Gurtin Municipal Bond Management

Municipal Credit Research Report

The Overlooked Role of the Government Development Bank in Puerto Rico's Crisis

July 2014

Executive Summary

Puerto Rico's recently passed legislation enables public corporations to essentially file for bankruptcy.

- Distressed public corporations, specifically the Puerto Rico Electric Power Authority (PREPA), are the driving force behind the legislation; only certain corporations are allowed to use the new authority while the Commonwealth itself and other key governmental agencies are excluded.
- We believe this is a desperate attempt to save the Commonwealth by fencing off its limited resources.

Unbeknownst to many, the Government Development Bank (GDB) is the lynchpin of the Commonwealth's finances, as every level of the public sector in Puerto Rico is reliant on its liquidity for survival; however, the GDB is also reliant on the rest of the public sector repaying outstanding loans for its own survival.

- The GDB has historically served as the ultimate backstop for the Commonwealth, its public corporations, and municipalities.
- The GDB is the sole source of liquidity for the Commonwealth's public sector.

Gurtin Municipal Bond Management has grave concerns about the GDB's solvency.

- The GDB's balance sheet is teeming with loans made to the Commonwealth and Puerto Rico corporations and municipalities.
- The GDB's solvency is dependent on continued capital market access, which is highly precarious and reliant upon market confidence in the Commonwealth.

The GDB's liquidity is running out and its assumptions for future cash-flow performance raise serious doubts about the ability to service their significant debt load.

- The six-month period from July 2013 to January 2014 is evidence of how quickly the GDB's liquidity can evaporate.
- The GDB's liquidity hinges on public sector depositors, like the distressed PREPA, not liquidating their deposit accounts.
- The GDB's future assumptions appear overly optimistic and are thus fraught with risk. These assumptions depend upon balanced budgets across the Commonwealth and continued market access, both of which look to be highly precarious at this point in time.

Gurtin Municipal Bond Management believes there are several realistic scenarios that could cause the Puerto Rico situation to transform into a full blown debt crisis for the Commonwealth.

The widespread belief that restructuring public corporations' debt improves the Commonwealth's credit quality ignores the vast and long-entrenched problems plaguing Puerto Rico.

Puerto Rico's recently passed legislation enables public corporations to essentially file for bankruptcy.

On June 25, 2014, the legislature of the Commonwealth of Puerto Rico approved the Puerto Rico Public Corporations Debt Enforcement and Recovery Act. While not called "bankruptcy", the legislation's end result is the creation of a bankruptcy-equivalent provision that provides an orderly process for the adjustment of a public corporation's debt. More specifically, it creates two paths for adjustment: 1) a voluntary process, whereby an authorized corporation and a supermajority of its bondholders arrive at a mutually agreed settlement, and 2) a process implemented if negotiations reach an impasse, whereby the courts become involved and payment is determined based upon a formula that determines the recovery rate assuming all creditors demanded immediate payment. Under this second process, there is a "cram down" provision which requires plan approval of only one class of creditors in order for the plan to become binding on all creditors.

Distressed public Corporations, specifically the Puerto Rico Electric Power Authority (PREPA), are the driving force behind the legislation; only certain corporations are allowed to use the new authority while the Commonwealth itself and other key governmental agencies are excluded.

Lawmakers were spurred to action as a result of the ongoing precarious state of financial affairs of multiple public corporations which had become sufficiently dire that a fear of disruption of essential services existed. The legislation explicitly excludes certain key governmental entities from utilizing the process, including the Commonwealth itself, the Government Development Bank for Puerto Rico (GDB), the pension systems, the Sales Tax Financing Corporation (COFINA), and the 78 municipalities, among others. Three of the major corporations which do have access are the Puerto Rico Highway and Transportation Authority (PRHTA), the Puerto Rico Aqueduct and Sewer Authority (PRASA), and the Electric Power Authority (PREPA). The intent of the legislation is to enable the corporation in question to negotiate a solution which allows it to wean itself of public support and ultimately become self-sufficient, though we regard this as nearly impossible given the poor fiscal condition of many corporations. Evidence of the magnitude of the corporation's financial distress can be found in PREPA's recent decision to conserve cash for fuel purchases by drawing on its debt service reserve fund. We believe this is a technical default, and regardless of whether one terms it a "default" or not, the use of debt service reserve funds to pay bondholders is almost always a precursor to a default.

We believe this is a desperate attempt to save the Commonwealth by fencing off its limited resources.

The Commonwealth has long dealt with a bleak fiscal outlook, but this recent legislation is a glaring acknowledgement of the extent of near-term distress. Confronted with the duality of limited remaining liquidity and the likelihood that it no longer has access to the capital markets, the Commonwealth is now willing to sacrifice some of its corporations in a last-ditch attempt to save itself just as a critically ill patient may willingly amputate diseased limbs in an effort to save his body. Given Puerto Rico's dire financial situation, it became imperative that the Commonwealth fence off its remaining liquid assets for the central government's survival, rather than continuing to allow their failing public corporations to consume them.

