



Puerto Rico Financial System's Stability and PROMESA's Oversight Board

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In 2016, the Puerto Rico Oversight, Management, and Economic Stability Act [hereinafter "PROMESA"] was approved.¹ In this statute, Congress delegates its powers under the territorial clause to the Financial Oversight and Management Board for Puerto Rico [hereinafter "Oversight Board"] and places it in charge of handling Puerto Rico fiscal crisis to "provide a method to achieve fiscal responsibility and access to capital markets".²

The Oversight Board has assumed control of a significant sector of the Puerto Rico financial system through its designation of the Public Corporation for the Supervision and Deposit Insurance of Puerto Rico Cooperatives [hereinafter "COSSEC" by its Spanish acronym] as "covered territorial instrumentality".³ COSSEC is the deposit insurer and banking supervisor of cooperative credit unions chartered under Puerto Rico Law.⁴ Through this action, the Oversight Board unilaterally assumed COSSEC's responsibilities. However, PROMESA's drafters never intended that the Oversight Board would assume the role of financial services supervisor.⁵

Currently, the Oversight Board is supervising the initial stages of the fiscal correction the Government of Puerto Rico is implementing. There is great uncertainty about the social and economic effects of the fiscal correction, and in this scenario, the Oversight Board's actions towards COSSEC are raising the risk of instability in Puerto Rico financial system.

This Paper discusses the connections between the Oversight Board's actions—in excess of its authority⁶—towards COSSEC and the risks to the stability of the Puerto Rico financial system these actions are creating. In addition, it identifies a means for Congress to untangle the Oversight Board from these risks.

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¹ P.L. 114-187, 130 Stat. 549 (2016).

² US CONST. ART. IV §3, PROMESA §§101(a) & (b)(2).

³ See *infra* note 9.

⁴ 2001 P.R. Laws 114, Art. 2.

⁵ On the PROMESA legislative process see, TRIGO, THE UNITED STATES AND THE PROMESA TO PUERTO RICO: AN ANALYSIS OF THE PUERTO RICO OVERSIGHT, MANAGEMENT, AND ECONOMIC STABILITY ACT (2016) (ebook).

⁶ See *infra* Part II.

I. The Oversight Board Becomes Lender of Last Resort by Assuming Financial Control over COSSEC

The Oversight Board rules over the funds of the Commonwealth of Puerto Rico and has authority to certify the fiscal plans and budgets for both the Commonwealth of Puerto Rico and designated "covered territorial instrumentalities".⁷ In addition, PROMESA authorizes the Oversight Board to control the processes to restructure the debt of Puerto Rico bond issuers.⁸ Even though, COSSEC does not qualify under either of these categories the Oversight Board has assumed financial control over it.

On September 30, 2016, at its first public meeting in New York, the Oversight Board assumed control over 25 entities, including COSSEC, by designating them as covered territorial instrumentalities under Section 101(d)(1)(A) of PROMESA.⁹ At that moment, the Oversight Board had no executive personnel nor advisors.¹⁰ Therefore, and not surprisingly, it did not provide any explanation to justify COSSEC's designation as covered territorial instrumentality.

A month later, on October 30, 2016, the Board published a document entitled COVERED ENTITIES UNDER THE PROMESA ACT where it provided the following sole statement as the basis for its designation of "initial" covered territorial instrumentalities.

In summary, the Board has resolved that entities and activities included in Puerto Rico's Comprehensive Annual Financial Report as part of the Primary Government, as Discretely Presented Component Units or as Fiduciary Funds are covered entities under the Act.¹¹

The Oversight Board's designation of COSSEC as a covered territorial instrumentality is inappropriate because COSSEC

- does not receive funds from the Commonwealth of Puerto Rico and
- has not issued bonds subject to PROMESA restructuring processes.¹²

Rather, COSSEC raises its own operating funds through fees paid by cooperative credit unions in Puerto Rico. Therefore,

- COSSEC's operating funds are not funds of the Commonwealth of Puerto Rico, and

⁷ PROMESA §§ 201 & 202.

⁸ PROMESA §§ 206, 304, 601(a) & (e).

⁹ See, video of the first meeting of the Oversight Board available at <https://junta.pr.gov/index.php/en/videos-of-meetings/> (starting at 21:22).

¹⁰ See, Minutes of the first meeting of the Oversight Board available at <https://juntasupervision.pr.gov/index.php/en/documents/>

¹¹ OVERSIGHT BOARD, COVERED ENTITIES UNDER THE PROMESA ACT 2 (October 30, 2016), <https://juntasupervision.pr.gov/index.php/en/documents>. But see, Oversight Board's document where it expanded the original list to 63 entities. OVERSIGHT BOARD, COVERED ENTITIES (November 18, 2016), <https://juntasupervision.pr.gov/index.php/en/documents/>

¹² See, COSSEC, AUDITED FINANCIAL STATEMENTS (June 30, 2016) available in Spanish at http://www.cossec.com/cossec_new/estados_financieros/Estados_Financieros_30_junio_2015_2016.pdf

- COSSEC is not a bond issuer.¹³

Therefore, the Oversight Board's control over COSSEC is not justified under PROMESA.

