



September 2, 2016

Chairman Orrin G. Hatch
Committee on Finance
United States Senate
Washington, DC 20510-6200

Dear Chairman Hatch,

I write to you as the Chairman of the bicameral and bipartisan Congressional Task Force created under the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA) to report on impediments in current Federal law to economic growth in Puerto Rico.

In March, 2012 I [predicted the insolvency of the Commonwealth](#) and have written about Puerto Rico for Reuters and provided research to Puerto Rico bondholders for four years. I have found the Puerto Rican people to be honest, upright and hard-working but suffering under a political system that generally favors the well-connected and whose politicians have done little to improve governance or the provision of services to the people.

Puerto Rico faces substantial economic, fiscal and political challenges that many others have documented. But the lifeblood of any economy is a healthy and well-functioning financial industry and I've seen little commentary on this sector of the Puerto Rico economy. It is vital that the domestic banking and credit union systems have sufficient capital and regulatory oversight to lend to individuals and businesses to expand economic activity on the island. Further it is critical that Puerto Rico broker-dealers and investment managers abide by the same investor protection standards that are used on the mainline. The protection of savers and investors is essential for a strong and vigorous economy.

Puerto Rico commercial banks are well regulated

The oversight of commercial banks is done by the Federal Reserve Board of New York and the FDIC. As a consequence Puerto Rico's commercial banks have high capital ratios and have minimal exposure to Puerto Rico central government debt. Although all Puerto Rico commercial banks have junk credit ratings it is believed that they could absorb any losses incurred with a further economic downturn.

The FDIC has stated that Puerto Rico commercial banks hold sufficient capital to absorb any loan losses and have manageable exposure to Puerto Rico government debt according to an [August 21, 2015 report by Reuters](#):

The five FDIC-insured Puerto Rico banks - Banco Popular de Puerto Rico, Banco Santander Puerto Rico, FirstBank Puerto Rico, Oriental Bank and Scotiabank de Puerto Rico - had \$442 million exposure to Puerto Rico government securities in September 2013. That fell to \$240 million as of June 30 [2015].

The banks are well capitalized, the letter said, and the FDIC stands ready to "ensure the orderly, least costly resolution of failed insured depository institutions should one of them become insolvent."

As a consequence of FDIC oversight depositors using Puerto Rico's commercial banks have confidence that their savings are guaranteed up to the FDIC limits.

Weak oversight of Puerto Rico investment management firms due to loopholes in federal law

Island investment managers and broker dealers have had insufficient oversight from federal regulators. The SEC and Finra has been making cases against Puerto Rico firms including [UBS](#) and is processing an [influx of arbitration case filings related to Puerto Rico bonds](#).

The [head of the FBI San Juan bureau, Douglas A. Leff, previously led](#) the agency's Complex Financial Crimes Branch in New York. Last month the FBI and SEC [announced that they will develop a close partnership](#) to investigate possible securities fraud in Puerto Rico.

U.S. Representative Nydia Velázquez (D-NY) has identified a decades-old loophole that caused significant financial losses for many Puerto Rican investors and retirees. Velázquez's legislation, [H.R.5322](#), was passed in the House and would extend to investment companies operating in Puerto Rico and all the U.S. territories the same rules as those that apply on the U.S. mainland. From [Representative Velázquez](#):

It has been publicly reported that some actors in Puerto Rico have used the current law's loophole to act both as an underwriter for the issuance of bonds, and then repackaged those same bonds into mutual funds they sold exclusively to investors on the island. While this type of arrangement is legal in Puerto Rico due to the 1940 exemption, it would be prohibited on the U.S. mainland. The situation has been compounded by Puerto Rico's ongoing debt crisis. Puerto

Rican investors holding government bonds have suffered massive losses and are claiming that some financial companies did not properly disclose the risks of these funds, due to this conflict of interest.

“For too long, this massive oversight in federal investment law meant that residents of Puerto Rico did not have the same consumer safeguards as are available on the mainland,” Velázquez noted. “The result has been that many retirees and others have suffered enormous losses on financial products they have been sold by unscrupulous companies.”