Unbeknownst to many, the Government Development Bank (GDB) is the lynchpin of the Commonwealth's finances, as every level of the public sector in Puerto Rico is reliant on its liquidity for survival; however, the GDB is reliant on the rest of the public sector repaying outstanding loans for its own survival.

We contend that the market is erroneously focused on either PREPA or the Commonwealth itself as the hub of the island's debt crisis, however, in reality, neither of these entities holds the key to Puerto Rico's financial future. Instead, it is the Government Development Bank (GDB) for Puerto Rico that is holding up Puerto Rico's teetering house of cards. The GDB was created in 1948, and since then has served as the fiscal agent, paying agent, and financial advisor to the Commonwealth and all of its instrumentalities, corporations and municipalities. We regard the GDB as the critical component in the Commonwealth's future for two key reasons: (1) the GDB has historically served as the ultimate backstop for the Commonwealth, its public corporations, and municipalities, and (2) the GDB is the sole source of liquidity for the Commonwealth's public sector.

The GDB has historically served as the ultimate backstop for the Commonwealth, its public corporations, and municipalities.

The importance of the GDB to the financial health of Puerto Rico is grounded in the fact that it acts as the ultimate backbone and backstop for the Commonwealth's entire public sector. It has stepped in to make debt service payments to bondholders when failing corporations were unable to pay (as it did for PREPA in October 2011), and it has provided loans to the Commonwealth to pay maturing debt. Similarly, the Commonwealth relied on the GDB to make all termination payments and collateral postings after rating downgrades earlier this year triggered credit events tied to corporations' interest rate swap agreements. The GDB has always been the final line of defense for bondholders, the only entity with ready liquidity when other Commonwealth obligors including the Commonwealth itself, pled poverty.

The GDB is the sole source of liquidity for the Commonwealth's public sector.

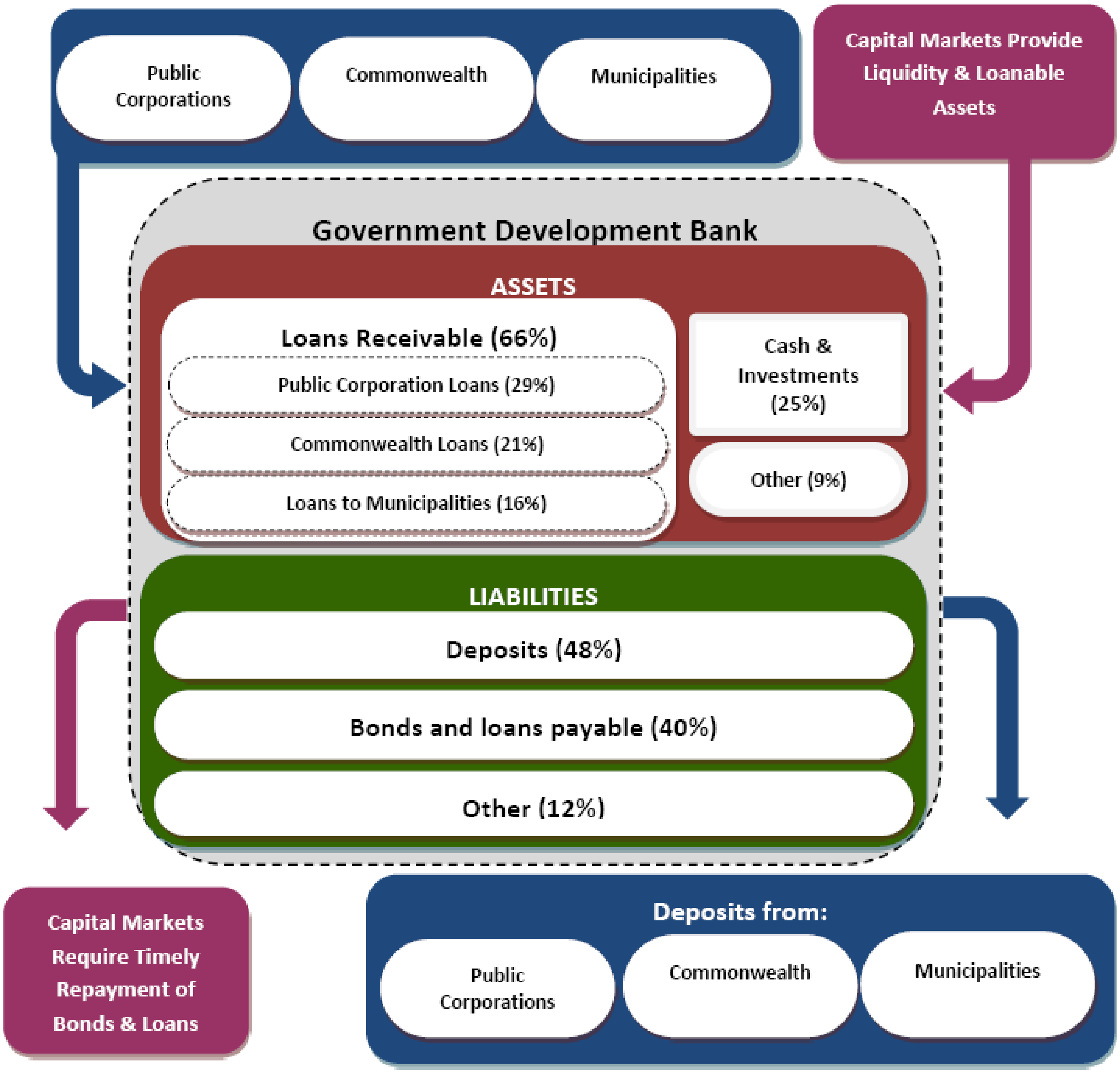
Beyond serving as the quasi lender of last resort, the GDB has also been used as credit card equivalent for the Commonwealth. Every level of government in Puerto Rico has taken on both short- and long-term loans from GDB, financing everything from capital projects to operating deficits. In recent years, a growing portion of the Commonwealth's public sector has depended upon the GDB as the lone funding mechanism for working capital – the cash necessary to operate on a daily basis. As the GDB states, "As a result of our lending function, GDB serves as the principal source of short-term liquidity for the Commonwealth, its agencies, public corporations and municipalities."[1] The GDB's cash and its ability to offer lines of credit to the rest of the island's public sector is the sole reason that the government and its essential services have not already collapsed.

