The importance of bond ratings

Sergio M. Marxuach
Opinion

Puerto Rico's credit rating has been in the news recently. When the government of Puerto Rico or one of its agencies issues bonds, credit rating agencies, such as Moody's Investors Service and Standard & Poor's Rating Services, analyze various quantitative and qualitative factors that may affect the borrower's ability and willingness to repay, including, but not limited to, the financial condition of the borrower, the prevailing economic conditions in the island, and the political environment at the time of going to the market. The result of this analysis is an opinion or judgment about the borrower that is commonly known as a credit rating.

Each credit rating agency has its own debt rating scale but they are fairly similar. Moody's rating scale goes from a rating of Aaa for borrowers with the best credit quality to C for bonds that are highly speculative; while S&P's scale goes from AAA for the best borrowers to D for borrowers that are in default or bankruptcy. In each of these scales an important distinction is made between investment and speculative or "junk" grades. Moody's considers debt rated at or below Ba1 to be a speculative investment, while for S&P's debt rated at or below BB+ is considered to be below investment grade. Puerto Rico's general obligation (GO) bonds are currently rated Baa3 by Moody's and BBB- by S&P's, in both cases just one notch away from a junk bond rating.

Why is this important? The credit rating agencies are, in effect, the gatekeepers to the capital markets because key players in those markets rely on the analysis and judgment of the rating agencies when making their investment decisions. It is estimated that in 2008 there were approximately $2.7 trillion in municipal bonds outstanding in the United States, of which more than 97% carried investment grade ratings from at least one credit rating agency. Thus, failure to obtain an investment grade rating will effectively close the municipal bond market for that borrower.

Puerto Rico currently has the lowest credit rating and the highest level of net tax-supported debt per capita in the U.S., a volatile combination, and there is a high probability that Puerto Rico's credit rating will be downgraded below investment grade. On February 13th, investment advisors Janney Montgomery Scott issued a report warning investors that "Puerto Rico's bonds are teetering at a dangerous precipice." Bond markets to a certain extent have already priced some of this risk, as the yield on the 10-year Puerto Rico general obligation bond has increased to 6.24%, "a leap of almost two percentage points in the past year." It is important to note, however, that the government of Puerto Rico is not currently in danger of defaulting on its general obligation bonds, which have statutory preference over other debt payments and financial obligations to government employees and suppliers. Given those legal protections, a downgrade to junk status would, in our view, be extremely unfair.

If the credit agencies decide nonetheless to "push Puerto Rico off that cliff into junk status", then the consequences would be quite serious and long-lasting. First, there would be a sharp increase in borrowing costs. According to Janney's analysis, the average spread between a BBB- municipal bond and a junk municipal bond is 290 basis points. Therefore, the tax-exempt borrowing costs for Puerto Rico could be well in excess of 9 per cent. In 2006, Puerto Rico may have had the option of placing debt at that price on the so-called "shadow banking system" of hedge funds and private equity funds, but, alas, that is not an option in the current financial environment.

Second, many institutional investors, such as insurance companies and pension funds, which currently hold Puerto Rico debt, would have to divest because they are allowed to hold only investment grade securities. In addition, these same institutional investors would be precluded from buying any new Puerto Rico debt until it is upgraded to investment grade.

Third, it would be very difficult for the Puerto Rican government to operate if it cannot borrow from the bond market. For example, the Commonwealth uses the proceeds of GO bond issues to finance, among other things, capital improvements and to repay past borrowing from the GDB by the central government. If this money is not available, then we can expect government infrastructure investment to drop off sharply, which would negatively impact GNP growth; some municipalities could be forced to impose new taxes to pay for needed infrastructure; and the GDB could take a hit on its balance sheet if the central government cannot honor its obligations on outstanding loans.

Finally, the GO downgrade may affect the credit rating of other government agencies, such the Public Building Authority, whose debt is currently guaranteed by the Commonwealth; and the Infrastructure Financing Authority and the Highway and Transportation Authority, which are subject to a constitutional "clawback" provision that allows the central government to capture part of their revenues to pay for its own GO debt.

In sum, our bond rating is a very serious matter. But while a downgrade to junk status would certainly aggravate our fiscal and economic situation, it is important to note that it is not the source of those problems. Our distressed credit rating did not cause our government to go bankrupt or our economy to stagnate, rather indiscriminate government spending and structural weaknesses in our economy slowly eroded our good credit. Simply put, the credit downgrade is a symptom, a warning sign that points to other deeply rooted problems in our economy. It is to those structural problems that we should direct our attention if we are to restore economic growth in Puerto Rico.

The author is Director for Policy Development at the Center for the New Economy, a Puerto Rico-based think tank. www.grupocne.org.