STANDARD & POOR'S

RATINGSDIRECT®

January 14, 2008

Puerto Rico Employees Retirement System; Appropriations

Primary Credit Analyst:
Horacio Aldrete-Sanchez, Dallas (1) 214-871-1426; horacio_aldrete@standardandpoors.com

Secondary Credit Analyst:
David G Hitchcock, New York (1) 212-438-2022; david_hitchcock@standardandpoors.com

Table Of Contents

Rationale

Outlook

The ERS Has A Long Track Record Of Receiving Employer Contributions

Governance Structure Closely Links The ERS And The Commonwealth

Legal Provisions

Puerto Rico Employees Retirement System; Appropriations

Credit Profile		
US$3,690.16 mil sr pens fdng bnds ser 2008B due 07/01/2057		
Long Term Rating	BBB-/Stable	New
US$500. mil senior pension funding bonds ser A due 07/01/2057		
Long Term Rating	BBB-/Stable	New

Rationale

Standard & Poor's Ratings Services assigned its 'BBB-' rating, and stable outlook, to Puerto Rico Employees Retirement System's (ERS) series 2008A senior pension funding bonds and series 2008B senior pension funding bonds.

The rating on the ERS bonds is the same as Puerto Rico's GO and appropriation rating. Standard & Poor's, however, does not necessarily expect the ERS bond rating to change with the commonwealth's rating.

The rating reflects the system's:

- Large pool of participating employers, including government agencies, most public corporations, and municipalities;
- Long track record of receiving employer contributions at a rate that has not been reduced since 1960;
- Statutory mandate by employers to appropriate the 9.275% contribution rate -- While contributions are subject to appropriation, they have a legal payment priority after only public debt; and
- Increasing projected debt service coverage (DSC), based on conservative assumptions of covered payroll growth throughout the bonds' life.

Factors that preclude a higher rating include:

- The credit quality of the leading contributors to the retirement system, in particular Puerto Rico ('BBB-'/Stable) and its agencies;
- The subordinate nature of the commonwealth's employer contributions to payments on its GO debt, which effectively makes a portion of the pledged revenues subject to the commonwealth's "claw back" provision;
- The legal precedent that precludes the Puerto Rico Legislature from making amendments to employer contributions that hinder the system's actuarial solvency -- This legal protection, however, does not apply to the legislature's ability to amend employer contributions if it has an effect on bondholders; and
- The bonds' extended 50-year maturity, which increases the risk of significant variations in the structure securing the bonds.

The bonds are limited, nonrecourse obligations of the ERS, secured solely by a pledge of participating employer contributions, currently paid at a rate of 9.275% of payroll. The ERS plans to issue roughly $4.2 billion of bonds in January to increase the funds currently available to pay benefits under the system's defined benefit plan. The ERS plans to issue a second installment of roughly $3 billion during calendar 2008.

The ERS is a trust created in 1951 to provide retirement and disability annuities, death benefits, and loans to Puerto Rico's public employees. The system administers two separate retirement plans: a defined benefit plan, which closed to new members on Dec. 31, 1999, and a defined contribution plan, available to employees who entered the system on or after Jan. 1, 2000. System benefits are funded by a combination of monthly or bimonthly employer and employee contributions and investment earnings. Participating employers are statutorily required to contribute to the defined benefit plan at a rate of 9.275% of payroll. The requirement to make this contribution is not tied to the number of participating employees in the defined benefit plan. Historically, actual employer contributions have been substantially below the annual required contribution, resulting in a $9.9 billion unfunded actuarial accrued liability, or a 19% funding ratio.

Global Insight Inc. developed five scenarios of projected growth in covered payroll. These scenarios include variations in government employment, labor force participation, inflation rates, and economic growth. The base case, which projects an average annual growth of 4.5% in covered payroll, consistent with historical commonwealth patterns, results in annual DSC of 1.4x within the first 20 years before increasing to above 4.0x in the outer years. This projection includes the full $7 billion of expected ERS senior pension funding bonds. Under a more conservative scenario, including the assumption of a drastic reduction in total government employment to 14% by 2017 from 24% in 2006, DSC remains adequate, ranging from 1.11x-3.50x. In addition, projected covered payroll can be 25% below baseline projections to attain 1x annual DSC.