Gurtin Municipal Bond Management has grave concerns about the GDB's solvency.

Given that the GDB is the sole source of liquidity for the entire public sector and that it has historically been the entity that has ensured the full and timely payment of the Commonwealth's debt, it is the GDB that is the central figure in the fragile state of affairs in Puerto Rico. The GDB's solvency is severely compromised by the precarious state of its balance sheet leaving no real alternatives for liquidity given the increasing likelihood that the Commonwealth and its corporations may have already lost access to the capital markets. The diagram below illustrates the multi-faceted layers of risk inherent in its operations and the significant reliance on the capital markets to remain solvent, thus reinforcing the notion that the GDB is the heart of the Commonwealth's finances, pumping the necessary liquidity to the public sector.

[1] Source: Government Development Bank for Puerto Rico's Special Liquidity Update, March 5, 2014, pg. 3.

Figure 1. The GDB is the risk fulcrum for Puerto Rico, as the Commonwealth survival depends on its solvency.[2]



[2] Source: GDB's FY13 financial statement. The data for "loans receivable" is from Note 7 in the GDB's financial statement, as this is the only place in the audit that disaggregates what level of government is responsible for loans. Data in Figure 2 is taken from the GDB's Operating Fund balance sheet, and the loans receivable are aggregated. Given the way the GDB reports its loan receivable data, the two sources provide slightly different percentages of loans receivable to total assets.

The GDB's balance sheet is teeming with loans made to the Commonwealth and Puerto Rico corporations and municipalities.

In recent years, the GDB has taken on a rapidly escalating amount of loans to the Commonwealth and other public entities. As you can see in Figure 2, in Fiscal Year 2013, the GDB's loan portfolio increased by 15% to $9.5 billion – an astounding 69% of the GDB's total assets – and as the diagram in Figure 1 shows, nearly 100% of these loans receivable have been made to the public sector. In the six months following the close of the 2013 fiscal year, the loan portfolio continued to expand, reaching $9.97 billion. Though recent disclosure shows that the GDB's loan portfolio has declined slightly, to $8.8 billion, the decline was entirely the result of the Commonwealth's use of approximately $1.8 billion of bond proceeds in 2014 to repay outstanding loans.[3] Therefore, the liability merely shifted from the GDB back to the Commonwealth in the form of future bond repayments. This reinforces our belief that the Commonwealth and the GDB's continued solvency are entirely reliant on their ability to access the capital markets. Netting out the repayments from bond proceeds, the GDB's loan portfolio actually increased by nearly $700,000 in the past six months. In recent years, the GDB's loan portfolio has grown because an increasing array of public sector entities is turning to the GDB for both capital and to finance operations. An inability to access the debt markets to fund necessary capital improvements and continued operating deficits at both the Commonwealth, which has recorded a deficit for 15 consecutive years, and its many distressed corporations, have led to increasing demands for both interim and long-term loans from the GDB. The GDB's independent auditor, KPMG, notes in its Fiscal Year 2013 financial statement, "The Bank's liquidity and financial condition depends on the repayment of loans made to the Commonwealth and its public entities which face significant fiscal and financial challenges in their ability to generate sufficient funds from taxes, charges, and/or future bond issuances."

As of January 2014, the date of the last robust disclosure from the GDB, the top 20 public sector borrowers accounted for 77% of the GDB's total loan portfolio. Loans to the central government alone totaled $2.9 billion, representing a whopping 29% of the GDB's total loan portfolio; notably, the loans to the Commonwealth's Treasury Department – the single largest borrower, as shown in Figure 3 –

Figure 2. GDB Balance Sheet Information ($000)[4]

	FY08	FY09	FY10	FY11	FY12	FY13
Loans Receivable	$5,202,422	$6,476,764	$6,802,779	$8,197,840	$8,258,359	$9,469,044
Loans as a % of Total Assets	47.7%	49.8%	51.5%	56.4%	55.2%	69%

[3] Source: Commonwealth of Puerto Rico's Update on Fiscal and Economic Progress, Investor Webcast, July 2014, pg. 9.
[4] 4 Source: Government Development Bank of Puerto Rico's financial statements (2008-13) – loans and total assets of GDB Operating Fund.

represented 22% of the GDB's total loan portfolio. The severity of the problem is best illustrated, however, by the recent rate of growth in borrowing by the Commonwealth itself. Loans directly to the Commonwealth increased by 135% between FY12 and FY13, and by over 80% in the six months from June 2013 to January 2014. While these loan amounts have modestly declined since January according to the GDB's deficient disclosure in a recent investor webcast, the totality of the decline can be attributed to the Commonwealth's March 2014 bond sale, while loans to public corporations and municipalities have continued their upward ascent.

