Puerto Rico Employees Retirement System Outlook Revised To Negative From Stable Based On Budget And Pension Challenges

Publication date: 26-Jul-2012 14:19:01 EST

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DALLAS (Standard & Poor's) July 26, 2012--Standard & Poor's Ratings Services revised its outlook on the Employees Retirement System (ERS) of the Government of the Commonwealth of Puerto Rico's $2.9 billion in senior pension funding bonds, series A, B, and C to negative from stable based on our opinion of the ability of the leading participating employers including, but not limited to the commonwealth, to continue to make their required contributions to the system in full and on a timely basis. At the same time, Standard & Poor's affirmed its 'BBB-' rating on the bonds.

Our current rating and outlook on the ERS bonds mirror our rating and outlook on Puerto Rico's (BBB/Negative) appropriation debt. "However, we believe that the commonwealth's fiscal and budgetary challenges, including the independent actuary's projected depletion of the retirement fund's gross assets by fiscal 2019, could limit the commonwealth's ability and willingness to provide the timely contributions that will be required to maintain an adequate debt service coverage on the ERS bonds," said Standard & Poor's credit analyst Horacio Aldrete-Sanchez. Puerto Rico's failure to adopt comprehensive measures to address its unfunded pension liability within the next year could result in a downgrade on the ERS bonds even without a corresponding downgrade on the commonwealth appropriation rating. While we recognize that the adopted multiyear increases to the employers' required contribution could result in higher annual debt service coverage on the bonds, we believe that the timely adoption of these increases will remain uncertain due to the commonwealth's fiscal and budgetary challenges.

Other factors that support our ratings include 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 11.275% contribution rate. These contributions, however, are subject to appropriation by the participating employers; and
- Adequate annual debt service coverage through fiscal 2027, which we believe could increase as a result of the passage of Law 116 of 2011, which requires annual increases of 1% to the employer contribution starting in fiscal 2012 through fiscal 2016, with additional annual increases of 1.25% until employer contributions reach 20.5% of payroll in fiscal 2021.

Factors that preclude a higher rating include:

- The credit quality of the leading contributors to the ERS, particularly Puerto Rico 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 Puerto Rico's "clawback" provision;
- Legal precedent that precludes the legislature from making amendments to employer contributions that hinder the actuarial solvency of the system. This legal protection, however, does not apply to the legislature's ability to amend employer contributions if it affects bondholders; and
- The extended maturity of the bonds, which increases the risk of significant variations in the contributions 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 pledge of participating employer contributions, currently paid at a rate of 11.275% of payroll.

The negative outlook is based on our opinion of the ability of the leading participating employers including, but not limited to the commonwealth, to continue to make their required contributions to the system in full and on a timely basis. Our outlook on the ERS bonds mirrors our outlook on the commonwealth's appropriation debt. However, we believe that the commonwealth's fiscal and budgetary challenges, coupled with the independent actuary's projected depletion of the retirement fund's gross assets by fiscal 2019, could limit the commonwealth's ability and willingness to provide the timely contributions that will be required to maintain an adequate debt service coverage on the ERS bonds. Although the ERS rating could be affected by any change in the commonwealth's GO or appropriation ratings, the failure by the commonwealth to adopt comprehensive measures to address its unfunded pension liability within the next year could result in a downgrade on the ERS bonds even without a corresponding downgrade on other commonwealth debt. While we recognize that the adopted multiyear increases to the employers' required contribution could result in higher annual debt service coverage on the bonds, we believe that the timely adoption of these increases will remain uncertain due to the commonwealth's fiscal and budgetary challenges.

RELATED CRITERIA AND RESEARCH

- USPF Criteria: **Special Tax Bonds**, June 13, 2007
- USPF Criteria: **State Ratings Methodology**, Jan. 3, 2011
- USPF Criteria: **Appropriation-Backed Obligations**, June 13, 2007

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