Appropriation risk is mitigated, in part, by an existing statute, which establishes that when the available funds for a specific fiscal year are not sufficient to cover the appropriations approved for that year, the governor is required to prioritize the disbursement of public funds in a specific order. The payment of interest and amortizations on the commonwealth's GO debt is at the top of this list, followed by the payment of binding obligations to safeguard the commonwealth's credit, reputation, and good name and the payment of employer contributions to retirement systems.

Outlook

The stable outlook reflects our expectation that employer contributions will increase as projected and that they will consistently flow into the ERS with historical levels. The stable outlook also assumes the rate of employer contributions will remain at least at 9.275%. Legislative action to reduce the statutorily mandated employer contribution rates might pressure the rating.

The ERS Has A Long Track Record Of Receiving Employer Contributions

There are 210 participant employers in the ERS, including the central government and its agencies, municipalities, and most public corporations. The system does not include Puerto Rico Electric and Power Authority, University of Puerto Rico professors, judges, and teachers. The employer contribution rate, which was last increased in 1990, has not been reduced since 1960.

While the system includes a large number of participants, employer contributions are concentrated with the 10 leading participants accounting for 54% of total employer contributions. Contributions from the central government and its agencies and departments (51% of total contributions) flow directly through the commonwealth's treasury department while public corporations and municipalities make their payments directly into the ERS. The timely collection of employer contributions is high with 95% of contributions received within 15 days of the due date and 98% of contributions received during the year the contribution is due. While there are a small number of entities that are persistently delinquent in their payments, the amount owed to the system is just 1.5% of all employer contributions. In addition, there are built-in incentives to promote timely payment of employer contributions, including a Memorandum of Understanding between ERS and the Government Development Bank for Puerto Rico, in which public corporations and municipalities are prevented from having access to funding sources if, as employers, they have unpaid employer contributions to the system. In addition, ERS is authorized to suspend preretirement benefits, such as loans, to employees of an employer three months past due in the payment of its system contributions.

Governance Structure Closely Links The ERS And The Commonwealth

The board of trustees sets policy and oversees the operations of the ERS. Board members include Puerto Rico's secretary of the treasury, the Government Development Bank's president, the commissioner of municipal affairs, and Puerto Rico's director of the office of human resources. In addition, the governor appoints three members to three-year terms. Two of these appointees must be members of the ERS or members of the Judiciary Retirement System with at least 10 years of credited service. Finally, the board includes a pensioner of the ERS or the Judiciary Retirement System. The administrator of the system, who is appointed by the board, oversees day-to-day operations.

Legal Provisions

The ERS has agreed to the monthly deposit of all employer contributions with a fiscal agent. The bond resolution creates a debt service reserve account funded from bond proceeds at 50% of the rolling average annual debt service for the following five years and features a prospective additional bonds test that requires projected contributions in each year, based on an independent forecast, to provide at least 1.40x DSC of senior bond debt service and 1.25x total debt service in that year. In addition, the flow of funds requires that excess revenues, after all debt service account requirements have been satisfied, remain in a general reserve account. Excess revenues can only flow back into the system from the general reserve account until the following conditions are met:

- During the bond year there has been no withdrawal from the debt service reserve account,
- The DSR for every class of funds is funded up to their required amounts,
- There are no outstanding amounts due to the fiscal agent,
- 10% of the next bond year's aggregate debt service for all bonds outstanding is currently on deposit in the general reserve account, and
- There can be no transfers into the system from the general reserve account in the event the employer's contribution rate is lowered to below 9.275%.

The legislature can lower the employer's contribution rate. A Puerto Rico Supreme Court case, Bayron Toro v. Serra, however, states the legislature can only amend the legislation regarding the employer's contribution if it furthers the actuarial solvency of the ERS, providing a degree of protection against potential efforts by the legislature to lower the employer contribution rate below the current 9.275%.