The GDB's solvency is dependent on continued capital market access, which is highly precarious and reliant upon market confidence in the Commonwealth.
The diagram in Figure 1 illustrates that in order for the GDB to maintain the necessary liquidity to keep the Commonwealth from collapsing, it is absolutely necessary for the Commonwealth's public sector to have access to the debt markets. The GDB not only relies on its borrowers being able to sell debt to repay their loans to the bank as the Commonwealth's recent use of $1.8 billion in bond proceeds to repay loans demonstrates , but it also relies on its own ability to access the market to recapitalize its dwindling liquidity. The GDB's current loan portfolio consists of $1.6 billion in loans to the central government of the Commonwealth, $5 billion in loans to government corporations, and $2.2 billion in loans to municipalities, which at 69% in aggregate; represent the lion's share of the GDB's "assets". While a "House of Cards" may be an appropriate analogy for Puerto Rico, a better description may be a classic Ponzi scheme: the Commonwealth and the public corporations of Puerto Rico are borrowing from both the public debt markets and the GDB. Meanwhile the GDB also has its own public debt outstanding; in fact, 40% of its liabilities are represented by $4.7 billion of debt payable to bondholders.

The GBD's solvency ultimately depends on its borrowers' ability to repay their loans in full and on time; a precarious notion given that at times as much as $2.3 billion in GDB loans were 90 days or more

Figure 3: The GDB's Top 5 Borrowers and Intended Source of Repayment ($000)[5]

Borrower	Outstanding Loan	Intended Source of Repayment
Commonwealth's Treasury Department	$2,191,973	General Fund Appropriations; Bond Proceeds
Highway and Transportation Authority	$1,709,898	Highway Act Revenues; Bond Proceeds
San Juan Municipality	$428,660	Municipal Tax Revenues
Special Communities Perpetual Trust	$360,403	General Fund Appropriations
Puerto Rico Public Buildings Authority	$346,287	General Fund Appropriations; Bond Proceeds

[5] Source: Government Development Bank for Puerto Rico's Special Liquidity Update, March 5, 2014, pg. 5.

delinquent.[6] Figure 4 clearly illustrates the perilous state of the GDB's solvency. The GBD is counting on a combination of future bond proceeds and legislative appropriations by the Commonwealth's for over 70% of its loan repayments. The GDB states, "Any failure to complete proposed bond offerings or delays could result in the write-down of certain GDB loans to the Commonwealth and/or its instrumentalities, which could in turn substantially impair GDB's capital and solvency."[7] Now that market access has likely been cut off for the Commonwealth, over 30% of the GDB's loan portfolio does not appear to have a repayment source.

The GDB's liquidity is running out and its assumptions for future cash-flow performance raise serious doubts about the ability to service their significant debt load.

In a special update to bondholders in March 2014, the GDB laid bare a troubling picture for its future solvency. Its loan portfolio is expanding rapidly, its liquidity is dwindling and its prospects for repayment rest on the hopes that the Commonwealth will be able to sell new debt in the future. The GDB stated that its liquid resources as of January 2014 stood at $2.2 billion, an amount that is dwarfed by its outstanding loans to the Puerto Rican public sector and by the $2.45 billion in short-term maturities and other financing needs that will come due this year. In its recent investor update, the GDB declared its investment portfolio had rebounded to $3.2 billion as of June 30, 2014. However, following the footnotes in the presentation, by July 1, that amount had shrunk to $2.4 billion – a largely unchanged level from its March update.[9] More concerning is that the GDB's liquid resources are nearly unchanged despite an inflow of $1.8 billion from the loan repayments derived from Commonwealth's March 2014 bond proceeds, an indicator that the GDB is burning cash at a quickened pace. The latest GDB assumptions are that the $2.45 billion in debt service and financing costs would be paid through the March 2014 bond sale by the

Figure 4: Sources of Repayment of the GDB's Loans (as of June 2013)[8]

Source of Repayment	% of Total Portfolio
Legislative Appropriations by the Commonwealth	38.2%
Proceeds of Projected Future Bond Sales	32.8%
Collection of Municipal Taxes	24.3%
Operating Revenues of Corporations	4.5%
Other	0.2%

[6] Source: GDB's 2012 official statement. The GDB has not released delinquent loan amounts in recent disclosure, however, the GDB states that it does not make write-offs or set asides for bad loans given that it expects all loans to be paid in full.
[7] Source: Government Development Bank for Puerto Rico's Special Liquidity Update, March 5, 2014, pg. 5.
[8] Source: Government Development Bank for Puerto Rico's Annual Financial Information filing for June 30, 2013 fiscal year.
[9] Source: Government Development Bank for Puerto Rico's Annual Financial Information filing for June 30, 2013 fiscal year.

