FitchRatings

FITCH ASSIGNS 'BBB+' RATING TO OUTSTANDING PUERTO RICO GO BONDS; OUTLOOK STABLE

Fitch Ratings-New York-19 January 2011: Fitch Ratings assigns a 'BBB+' rating to approximately $9.2 billion of outstanding general obligation (GO) bonds of the Commonwealth of Puerto Rico. The Rating Outlook is Stable.

RATING RATIONALE:
--Financial operations historically have been weak with a record of budgetary and GAAP deficits, overestimation of revenues, unfunded overspending, and a reliance on borrowing to meet budgetary gaps. The government has taken dramatic steps to restructure fiscal operations and stimulate the economy. The fiscal stabilization plan, with its emphasis on reduced government spending, was designed to close the structural gap over the course of three fiscal years. Its successful implementation is a positive credit factor.
--The commonwealth's economy, which is limited but closely linked to the U.S. economy, is experiencing the fourth straight year of recession - a downturn that started earlier, was deeper, and is lasting longer than the U.S. national recession. There are signs the economy is beginning to stabilize and modest growth is expected in fiscal 2011.
--Debt levels are very high, partially reflecting the consolidated nature of the central government's role, and have increased as the commonwealth has used deficit financing as part of its fiscal stabilization plan.
--Pension funding is exceptionally low and, absent significant action, the main pension fund will run out of resources within a few years. Although the government is expected to take steps to begin to rectify the pension funding problem, its ability to do so may be limited by the ongoing weakness in the economy, narrow financial operations, and already high debt levels.

KEY RATING DRIVERS:
--Successful implementation of fiscal and economic reform that results in a balanced budget and emergence from the prolonged recession.
--Further reform of the pension system to increase funding levels over time.

SECURITY: The bonds are a general obligation, full faith and credit obligation of the Commonwealth of Puerto Rico. GO bonds benefit from a constitutional first claim on commonwealth revenues, including transportation-related and rum excise tax revenues dedicated to specific authorities and other bonds.

CREDIT SUMMARY:
Puerto Rico's GO rating reflects the somewhat limited nature of its economy, its strong ties to the U.S., the ongoing recession, a history of weak financial operations, and very high liabilities including outstanding debt and unfunded pensions. The significant progress the current administration has made in implementing fiscal and economic reform is a positive credit factor. Strong legal provisions for GO debt include a constitutional first claim on commonwealth revenues, including transportation-related and rum excise tax revenues that are dedicated to specific authorities and other bonds.

Faced with growing budgetary and GAAP deficits, a history of overestimating revenues and overspending, and a reliance on borrowing to meet budgetary gaps, the current administration has taken significant action to restructure the budget amidst the prolonged recession. The administration has demonstrated its willingness and ability to make significant changes to fiscal operations. It has successfully enacted legislation to implement both temporary and permanent revenue enhancements, stepped up revenue collection enforcement, and dramatically reduced public spending. The fiscal stabilization plan, with its emphasis on reduced government spending, is designed to close the structural gap over the course of three fiscal years, by fiscal 2012; there has been significant use of deficit borrowing under the sales tax backed (COFINA) credit during the transition period.

The administration is now turning its attention to tax reform and is expected to focus subsequently on pension reform, both intended to achieve longer term structural balance. The tax reform proposal, which is before the Puerto Rico legislature, would replace revenues lost through significantly lower personal and corporate income tax rates with a temporary excise tax on certain manufacturers and ultimately by implementation of a source income rule for multi-national corporations. The restructuring of the tax system is intended to stimulate the economy and promote private sector investment by providing tax relief to individuals and corporations, simplifying the tax system, and reducing tax evasion. The top corporate tax rate will be reduced immediately from 41% to 30% and there will be tax relief across all corporate income tax brackets. All individual tax payers will likewise have tax relief, the number of tax deductions will be reduced from 28 to five and the average tax rate will be reduced 49% by fiscal 2016. The loss of income tax revenue is expected to be more than offset by a temporary excise tax on transactions between manufacturers and distributors that are part of the same holding or control group. The excise tax, enacted in December 2010 as Act 154 and effective Jan. 1, 2011, includes tax credits for the affected companies who maintain employment at at least 90% of the current level, and will be phased out by fiscal 2016 when it is replaced by the income from the source income rule. There is risk that the tax reform plan will not generate sufficient revenues to offset the loss of income tax revenues and ultimately result in a structurally balanced budget as planned. This concern is mitigated in part by a requirement that tax reductions beyond fiscal 2014 meet a three-pronged test of fiscal and economic growth, which includes targets for expense controls, general fund net revenues, and growth in gross national product (GNP). It is also Fitch's expectation that management will take additional action to balance the budget should revenues not materialize as anticipated.

