Moody's Investors Service

Global Credit Research
New Issue
4 JAN 2008

New Issue: Puerto Rico Employees Retirement System

MOODY'S ASSIGNS Baa3 TO APPROXIMATELY $4 B PUERTO RICO PENSION FUNDING BONDS, SERIES A

OUTLOOK ON TAXABLE BONDS IS STABLE

Puerto Rico (Commonwealth of)
State
PR

Moody's Rating

ISSUE	RATING
Senior Pension Funding Bonds, Series A	Baa3

Sale Amount	$4,000,000,000
Expected Sale Date	01/15/08
Rating Description	Senior Pension Funding Bonds

Opinion

NEW YORK, Jan 4, 2008 -- Moody's Investors Service has assigned a rating of Baa3 to the Senior Pension Bonds, Series A, issued by the Employees Retirement System of the Government of the Commonwealth of Puerto Rico. The par amount of the taxable bonds is expected to be approximately $4 billion, and they are expected to sell in January. The bonds will have a final maturity date of 50 years.

Proceeds of the bonds will be used to increase the funds currently available to pay pension benefits and to reduce the unfunded accrued actuarial pension liability. It is expected that an additional issuance of approximately $3 billion, on parity with the Series A bonds, will take place in the first half of calendar year 2008. The Baa3 rating takes into account the full planned issuance of the approximately $7 billion. The rating reflects the lack of legal separation from the commonwealth, the structure of the bonds and the mechanisms in place to make statutorily mandated employer contributions, as well as the relatively weak rating of the commonwealth compared to the ratings of U.S. states. While the rating is the same as the commonwealth's general obligation rating, Moody's does not expect that the rating on the pension funding bonds will necessarily move with the rating of the commonwealth. The stable rating outlook reflects the general stability the employer contribution payments have shown and are expected to show, as well as the stable outlook on the commonwealth at this time.

Credit Strengths

-- The commonwealth's employers have a long history of making the employer contribution payments.

-- The Employees Retirement System is large and diverse, including central government agencies, municipalities, and most public corporations.

-- Higher debt service coverage in the outyears provides some protection from possible fluctuations in employer contributions due to economic dips or changes in delinquent payments.

-- Statutory mandate to appropriate the 9.275% contributions reduce appropriation risk.

-- Legal protections prevent the legislature from making amendments that do not support the actuarial solvency of the ERS.

Challenges

-- Lack of complete legal separation from the commonwealth, which is low-rated compared to states.

-- Employer contributions are partially subject to "clawback" provision.

-- Legal protection prohibits the legislature from making the system worse off, actuarially, but doesn't prohibit them from making changes that make bondholders worse off.

-- 50-year maturity increases risk of structural changes.

The Employees Retirement System (ERS) of the Commonwealth of Puerto Rico is a trust created by law in 1951 to provide pension benefits. The benefits are funded by regular contributions made monthly or twice a month to the ERS by the government and its instrumentalities and their employees, and investment earnings. Government employers are required by law to make employer contributions of 9.275% of their payroll. At present, the system is only 19% actuarially funded. The ERS plans to issue approximately $4 billion at this time, and another $3 billion in the near future. This will bring the system to a funded ratio of approximately 70%. ERS is pledging the future employer contributions (at the current 9.275% rate) to the payments of the bonds, investing the proceeds, and using the proceeds and earnings on them to pay benefits.

EMPLOYEE RETIREMENT SYSTEM IS LARGE AND DIVERSE

The ERS includes central government agencies, municipalities, and most public corporations. It does not include PREPA (Puerto Rico Electric and Power Authority), the University of Puerto Rico, judges, and teachers. The system is large and has a broad variety of member employers, with 225 government employers, 176,000 active participants, and 99,800 retirees and beneficiaries. ERS has 2 defined benefit plans and one defined contribution plan. The defined benefit plans were closed in 2000, and all new participants are in the defined contribution plan.