Commonwealth, which financed $895 million of the expenses, with the remainder expected to be refinanced in the public or private credit markets. Therefore, the operating assumption is that the limited remaining liquidity will not be needed to pay future bills, but rather, like in any good Ponzi scheme, the debt markets will continue to provide an infinite lifeline for Puerto Rico to maintain the needed resources to pay existing bondholders.

The six-month period from July 2013 to January 2014 is evidence of how quickly the GDB's liquidity can evaporate.

The GDB's $2.4 billion in liquidity is likely insufficient to meet the various demands being placed on its weakening shoulders. For instance, in the six months between July 2013 and January 2014, the GDB was forced to use cash on hand to: 1) loan the Commonwealth $543 million to repay maturing bond anticipation notes, 2) loan the Puerto Rico Ports Authority $136 million to repay bonds that experienced a failed remarketing, 3) pay $114 million to cover the costs of terminated swap agreements and post collateral on other swap agreements, and 4) purchase $240 million of the Commonwealth's loans from commercial banks; in other words, in those six months alone, the GDB was forced to come up with just over $1 billion to resolve the other public sector entities' problems. These problems will continue to mount given that the fallout from the Commonwealth's continued downgrades into junk bond territory are still unraveling, leading to a number of unanticipated financing costs such as swap terminations and accelerated bond payment provisions. No provisions for any such events are included in the GDB assumptions for uses of the $2.4 billion in liquidity outlined above.

The GDB's liquidity hinges on public sector depositors, like the distressed PREPA, not liquidating their deposit accounts.

The diagram in Figure 1 highlights one of the core risks confronting the GDB's remaining liquidity: its role as the depositor for the Commonwealth's public sector. Approximately 48% of the GDB's liabilities are deposits made by Puerto Rico and its public entities as of its audited FY13 financial statements. These include over $3.1 billion in demand deposits, and $2.3 billion in certificates of deposit. Should the central government, agencies, or municipalities begin to draw on their deposits to meet working capital needs, the GDB would be forced to liquidate its own investments which are currently insufficient to meet even 50% of its depository liabilities. Like any good "House of Cards," its future cash flow assumptions assume only 2% of deposits will be lost to attrition per quarter, meaning only $156 million will be withdrawn in fiscal year 2015, a modest level that would appear highly optimistic.

The GDB's future assumptions appear overly optimistic and are thus fraught with risk. These assumptions depend upon balanced budgets across the Commonwealth and continued market access, both of which look to be highly precarious at this point in time.

How does the GDB come to the conclusion that $2.4 billion in liquidity is sufficient? The answer: by using unrealistic assumptions to show that it will remain solvent. In fact, in its liquidity update to the market, the GDB states, "The projection, while presented with numerical specificity, is inherently imprecise, and there can be no assurance that it will prove reliable. In fact, actual results will likely vary materially from those shown in the projection."[10] As for its inherent imprecision, it assumes that the Commonwealth, all government corporations, and all municipalities will run balanced budgets in 2015 without relying on the GDB for deficit financing or capital improvement financing. This is certain to be false – the Highway Authority alone has been running deficits that exceed $500 million annually with no signs of subsiding. It also assumes the debt markets will continue to lend Puerto Rico money. More specifically, it implies that: 1) the Puerto Rico Highway and Transportation Authority (PRHTA) will be able to refinance $400 million of bond anticipation notes in the debt markets, and that it will be able to continue to pay its GDB loans on time and in full; and 2) the GDB itself will be able to place new notes or refinance existing notes of $292 million. The Commonwealth's recent investor update was filled with sanguine suppositions of using new vehicles to access the debt market as early as this year, capped by a jaw-dropping belief of the capacity to assume nearly $6.5 billion in new debt – nearly double the size of the still shocking 2014 bond sale.[11]

The GDB ends its March update to the market by stating, "Although GDB has previously assisted the Commonwealth and its instrumentalities in satisfying obligations, GDB is not legally required to provide such assistance to any or all of these governmental entities and there is no assurance that it will continue to provide such assistance to any or all of these governmental entities." [12] Bondholders' historical last line of defense is showing severe cracks.

[10] Source: Government Development Bank for Puerto Rico's Special Liquidity Update, March 5, 2014, pg. 8.
[11] Source: Commonwealth of Puerto Rico's Update on Fiscal and Economic Progress, Investor Webcast, July 2014, pg. 10.
[12] Source: Government Development Bank for Puerto Rico's Special Liquidity Update, March 5, 2014, pg. 8.

