

## MEMORANDUM FOR POLICYMAKERS

### THE AD HOC GROUP OF PUERTO RICO GENERAL OBLIGATION BONDHOLDERS

JANUARY 9, 2017

#### THE COFINA STRUCTURE IS UNCONSTITUTIONAL

COFINA is a conduit through which billions of dollars were borrowed on the back of the Commonwealth's core revenues. COFINA's only source of funds to pay its \$17 billion of bonds (and growing) is sales and use tax (SUT) revenues illicitly assigned by the Commonwealth. **The most powerful path for solving the Commonwealth's fiscal crisis is to recognize the invalidity of that assignment and return those revenues to the Commonwealth.** Doing so would immediately increase the General Fund by over \$700 million in the current fiscal year alone and by more than \$50 billion over the remaining life of COFINA's existing bonds.

Inexplicably, the Commonwealth has done precisely the opposite -- bestowing singular favoritism on COFINA debt holders by paying them in full, and opposing (on procedural grounds) the GO group's legal challenge to the COFINA debt on procedural grounds. The Oversight Board has likewise sought (also on procedural grounds) to prevent that challenge from moving forward.

COFINA is an illicit artifice. It is an entity whose sole purpose has been to borrow money with the backing of SUT revenues diverted from the Commonwealth. This gimmick was set up in 2007 to end-run several core, interlocking protections against fiscal irresponsibility enshrined in Puerto Rico's Constitution for the protection of Constitutional Debt (and in turn, the people of Puerto Rico). These protections include, among other things, the debt-service limit, the maturity limit, and the debt-service priority and first claim against all available resources.

First, the Constitution prohibits the Commonwealth from borrowing money if the resulting debt service in any future year would exceed a prescribed, modest portion of the Commonwealth's revenues (essentially 15% of the recent average revenues at the time of borrowing). This debt-service limit was intended to ensure that the Commonwealth would have plenty of revenues available after debt service to provide each year's essential governmental services. Starting with its very first borrowing in 2007, COFINA issued debt that would have offended this limit if it had been issued by the Commonwealth.

Second, the Constitution generally prohibits the Commonwealth from borrowing money with a maturity exceeding 30 years. Without this maturity limit, the Commonwealth could undermine the debt-service limit by pushing out maturities ever further and borrowing from future generations. Here again, from the moment of its creation, COFINA issued debt that would have offended this Constitutional protection if it had been issued by the Commonwealth.

Third, the Constitution requires that all of the Commonwealth's resources be available first to service its own constitutionally protected debt. This priority and first claim was intended to

ensure that the Commonwealth could obtain and keep optimal access to the capital markets. The diversion of SUT to COFINA would gut this crucial protection.

If the COFINA structure were legal, it would render useless all three of these constitutional provisions. In fact, if taken to its logical extreme, the Commonwealth could attempt through mere legislation to divert an unlimited amount of its tax collections from any source to COFINA-like structures. Such a structure is a transparent end-run around the explicit protections for Constitutional Debt, a result totally at odds with Puerto Rico's Constitution.

**If the purported diversion of SUT revenues to COFINA is recognized as invalid, COFINA's bonds would be debts of an "empty box," not debts of the Commonwealth.** COFINA's bondholders knew COFINA would have no ability to pay them in this event, and they did not bargain for recourse against the Commonwealth if this risk was realized.

Rather than bestowing inexplicable favoritism on COFINA's debt, the Commonwealth should put an immediate end to the diversion of tens of billions of its SUT revenues to COFINA, and the Oversight Board should immediately exercise its statutory right to claw back the funds paid to COFINA since PROMESA was enacted. Nothing else the Commonwealth or the Board can do would accomplish as much to restore Puerto Rico to fiscal health.