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Our bond rating is a serious matter

Sergio M. Marxuach
Commentary

Last week, members of the Acevedo Vilá administration met with representatives of Moody's Investors Service and Standard & Poor's Rating Services, the credit rating agencies informally known as Moody's and S&P respectively.

When the government of Puerto Rico or one of its agencies issues bonds, these rating agencies 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 which is known as a rating.

Each 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 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 debt rated at or below BB+ is considered to be below investment grade. Puerto Rico's bonds are currently rated Baa2 by Moody's and BBB by S&P, in both cases we are just two notches away from a junk bond rating.

Why should we care about rating agencies and their rating scales? The rating agencies are 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. In the municipal bond market, failure to obtain an investment grade rating will effectively close the market for that borrower.

Last year, the U.S. Federal Reserve estimated that there were approximately $2 trillion in municipal bonds outstanding, of which more than 99 percent carried investment grade ratings from Moody's. Furthermore, according to data provided by the Bond Market Association, during the period between January and Sept. 30, 2005, there were 6,040 new issues of general obligation (GO) debt by municipal issuers, which raised a total amount of $119.832 billion for the borrowers. Only 33 of these new issues, which raised $101.1 million, or a mere 0.1 percent of the total funds raised, were rated Baa by Moody's. So even at our current investment grade rating of Baa2, it would be very difficult for Puerto Rico to place the $675 million GO bond offering it plans to make this year because the amount of debt the commonwealth seeks to issue is 6.6 times larger than what the market could absorb at that rating level during the first three quarters of last year. It is also interesting to note that during this period there were no GO issues rated below Baa.

Puerto Rico currently has the lowest credit rating and the highest level of net tax supported debt per capita in the United States, a volatile combination, and there is a high probability that Puerto Rico's credit rating will be downgraded below investment grade. Such a downgrade would have serious and long-lasting consequences.

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. This would effectively close the bond markets to the Puerto Rican government.

It would be very difficult for the Puerto Rican government to operate if it cannot borrow from the bond market. For example, the commonwealth plans to use the proceeds of the proposed $675 million GO bond issue to finance, among other things, capital improvements in several municipalities 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 could 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.

Bear in mind also that it may take several years to recuperate Puerto Rico's investment grade. Indeed, it took the City of Philadelphia five years to reestablish its rating after it was downgraded to junk status in 1990. Thus, there is a good probability that the scenario we have described will play out over several years, further magnifying the negative economic impact of the downgrade.

So, our bond rating is a serious matter. From published reports it appears that the rating agencies' representatives left with a positive impression of the efforts currently undertaken to balance the budget and cut government expenses. Unfortunately, a good impression is only that, a brief, fleeting perception. It remains to be seen whether our legislators and executive branch officers can deliver genuine fiscal and tax reforms. For the good of Puerto Rico, we truly hope that they do.

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