Gurtin Municipal Bond Management believes there are several realistic scenarios that could cause the Puerto Rico situation to transform into a full blown debt crisis for the Commonwealth. As we have already explained, Puerto Rico's survival in large part depends on continued market access. The GDB cannot survive if the Commonwealth and its corporations cannot issue debt, because without bond proceeds, they cannot repay their mounting loans to the GDB. Additionally, if the GDB cannot issue its own debt, it is unclear how it can continue to support the remainder of the Commonwealth's public sector with its scarce and diminishing liquidity. Therefore, Scenario 1 in Figure 5 below outlines a collapse caused by Puerto Rico being shut out by the capital markets. This is becoming an increasingly likely scenario given the recent and likely continued downgrades of all Commonwealth bonds. If access to the debt markets is prohibitive, the Commonwealth and its corporations will be unable to satisfy both existing bondholder liabilities and current GDB loans.

Scenario 2 in Figure 6 below is a default caused by the GDB cutting off the Commonwealth or its corporations. The GDB has explicitly told the market that while it has historically ensured that obligations are paid, it is not legally required to do so, and is increasingly unable to do so. Though the current bankruptcy legislation is an attempt to shield the GDB's limited resources from failing public corporations and preserve them for the Commonwealth and the GDB itself, these failing corporations are still the largest single group of borrowers from the GDP. Should their repayments to the GDB be brought into the bankruptcy negotiations or should they simply be unable to pay their loans, the GDB may very well be forced to cut off everyone, causing a cascade of defaults.

Figure 5: Scenario 1: The capital markets cease lending to the Commonwealth, its corporations, and/or the GDB

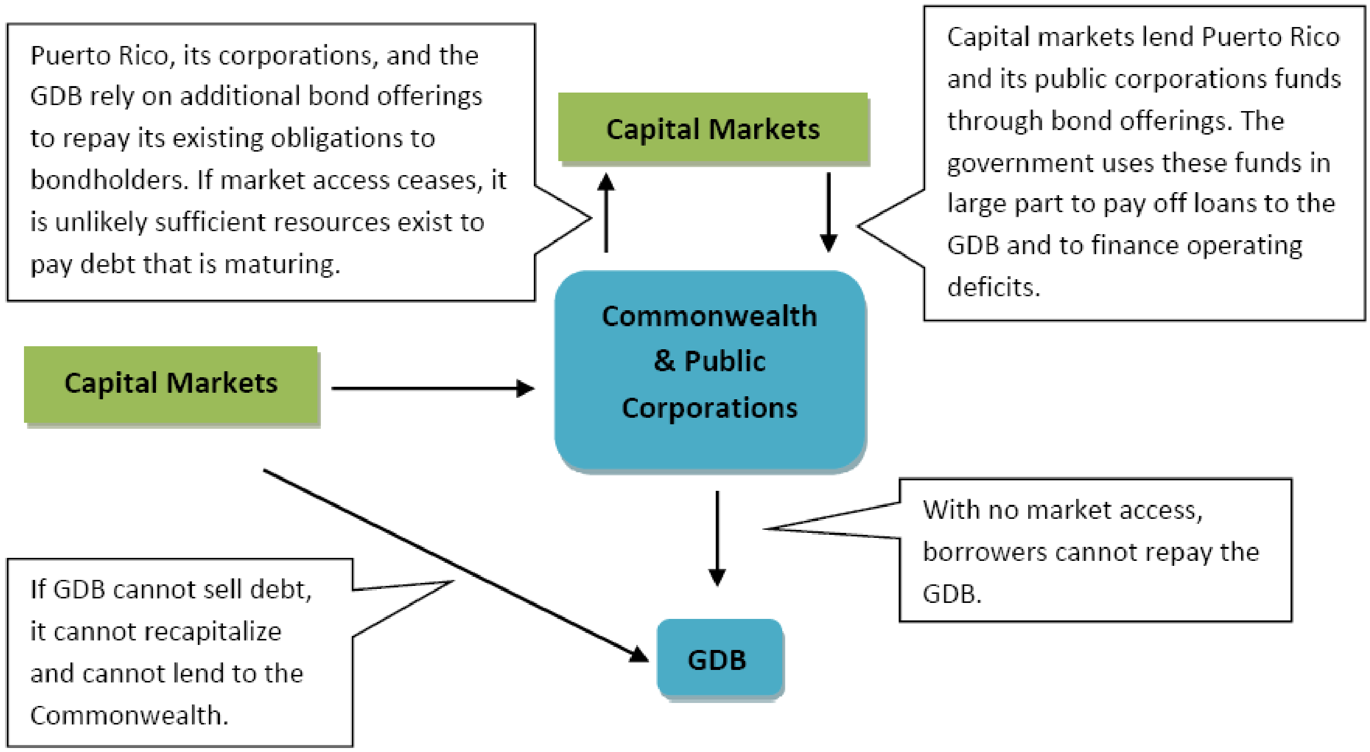
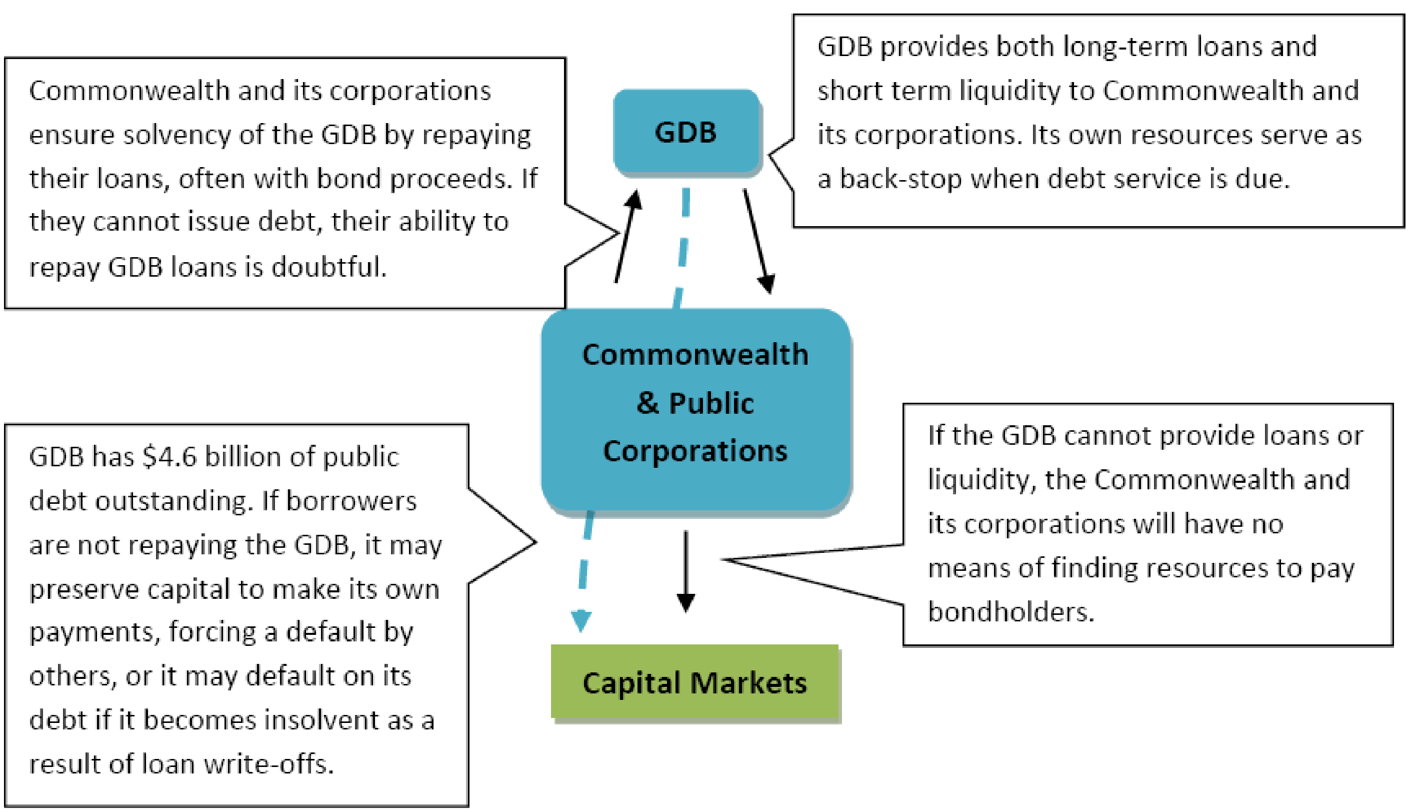


