into infrastructure and more into financial engineering — and of course the debt started to increase."

Bloomberg Business

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April 6, 2016 — 2:01 AM PDT Updated on April 6, 2016 — 10:24 AM PDT