PUERTO RICO CONFERENCE

Entrepreneurship for Growth

2010

March 24, 2010 | Conrad San Juan Condado Plaza | 7:30 a.m. - 5:00 p.m.

Puerto Rico Chamber of Commerce

STANDARD & POOR'S

Puerto Rico Conference
Entrepreneurship for Growth

Horacio G. Aldrete
Director, Analytical Manager
Public Finance

The McGraw·Hill Companies

State credit trends we have observed through February 2010

- Credit trends in the sector were what we consider strong through fiscal 2008 and upgrades exceeded downgrades
  - 15 state ratings were upgraded from 2006 through 2008 and one state rating was downgraded.
- This shifted in 2009, and early 2010 as budget pressure mounted.
  - Three state ratings were lowered in 2009 and early 2010. California's general obligation rating was lowered twice to 'A-' from 'A+‘, Illinois' was also lowered twice to 'A+' from 'AA‘, and Arizona to ‘AA-’ from ‘AA’.
  - Six state ratings have a negative outlook (Arizona, California, Florida, Illinois, Ohio and Rhode Island)
  - Two state ratings had outlooks revised from positive to stable (Kentucky and Idaho).
  - Louisiana, North Dakota, Texas and West Virgina were upgraded.

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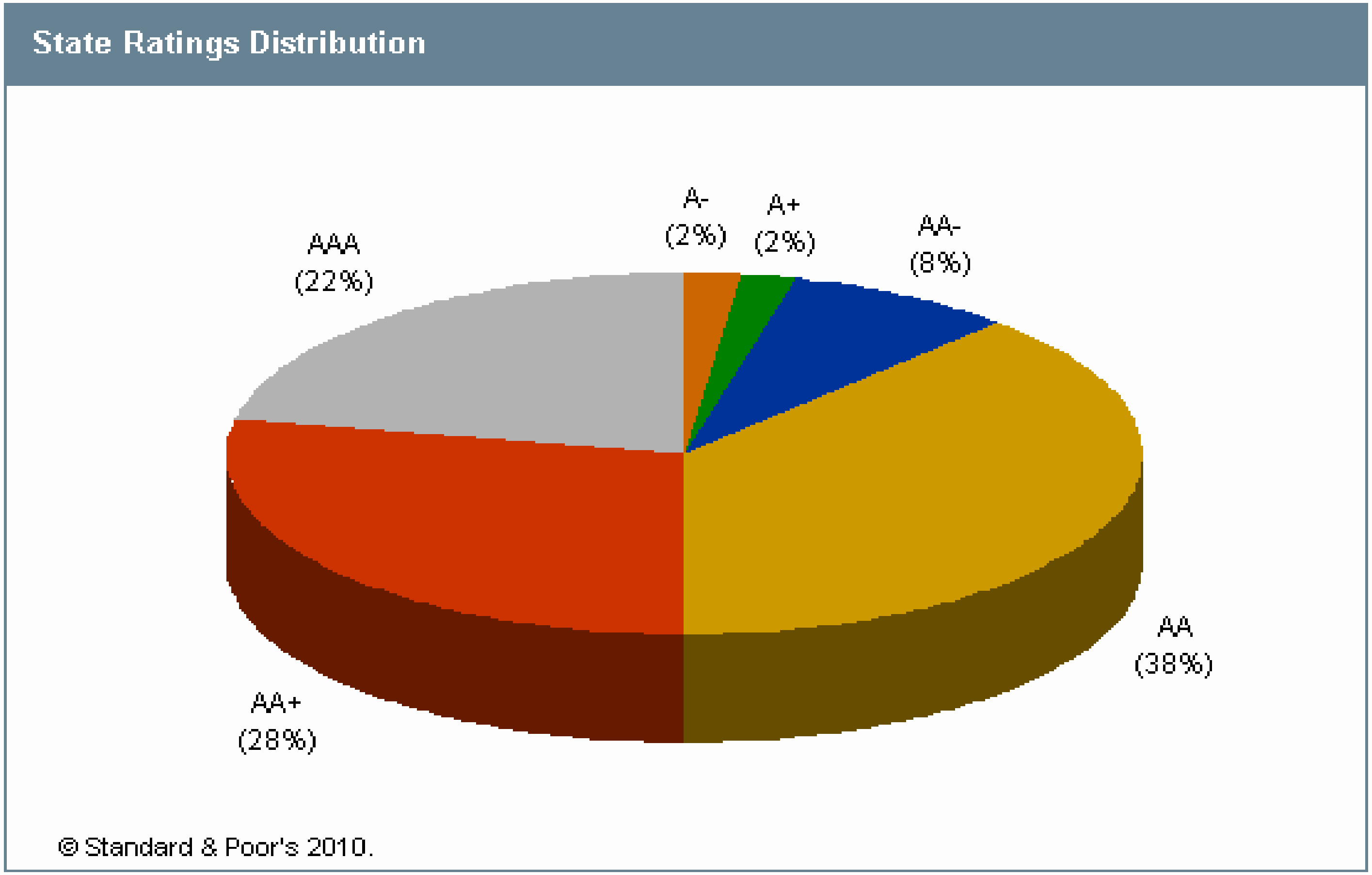
Distribution of State Ratings as of 2/2010