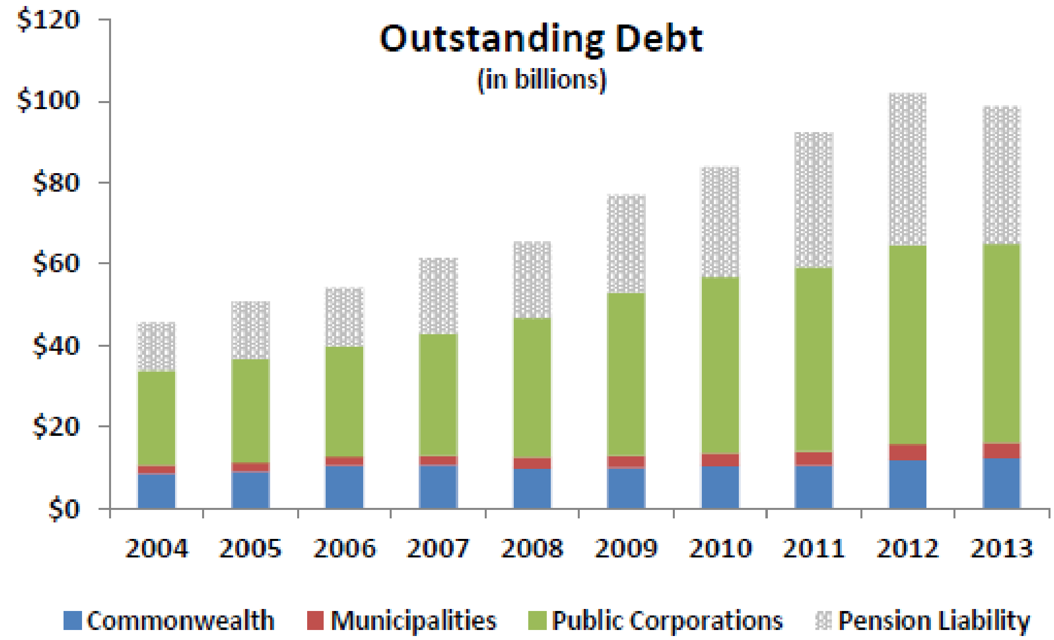
Figure 6: Scenario 2: The Government Development Bank for Puerto Rico (GDB) is unable to provide liquidity to support the Commonwealth and/or its corporations