I encourage the Task Force to incorporate Representative Velázquez’s legislation in their recommendations.

Puerto Rico’s credit unions lack appropriate oversight

The regulation of Puerto Rico’s [116 credit unions is done on island by locally chartered regulator COSSEC](#) and depositor protection falls short of mainland standards.

There are two areas of concerns. First COSSEC (Public Corporation for the Supervision and Insurance of Cooperatives of Puerto Rico) lacks sufficient internal controls according to a report by the Puerto Rico Comptroller and second a substantial amount of COSSEC and individual credit union capital is invested in Puerto Rico government debt. The potential losses on this debt were papered over when the Puerto Rico Legislature amended the local mark-to-market accounting law for these entities (Puerto Rico Act 220-2015).

A [May 3, 2016 report by Sin Comillas](#) highlights the problem of internal controls of COSSEC:

An audit by the Comptroller of Puerto Rico reveals three findings on fiscal operations related to the investments of the Public Corporation for the Supervision and Insurance of Cooperatives of Puerto Rico (COSSEC). The audit highlighted the lack of professional and consulting contracts of those investments with custodian banks, absence of a written procedure to govern the operations of the Investment Committee and deficiencies related to the quarterly reports of investment services.

Puerto Rico credit unions and their regulator COSSEC are potentially insolvent because the bulk of their capital is debt issued by the Puerto Rico central government. Puerto Rico general obligation debt and bonds of the Government Development Bank have not been paid and this debt is trading between 20 and 65 cents on the dollar. If credit

unions and COSSEC marked their assets to current market prices rather than their cost (100 cents on the dollar) they potentially would be near insolvency.

To protect the solvency of these entities as the Puerto Rico central government was planning to default on their debt obligations the [Puerto Rico Legislature passed Act 220-2015](#) on December 15, 2015 to suspend mark-to-market accounting for credit unions (emphasis mine):

Article 11.01 - Special Investments

(a) they are referred to as "Special Investments":

i. The investments held by cooperatives in bonds, securities and other evidences of indebtedness of the Government of Puerto Rico and its agencies, corporations, instrumentalities, authorities and political subdivisions, including the Government Development Bank of Puerto Rico and its affiliates made on or before 31 March 2015; and any investments, bonds, bills of debt, notes, commercial paper, capital notes, certificates, shares, instruments or other assets and / or securities received as part of any transactions, restructurings, refinancings or initial and subsequent renegotiations of any of described instruments, including instruments by entities or special structures or conduit as part of the transactions referred to above or processes of restructuring, refinancing or renegotiation issued.

ii. The Special Investments described in subsection (a) (i) of this Article or those arising as a result of a renegotiation, as described in subsection (a) (i) of this Article shall be considered as permitted investments, regardless what have any regulations, circular letters, examination report or any other administrative determination of the Corporation and of any other government agency of the Commonwealth of Puerto Rico.

Article 11.02 - Accounting for Special Investments

(a) Effective April 1, 2015, the Special Investments will be recorded in the books of each cooperative at amortized cost the same and not the market value ("fair value" or "mark to market"), regardless of their classification as securities available for sale ("available for sale"), or to be held to maturity ("held to maturity"). It amortized cost is defined as the amount paid for the investment, plus the amount of incidental acquisition costs. **Subsequently Special Investments will remain recorded at amortized cost based, subject to payments, redemptions and other transactions that are the subject. Under this accounting standard, accounting records and financial statements of each cooperative will not reflect unrealized losses relative to Special Investments, provided**

that any realized loss of any kind attributable to the Special Investments shall be governed by the provisions of subsection (b) of this Article.