State Rating Distribution[1]



State Credit Update

From a credit standpoint, the state sector has, in our view, a relatively high credit profile and a history of managing through volatile economic periods.

We believe the relative credit stability for the sector to date reflects that:

- States tend to have well-developed budget and revenue monitoring processes and have been actively managing their budget gaps. Those that have not managed budget gaps have been downgraded.
- Most states have broad authority to enhance revenues, adjust spending and manage disbursements.
- The American Recovery and Reinvestment Act of 2009 (ARRA) has provided an unprecedented level of federal funding to state governments -- $140 billion to assist in budget balance.

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State Credit Update - Continued

- Most states entered the recession with high reserves which continue to provide flexibility in our view.
- Access to internal liquidity is high for many states.
- State governments typically have easy and cost effective access to the capital markets which is helpful for both budget balance and liquidity.

What We See As State Credit Challenges For 2010

- The revenue environment will likely remain fluid. All three major state tax sources (personal income tax, sales tax and corporate income tax) have performed weakly for nearly all states and this is likely to continue.
- Recovery in state revenues will likely lag economic recovery by a year or more.
- Federal stimulus funds will be exhausted in fiscal 2011 (however we believe there could be greater flexibility to manage education and Medicaid expenditures without maintenance of effort provisions).
- Pension funding requirements will be increasing but actuarial smoothing of losses will mitigate some of the budget impact.
- Social service spending pressures will likely mount.
- Local governments may be experiencing fiscal stress

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Our Views of State Debt

- We expect that the current economic and budget climate will continue to translate to more borrowing for some states. We have seen debt issuance to fund operations, manage pension costs, replace pay-go financing, or restructure outstanding debt for budget relief.
- So far we estimate that more than $15 billion has been issued or is planned – this compares to $30 billion during the last recession.
- Pension obligation bonds (POBs) may reemerge as a key financing tool for unfunded pension liabilities – we believe it is important to understand how the POB fits into the overall debt and liability structure of a prospective issuer.
- Debt affordability measures tied to revenue have been under pressure due to significant and prolonged revenue decline.

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Our View of US State Pensions

S&P's Report: "Market Declines Will Shake Up U.S. State Pension Funding Stability" – February 26th, 2009 shows the following:

- In 2007 (the latest year with substantially complete data available), according to our analysis, the mean funded ratio for the principal state pensions was 83%.
- Total gross unfunded actuarial accrued liability (UAAL) for the 50 states in 2007 is $368.5 billion, down slightly from 2006.
- The average U.S. state has a UAAL of $7 billion, or $1,458 per capita, and has a funded ratio of 83%.
- Cumulative pension liabilities exceed tax supported debt for 2007.

Our View of US State Pensions

- Given market volatility, we expect pension funding ratios to decline.
- Wilshire Associates reports the median performance for public pension funds for calendar year 2008 was minus 24.91%.
- Median performance from June 30, 2008-June 30, 2009 was -16.84%.
- Actual losses recorded by state plans will be determined by the reporting time horizon and asset allocation.

BUT…

- Median performance for the 3rd quarter of 2009 was 11.39%!!!

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Our View of State OPEB Status

•OPEB information available for the first time in fiscal 2008 audits

•S&P’s Report “U.S. States' OPEB Liabilities And Funding Strategies Vary Widely” – June 3, 2009 shows the following:

- Based on the reports done to date, OPEB liabilities total $459,817-$473,936 for the states (the range reflects valuations that show a liability with and without pre-funding);
- Range of liabilities is wide -- $0 for Nebraska to $50.6 billion for New Jersey
- Median liability: $2.4 billion
- Average Liability: $9.2-$9.5 billion

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Our View on State Credit Heading Into 2010

- Economic performance among states has been uneven during the recession and we expect this to be the case in recovery which will contribute to better revenue performance for some states.
- Recognizing the challenges and implementing what we consider difficult and what may be politically unpopular spending and revenue measures will continue to be key elements of credit stability.
- We expect that some states will see their credit quality tested as the recession lingers, spending pressures continue and stimulus funds are depleted.