The commonwealth's economy has experienced four straight years of recession, which started earlier, was deeper, and is lasting longer than the U.S. national recession.

Commonwealth GNP contracted 1.2% in fiscal 2007, 2.8% in fiscal 2008, 3.7% in fiscal 2009 and a further 3.6% in fiscal 2010. Over the course of the recession, Puerto Rico has lost over 100,000 jobs (approximately 10% of non-farm employment); the unemployment rate, which is typically much higher than the U.S. national rate, peaked at 16.9% in April 2010. Modest expansion had been predicted for fiscal 2010 with the federal and commonwealth stimulus plans expected to offset the steep workforce reductions associated with the fiscal stabilization plan. While this expansion was not realized and the economy continued to contract in fiscal 2010, there are indicators that the economy is beginning to stabilize, including a slowing of employment losses and increasing retail sales. However, employment continues to decline, with a year-over-year decrease of 1.9% in November while the U.S. grew .6%. Modest recovery of .4% of GNP is now expected in fiscal 2011, which began July 1.

Debt levels are very high, partially reflecting the consolidated nature of the central government's role, and have increased as the commonwealth has used deficit financing as part of its fiscal stabilization plan. Net tax supported debt is approximately 68% of 2009 personal income and over $10,000 per capita. The commonwealth utilizes a complex debt structure that includes GO, sales tax, guaranteed, and public corporation debt. There is approximately $1.47 billion of variable-rate GO debt outstanding, of which $1.34 billion has demand features supported by liquidity facilities. The commonwealth is actively pursuing several strategies to address expiring liquidity facilities ($573 million in fiscal 2011 and $770 million in fiscal 2012), including renewal and replacement, remarketing in fixed-rate mode, and refunding with fixed-rate debt. All variable-rate debt is synthetically fixed using interest rate swap agreements, with a mark-to-market value of negative $53 million as of Dec. 31, 2010. If the commonwealth refunds variable-rate debt it will also fund any payments associated with swap termination. The commonwealth benefits from its relationship with the Government Development Bank for Puerto Rico, which provides a degree of flexibility and liquidity. The commonwealth may come to market shortly, depending on market conditions, with a partial refunding of fiscal 2011 maturities for budget relief. GO amortization is a slow 20% and 44% in five and 10 years respectively.

Pension funding is exceptionally low: as of June 30, 2009, the Employees Retirement System (ERS) had a funded ratio of just 9.8%, with an unfunded accrued actuarial liability (UAAL) of

$17.8 billion (28% of 2009 personal income). Absent significant action, the main pension fund will continue to erode with the system projected to deplete its assets by fiscal 2019 under current funding and disbursement trends. System contributions are defined by law rather than by actuarial requirements and payments have not been covering the actuarially determined annual required contribution or even current benefit payments, which have exceeded contributions and investment income since 2004. Shortfalls have been covered with loans, sale of assets, and pension bond proceeds issued in 2008. The administration is considering several alternatives to improve the solvency of the pension systems, including increased contributions, changes in benefits, and asset sales to provide funding status relief. Despite limitations imposed by ongoing weakness in the economy, narrow financial operations, and already high debt levels, it is Fitch's expectation that the government will begin to take steps to rectify the pension funding problem.

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Applicable Criteria and Related Research:
--'Tax-Supported Rating Criteria', dated Aug. 16, 2010.
--'U.S. State Government Tax-Supported Rating Criteria', dated Oct. 8, 2010.

For information on Build America Bonds, visit 'www.fitchratings.com/BABs'.

Applicable Criteria and Related Research:
U.S. State Government Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=564546
Tax-Supported Rating Criteria
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