The Commonwealth of Puerto Rico does not have a central bank that may act as lender of last resort for Puerto Rico cooperative credit unions. Therefore, in case COSSEC may not be able to manage multiple insolvencies, the use of funds of the Commonwealth of Puerto Rico will be required to contain a financial crisis at Puerto Rico cooperative credit unions. Indeed, the Commonwealth of Puerto Rico is the lender of last resort for Puerto Rico cooperative credit unions.

Under PROMESA, the Oversight Board has the ultimate authority over the funds of the Commonwealth of Puerto Rico.¹⁴ This fact raises the concern of whether in a scenario when a lender of last resort is needed, the Oversight Board will prioritize the financial stability of Puerto Rico cooperative credit unions, and ultimately of the Puerto Rico financial system, over PROMESA's compliant budget requirement.¹⁵

II. The Oversight Board Becomes Banking Supervisor by Assuming Operational Control over COSSEC

The Oversight Board's designation of COSSEC as a covered territorial instrumentality has since been abusively applied to directly interfere with COSSEC's ability to act as deposit insurer and banking supervisor of Puerto Rico cooperative credit unions. At its second public meeting on October 14, 2016 in New York, the Oversight Board Chairman José Carrión invoked Section 207 of PROMESA to exercise operational control over COSSEC and other designated covered territorial instrumentalities.

No covered territorial instrumentality may proceed with any transaction out of the ordinary course of business or that could have material financial impact, without the prior approval of the Board. A transaction could be financial or **non-financial**, and would include but not be limited to any issuance of debt or guarantee, exchange, modification, repurchase, redemption, or entering into similar transactions with respect to any debt of the Commonwealth of Puerto Rico, including all covered territorial instrumentalities, **as provided in Section 207** (emphasis added).¹⁶

Then, singling out COSSEC, Carrión continued:

As an example, the proposed transaction of exchange of preferred shares of the Public Corporation for the Supervision and Insurance of Cooperatives [known

¹³ On the contrary, COSSEC is a bondholder because it has Puerto Rico bonds among its investments. *Id.*

¹⁴ PROMESA § 202.

¹⁵ *Id.* Even though section 205(a) of PROMESA states that the Oversight Board may submit recommendations to the Government of Puerto Rico to "promote financial stability" it does not seem to refer to the stability of Puerto Rico financial system.

¹⁶ See, video of the second meeting of the Oversight Board, available at <https://junta.pr.gov/index.php/en/videos-of-meetings/> (starting at 21:40).

as COSSEC by its acronym in Spanish] for obligations of the Commonwealth of Puerto Rico is a transaction that requires prior approval of the Board.¹⁷

These statements were then incorporated in an Oversight Board's resolution.¹⁸

Although COSSEC's proposed transaction of exchange arguably "could have material financial impact", it does not fall under the scope of Section 207, which provides that no covered territorial instrumentality may, without prior approval of the Oversight Board, "issue debt or guarantee, exchange, modify, repurchase, redeem, or enter into similar transactions **with respect to its debt**" (emphasis added).¹⁹ The transaction of exchange proposed by COSSEC intended to swap COSSEC preferred shares for Puerto Rico bonds in which a group of Puerto Rico cooperative credit unions had invested.²⁰ These bonds were causing significant losses to these cooperative credit unions and consequently impairing their capitalization. This transaction is a legitimate and proper action for a banking supervisor and deposit insurer who is managing a financial crisis at banking institutions. It is like the course of action that the U.S. Treasury adopted to protect U.S. banking institutions in the 2008 financial crisis.²¹ Because the transaction does not relate to COSSEC's own debt, it is not subject to oversight under Section 207.

Clearly, the Oversight Board's interpretation of Section 207 to apply broadly to "any debt of the Commonwealth of Puerto Rico" exceeds the scope of Section 207, which is limited to apply to the debts of the covered territorial instrumentality itself. The application of this expanded interpretation in the case of COSSEC constitutes an abusive over-reach of the Oversight Board's authority that usurped COSSEC's legitimate role and function of deposit insurer and banking supervisor.