- (b) Any losses attributable to Special Investments, both in the case of disposal thereof as well as while retained by the cooperative, which arise by reason of the application of any rule, ruling, analysis or procedure provided by the principles generally accepted accounting or regulatory requirements or pronouncements agencies will be amortized over a period not to exceed fifteen (15) years. The repayment period will be defined by the Board of Directors of each cooperative, taking into consideration the recommendations of (the) President (a) Executive (a) and financial and accounting advisors to the institution, provided that such advisers have not participated in the sale and placement of Special Investments. For purposes of this Act, the term "Losses under Special Amortization" as those losses relating to Special Investments that are subject to amortization calculated it is defined as provided in this Article. The financial statements of the cooperative identified separately in the statement of income and expenses and notes those Special Investments that have been available and are subject to amortization of losses in accordance with the provisions of this Article.

It is unlikely that the U.S. Congress would allow mainland credit unions to amortize substantial capital losses over a 15 year period. Congress should not allow island credit unions to do this either.

Puerto Rico's credit union regulator has minimal coordination with the [National Credit Union Administration](#) which oversees mainland credit unions and steps in when a CU needs to be resolved. Consequently the 966,000 savers using Puerto Rico's credit unions are exposed to substantial risk that more well-managed mainland credit unions do not face.

The Task Force should weigh the value of continuing to allow Puerto Rico's credit unions to be locally regulated or whether the oversight of the NCUA should be extended to the island's savers. I would encourage the Task Force to fold regulation of Puerto Rico's 116 credit unions into the NCUA.

SBA should review impediments to doing business in Puerto Rico

The [World Bank ranked Puerto Rico 57th globally in ease of doing business](#) for 2016. The Commonwealth fell one rank since 2015.

Topics	DB 2016 Rank	DB 2015 Rank
Starting a Business	51	45
Dealing with Construction Permits	135	133
Getting Electricity	57	57
Registering Property	164	159
Getting Credit	7	6
Protecting Minority Investors	88	87
Paying Taxes	134	134
Trading Across Borders	93	92
Enforcing Contracts	100	100
Resolving Insolvency	7	7

The two categories with high rankings, Getting Credit and Resolving Insolvency, occur in federally regulated entities (ie commercial banks overseen by NY Fed and FDIC and federal bankruptcy courts). Making it easier to do business in Puerto Rico could boost economic activity.

It is very discouraging that the World Bank rates paying taxes in Puerto Rico at 134th. Tax collection is the lifeblood of any government. The [World Bank ranks doing business in Greece](#) at 60th globally but rates paying taxes in Greece at 66th substantially better than Puerto Rico.

Overall there are many impediments to doing business in Puerto Rico and this undoubtedly slows velocity of economic activity. The Small Business Administration operates in the Commonwealth and Congress could instruct the SBA Office of Inspector General to undertake an analysis of impediments to doing business in Puerto Rico. Two excellent private efforts have already begun to examine how to make doing business with the Puerto Rico government more efficient ([Code for America](#) and the [Puerto Rico Digital Service](#)). The SBA could partner with one or both of these groups in their effort.

Increase government data transparency

Puerto Rico lags far behind many mainland state governments in making government data transparent. State governments have published real-time databases of employee compensation, pensions, debt data and state checkbooks.

- [Government Data and Accountability](#)
- [Government Compensation in California](#)
- [State of Ohio's online checkbook](#)
- [Debt at a glance](#) - Texas Comptroller of Public Accounts

Congress could premise receipt of federal funds for Puerto Rico central government activities on the government publishing more public data. Puerto Rican citizens deserve to see how their government spends money and could possibly provide a check on corrupt expenditures.

Summary

Congress can strengthen the Puerto Rico economy through several small changes in federal law:

- 1) Adopt Velázquez's bill, [H.R.5322](#) for improved oversight of Puerto Rico investment management firms
- 2) Extend National Credit Union Administration oversight to Puerto Rico's credit unions
- 3) Require SBA to study impediments to doing business in Puerto Rico
- 4) Premise receipt of federal funds on Puerto Rico central government publishing employee, pension, debt , expenditure and cash liquidity data online

Thank you for this opportunity to provide comments to the Task Force. I look forward to your work contributing to a stronger and more prosperous Puerto Rico. Please advise if I can provide further information.

Kind regards,
Cate Long