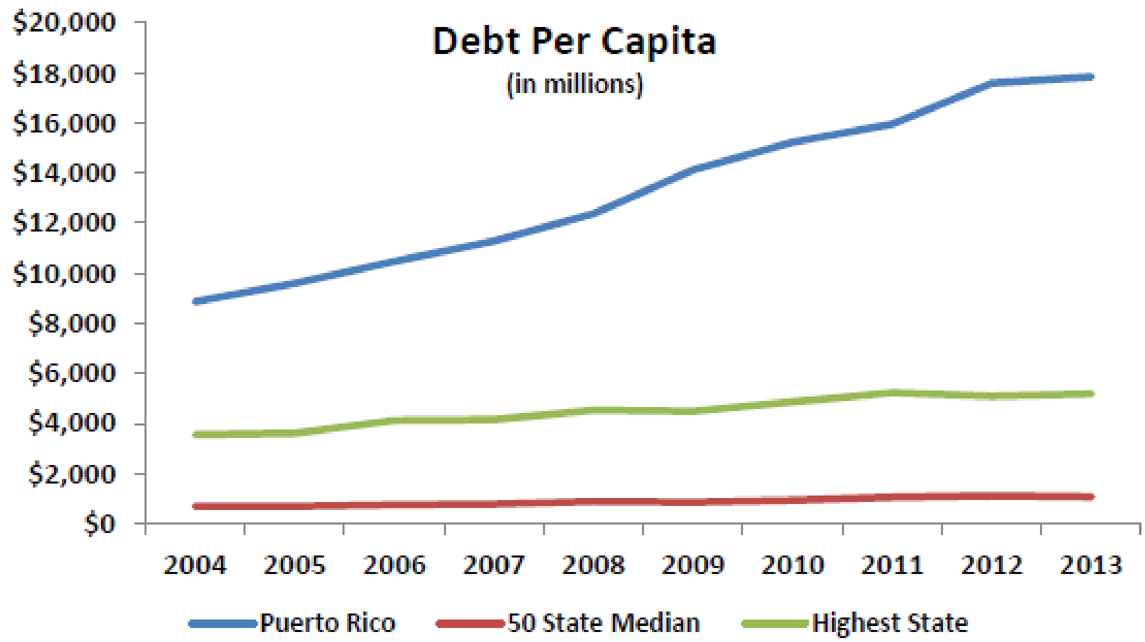


The widespread belief that restructuring public corporations' debt improves the Commonwealth's credit quality ignores the vast and long-entrenched problems plaguing Puerto Rico.

Fundamental credit analysis revealed long ago that Puerto Rico was a credit event in waiting only abetted by the market's willingness to continue to provide the Commonwealth unlimited access to debt markets. Similar to Detroit, Gurtin Municipal Bond Managment has long viewed Puerto Rico falling into credit distress as an eventual inevitability. The island amassed unsustainable debt levels illustrated by the fact that its debt per capita exceeds its per capita personal income. In other words, each resident is now responsible for more debt than they make in a single year. As the graphs in Figure 7 below depict, in the past 10 years, Puerto Rico has continued to trend well away from not only the median debt levels of the 50 U.S. states, but also from the state with the highest debt levels in any given year. Additionally, the island's economy continues to suffer from exceedingly and stubbornly high unemployment, population loss, and poverty levels that far exceed any U.S. state.

Figure 7: Puerto Rico's debt levels are unsustainable, and are already at unaffordable levels for the island's residents[13]





[13] Source: Moody's Investors Service & Commonwealth of Puerto Rico Financial Information and Operating Data Reports, Oct 18, 2013 and May 15, 2009, respectively.

Conclusion

Gurtin Municipal Bond Management has avoided Puerto Rico's debt since our firm's inception. Unlike the many mutual funds and managers that succumbed to the lure of juicy yields and triple tax-exempt status of the island's debt, we firmly believed that the Commonwealth's credit fundamentals were suggestive of looming credit distress and did not present a risk-adjusted value for our clients. Those who cling to the belief that the Commonwealth's latest maneuver of allowing certain corporations to restructure their debt will improve the credit quality of other Puerto Rican bonds are yet again ignoring fundamental credit analysis in favor of fanciful delusion. This delusion is further enabled by the failure to recognize that the GDB represents the lynchpin to Puerto Rico's teetering house of cards. We contend that the bankruptcy-equivalent legislation is a last-ditch effort to fence-off the GDB's limited remaining liquidity from failing public corporations. However, in doing so, the Commonwealth may very well have ensured it also fenced itself off from the debt markets, and consequently ended Puerto Rico's Ponzi scheme by pushing the GDB towards inevitable insolvency.

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