Also at the same meeting of October 14, 2016, the Oversight Board required COSSEC to submit a fiscal plan separate from the fiscal plan of the Commonwealth of Puerto Rico. Later, on April 28, 2017, at its seventh public meeting (also in New York), Mr. Carrión, stated that "COSSEC's [fiscal] plan is under review pending completion of possible technical recommendations regarding the instrumentality operations. It is expected to be completed in the next 30 to 45 days".²² The 45-day period will expire on June 12, 2017. In the meantime,

¹⁷ *Id.*

¹⁸ Neither the resolution nor the minutes of the second meeting have been posted to the Oversight Board website (last visited June 5, 2017).

¹⁹ See *supra* note 16; PROMESA § 207.

²⁰ This transaction is the functional equivalent of a purchase of Puerto Rico bonds in the secondary market.

²¹ Indeed, two FDIC insured banks located in Puerto Rico (Popular Inc. and First BanCorp) received direct financial assistance from the U.S. Treasury. On May 10, 2017, U.S. Treasury announced "that it had agreed to sell all of its remaining 10,291,553 shares of First BanCorp. (FBP) common stock, exiting Treasury's largest remaining bank investment in the Troubled Asset Relief Program (TARP)." See, <https://www.treasury.gov/press-center/press-releases/Pages/sm0078.aspx>; U.S. TREASURY, TROUBLED ASSET RELIEF PROGRAM-MONTHLY REPORT TO CONGRESS APRIL 2017 1 (May 10, 2017), <https://www.treasury.gov/initiatives/financial-stability/reports/Pages/Monthly-Report-to-Congress.aspx>; Popular, Inc. Completes Repayment of TARP Funds (July 2, 2014), <http://newsroom.popular.com/press-release/investors/popular-inc-completes-repayment-tarp-funds>

²² See, video of the seventh meeting of the Oversight Board available at <https://junta.pr.gov/index.php/en/videos-of-meetings/> (starting at 23:56).

the uncertainty regarding the financial health of COSSEC as well as its authorization to perform its responsibilities as deposit insurer and banking supervisor of Puerto Rico cooperative credit unions lingers.

III. The Oversight Board's Actions Towards COSSEC Impedes Financial Intermediation

The virtual limbo in which the Oversight Board has placed COSSEC through its wrongful actions, by

1. designating COSSEC as a covered territorial instrumentality,
2. obstructing COSSEC's legitimate actions as deposit insurer and banking supervisor, and
3. delaying the evaluation of COSSEC's fiscal plan,

has placed Puerto Rico cooperative credit unions at competitive disadvantage in relation to commercial banks located in Puerto Rico.

The resulting uncertainty

- undermines COSSEC's status as deposit insurer and
- hinders Puerto Rico cooperative credit unions from attracting deposits.

This situation, in turn, impedes financial intermediation to improve Puerto Rico's economic condition since it discourages the much-needed development of local capital. Ironically, the Oversight Board, the very body that Congress placed in charge of aiding the financial and economic recuperation of Puerto Rico, is thwarting Congressional goals through its abusive and illegitimate treatment of COSSEC.²³

IV. The Oversight Board's Actions Towards COSSEC Raise the Risk of Contagion to FDIC Insured Banks Located in Puerto Rico

The 2016 COSSEC Audited Financial Statements state that in 2017 six cooperative credit unions will probably face insolvency problems, and an additional group of cooperative credit unions will need financial assistance due to capitalization problems caused by these institutions' investments in Puerto Rico bonds.²⁴ In a February 2016 memo to the House Natural Resources Committee attorney José Sosa-Llorens and Mr. Fernando Viñas-Miranda, Managing Director of Samuel A. Ramirez & Co., Inc., representing 25 of the largest cooperative credit unions in Puerto Rico (known as G25), asked the Committee to authorize

²³ Even more, the Oversight Board's actions contradict section 205(a) of PROMESA which states that the Oversight Board may submit recommendations to the Government of Puerto Rico to "promote ... economic growth".

²⁴ See *supra* note 12, at 6. Indeed, on May 16, 2017 a group of fourteen cooperatives credit unions filed a Notice of Appearance in both the Commonwealth of Puerto Rico and COFINA Title III Bankruptcy cases. See, Notice of appearance and request for notice filed by VANESSA MEDINA ROMERO on behalf of COOPERATIVA A/C YAUCO, COOPERATIVA A/C LOS HERMANOS, COOPERATIVA A/C SAN JOSE, COOPERATIVA A/C LOMAS VERDES, COOPERATIVA A/C LAS PIEDRAS, COOPERATIVA A/C JESUS OBRERO, COOPERATIVA A/C SAULO D. RODRIGUEZ, COOPERATIVA A/C AGUAS BUENAS, GERENCOOP, FEDECOOP, Educoop, COOPACA, COOPERATIVA A/C CAGUAS, COOPERATIVA A/C CABO ROJO (May 16, 2017), <https://cases.primeclerk.com/puertorico/Home-DocketInfo>