EMPLOYERS HAVE LONG HISTORY OF PAYING STATUTORY CONTRIBUTIONS

There are 225 employers in the system, and they make employer contributions once or twice a month to the system. The Department of the Treasury makes contributions on behalf of central government agencies and departments and certain public corporations at the same time that payroll checks are processed (approximately every two weeks). The remaining public corporations and municipalities pay the ERS directly, also when payroll checks are processed. While there are a large number of employers, the concentration of contributions is skewed. The top 10 employers with regard to size of contributions account for 51% of total employer contributions.

The current statutory employer contribution rate is 9.275% of total payroll. The commonwealth has not reduced the contribution rate since 1960.

A small number of employers are consistently late with employer contributions, or don't pay at all. The system normally receives approximately 95% of employer contributions within 15 days of the due date, and more than 98% within the year the contribution is due. The ERS has the statutory authority to compel payments from an employer. Failure to remit contributions on time constitutes a misdemeanor. There are a small number of employers who pay one month late each year, there are some who pay a few months late, and there is a very small number who consistently do not make their employer contribution payments. The number of employers who do not make their payments, and the amount of money that is owed to the system by these employers, is extremely small when compared to the total amount of employer contributions received.

The ERS has the legal authority to notify and require employers to make contributions, and may suspend benefits to the employees of any agency that does not make its contributions. In addition, heads of agencies/municipalities that do not comply are guilty of a felony punishable by imprisonment.

DEBT SERVICE COVERAGE GROWS OVER TIME

Global Insight provided the commonwealth with a number of projections of employer contributions. The baseline projection projects that from 2007-2058, the average annual growth rate of covered payroll is 4.5%. This is based on a number of underlying assumptions, including assumptions on employment (total employment in the ERS increases 1% per year), labor force participation (rate assumed to grow from 47% to 63% by 2058), unemployment (unemployment rate falls from 10.4% to 3.6% by 2058), and average wages (assumed to grow 3.5% per year).

Given the baseline projection of employer contributions, debt service coverage (assuming the planned $3 billion issuance next year as well as the current issuance) rises from 1.3 times in the first couple of years to over 4 times in the outyears. A more conservative forecast of employer contributions, also provided by Global Insight as one of a variety of scenarios, results in debt service coverage growing from 1.2 times to approximately 3 times in the later years. Employer contributions could come in at 20% below the base case assumptions every year for the life of the bonds and the contributions would still be at least equal to debt service.

LEGAL DECISION AND ABT OFFERS BONDHOLDER PROTECTION

The ERS has agreed to deposit all employer contributions with a fiscal agent promptly upon receipt. In addition, there exists a Memorandum of Understanding between ERS and the Government Development Bank (GDB), public corporations, and municipalities that prevents them from access to funding sources if they haven't paid their employer contributions to ERS. Under this, the ERS has collected $1 million in the past year.

A Puerto Rico Supreme Court case, Bayron Toro vs. Serra, states that the legislature can only amend the legislation regarding the employer contributions if it furthers the actuarial solvency of the ERS. This offers some protection as it limits the ability of the legislature to make changes such as lowering the statutorily required employer contribution rate.

There is an additional bonds test of 1.4 times for senior bonds and 1.25 times for subordinate bonds. The system has no plans to issue subordinate bonds at this time. In addition, a Debt Service Reserve Fund is to be funded with 50% of average annual debt service for the next 5 years.

Outlook

The rating outlook for the pension funding bonds is stable at this time, reflecting the newfound stability the commonwealth has shown over the past year, meeting budget targets and progressing toward structural balance even while in a recessionary period.

What could move the rating--UP

"Increase in legal separation from the commonwealth.

"Statutory increase in employer contribution rate, demonstrating commonwealth support for the bonds and resulting in dramatically increased coverage.

"Strengthening of legal protections to bondholders.

What could move the rating--DOWN

"Decrease in statutorily mandated employer contribution rates, resulting in coverage decline.

"Prolonged and severe recession or other change resulting in dramatic decline in employer contributions.

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