Municipal Ratings on a Global Scale

- S&P's ratings opinions and analyses provide a common language for issuers and investors who are interested in the creditworthiness of issues or issuers. Our ratings may be useful to investors to help assess credit risk.
- We believe the global credit markets benefit from standards and benchmarks that are understood by all, *which is one reason we use the same scale across all sectors.*

S&P Municipal Ratings and Default Rates

- In 2001, Standard & Poor's completed its first US Public Finance (USPF) default and transition study.
- At that time, we reiterated our commitment to a global scale, highlighted the differences we saw in credit characteristics and performance between and among different sectors, and undertook a criteria review that continues through today.
- S&P has been systematically reviewing a large number of U.S. public debt instruments over the last several years in an effort to promote generally comparable ratings across asset types.
- Since 2001, more than 8,000 US Public Finance ratings have been upgraded

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S&P Municipal Ratings and Default Rates

- In 1986, only about 20% of municipal bonds rated by S&P held AAA or AA ratings; currently, more than 35% are rated that highly. For the state sector, 98% are rated AAA or AA category. Only 1.7% of corporate bonds held ‘AAA’ or ‘AA’ ratings in 2008.
- Approximately 98% of rated municipal issuers are investment grade, compared with less than 20% of corporate issuers that S&P has rated in recent years.

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Where Does the Commonwealth's Credit Fit in All This?

- **Current rating: 'BBB-'/Stable outlook**
- **Similarities (from a credit perspective) with other U.S. States:**
  - Similar sovereign powers for taxation and expenditure reduction
  - Proven access to the capital markets to fund capital and operating needs

- **Distinct Features (from a credit perspective)**
  - Credit Stability provided by GDB
  - Economic indicators remain substantially below what we observe in the continental U.S.
  - Until very recently, the Commonwealth had not made the difficult decisions to balance its budgets that we typically observe in other states during periods of economic decline.

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Credit Implications of Current Deficit

In our opinion, there are four main factors that we will continue to consider in our assessment of the stability of the Commonwealth's GO credit rating in the near term:

- **Fiscal and Budget Measures to Narrow the Gap**
- **The Government Development Bank Provides an Element of Stability**
- **Continued Market Access**
- **The Economic Recession will Continue to Pressure Revenues**

GDB Provides An Element of Stability

- **We believe the Commonwealth will need to rely, at least temporarily, on increased support from GDB to fund the budget gap**
- **The stabilizing effect of GDB on the Commonwealth's credit rating has its limitations. Pressure on the Commonwealth's GO rating will likely increase if:**
  - Reliance on GDB increases significantly
  - The Commonwealth does continue to apply measures <u>in the near term</u> to reduce the structural deficit
  - Reliance on GDB becomes a long-term and growing source of deficit financing for the Commonwealth

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Continued Market Access

- **In our opinion, Puerto Rico (and its agencies and instrumentalities, including GDB, and COFINA) will likely continue to rely on market access to fund its cash-flow needs to cover the deficit. A lack of sufficient market access to meet its funding needs could forestall one avenue that Puerto Rico has used in the past to solve cash shortfalls.**
- **Constitutional provisions that give priority payments to the Commonwealth's GO debt service support the current GO rating**

Select Articles: US Public Finance

- *“U.S. States' OPEB Liabilities And Funding Strategies Vary Widely” – June 3,2009*
- *Standard & Poor's Credit Views Of The Municipal Bond Provisions In The 2009 Stimulus Act – May 28, 2009*
- *“U.S. Public Finance Upgrades Continued To Outnumber Downgrades In The First Quarter, But Ratio Has Weakened Due To The Recession” – April 28, 2009*
- *“The Capital Gains Tax Picture Is Far From Clear For Most States” – April 8, 2009*
- *“Recession's Effect On Revenues Dominates U.S. States' Budget Deliberations” – March 31st, 2009*
- *“Market Declines Will Shake Up U.S. State Pension Funding Stability” – February 26th, 2009*
- *U.S. State And Local Governments Are Also Counting On A Federal Stimulus Package – February 4th, 2009*
- *How "Smoothing" Can Ease The Pain Of Pension Fund Losses For State And Local Governments – January 27th, 2009*
- *U.S. States Brace For Difficult Budget Environment In 2009 – December 19, 2008*
- *“States Weather Credit Market Disruptions, But Are Likely to Step Up Borrowing As Economy Slows” - July 14th, 2008*
- *Time May Be Ripe For A POB Revival – January 23, 2008*

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