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# Puerto Rico Municipal Finance Agency; Miscellaneous Tax

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# Puerto Rico Municipal Finance Agency; Miscellaneous Tax

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Many issues are enhanced by bond insurance.

## Rationale

Standard & Poor's Ratings Services has revised its outlook on the Puerto Rico Municipal Finance Agency's (MFA) bonds outstanding to negative from stable and affirmed its 'BBB-' rating. The outlook revision is based on our assessment of the pledged revenues securing the bonds, including revenue derived from the commonwealth's pledge to appropriate funds for the repayment of debt service. MFA has approximately $1.1 billion in bonds outstanding.

The ratings reflect our view of the following credit strengths:

- A several obligation of participating municipalities, secured by a dedicated unlimited property tax levied by each municipality sufficient to cover the debt service on outstanding and proposed debt. Also pledged is a first lien on the basic property tax levied by municipalities, which management represents has never been tapped to pay debt service;
- Commonwealth appropriations of matching equalization funds, which historically have made up approximately 33% of total revenue dedicated to the payment of MFA debt service;
- A moral obligation pledge by the commonwealth to replenish the debt service reserve account, should any of the preceding sources prove insufficient to cover debt service; and
- Strong oversight by Government Development Bank for Puerto Rico (GDB) and strong coverage of 5.63x, based on the combination of special additional property tax, basic property tax, the municipal redemption fund balance, and commonwealth matching fund appropriations.

Limiting factors include:

- The presence of economically shallow participating municipalities whose individual tax bases may exhibit vulnerability during economic cycles; and
- The vulnerability of matching fund revenues, the appropriation of which could be affected by a downturn in the collection of the commonwealth's general revenues.

Securing the bonds is a several obligation of participating municipalities, secured by the full faith and credit of each municipality, including a dedicated property tax levied by each municipality sufficient to cover the debt service on outstanding and proposed debt. Also pledged is a first lien on the basic property tax levied by municipalities, which has never been tapped to pay this debt service. Commonwealth appropriations of matching equalization funds, which make up about 61% of estimated total revenue in fiscal 2011, are also pledged to the payment of MFA debt service. The security also includes a moral obligation pledge by Puerto Rico to replenish the debt service reserve account, should any of the preceding sources prove insufficient to cover debt service. A total of 78 borrowers have taken out loans through the MFA totaling $1.1 billion. The loans are concentrated among seven borrowers accounting for 59.91% of the total amount of the loans. San Juan is the single largest borrower, accounting for approximately 25.9% of the total. Standard & Poor's does not rate the borrowers.

The pledged revenues are collected by the central Municipal Revenues Collection Center (known by its Spanish acronym CRIM), on a pro rated basis for each participating municipality, with the amount needed for debt service deposited into a lock box--the excess is redistributed to the municipalities for operations after debt service obligations and reserve requirements are met. Providing added credit support is a two-tier coverage test requiring a minimum coverage for annual and maximum debt service to take on additional debt for municipalities that participate in the program. In addition, the monitoring mechanism prompts the GDB to alert Standard & Poor's if the sum of any municipality's dedicated special tax levy (referred to as CAE), redemption fund balance, and commonwealth's matching funds falls below 2x coverage of maximum annual debt service (MADS). This would trigger the intercept of basic operating property tax revenues and matching funds to be received by municipalities from the commonwealth. A reserve account is funded with MFA bond proceeds equal to the higher of a) 50% of MADS on the bonds; and b) 100% of the largest participating municipality's MADS. There is a moral obligation pledge on the part of the commonwealth to replenish the reserve fund if it is drawn upon--an event that has never occurred. The program has a history of strong coverage of annual debt service, with average coverage for the payment of GO debt from all sources at 5.63x. The redemption fund balance provides individual coverage averaging 2.65x.

## Outlook

The negative outlook is based on our assessment of the pledged revenue securing the bonds, which include appropriations from Puerto Rico. While revenue from local property tax collections has produced adequate coverage of annual debt service, the negative outlook reflects our view that the maintenance of coverage levels consistent with historical levels requires the inclusion of appropriations from the commonwealth. We could revise the outlook stable if MFA maintains coverage and we revise the outlook on the commonwealth appropriation rating to stable from negative.

## Participating Municipalities/Structure

The MFA bonds are secured a pledge of the debt service payments to be received from an underlying portfolio of general obligation (GO) bonds and notes issued by Puerto Rico's 78 municipalities and is secured by a pledge of the applicable municipality's ad valorem (property) taxes without limit as to rate or amount on all of its taxable property.

This unlimited tax is made up of two components. First, there is CAE, which is a dedicated property tax of unlimited rate, the proceeds of which CRIM deposits into the municipality's redemption fund, a special fund held by GDB and used to service the municipality's GO debt. If the CAE revenues are insufficient, the bonds have a first lien on all other fixed rate property taxes and other revenues of the municipality, including any commonwealth appropriations from a portion of its lottery revenues and commonwealth general fund monies that are paid to each municipality according to formulae established by Puerto Rico and administered by CRIM.

The available revenues provide a diverse mix of revenues available for repayment of municipal GO debt, including tax revenues from the 1.5% municipal sales and use tax. The municipal sales tax is collected by CRIM and jointly administered by the Puerto Rico Treasury department and the municipalities. The treasury sets aside 0.5% of the tax, which is dedicated for specific municipal uses such as solid waste, healthcare, et cetera, with the remaining 1% available for general purposes, including the repayment of municipal GO loans.

CRIM is responsible for the assessment, collection, and distribution of all municipal property taxes. CRIM is required by law to establish a trust fund at GDB known as the municipal redemption fund, which is the main source of repayment for municipal GO debt and MFA's bonds. The redemption fund includes the special additional property tax (CAE) collections levied by each municipality and collected by CRIM. If revenues in an individual redemption fund are insufficient to make debt service payments on the loans, CRIM is authorized to apply the revenues from that individual municipality captured in the matching fund to make debt service payments on its municipal debt. The matching fund includes revenues from commonwealth appropriations (2.5% of net internal general fund revenues), 35% of annual net revenues from the operation of the electronic lottery (currently capped at $26 million), and other transfers from the commonwealth's general fund to compensate for exemptions in taxable property.

There are a total of 78 municipalities participating in the MFA bond programs.

## Commonwealth Oversight

Puerto Rico's oversight powers, including the centralized collection and distribution of property taxes and other revenues owed to the municipalities, enhance the credit quality of the underlying municipal GO debt. CRIM is authorized by law to assess and collect all municipal property taxes and distribute the commonwealth's matching revenues to the municipalities. CRIM first directs all property taxes collected to the GDB-held redemption fund to ensure the repayment of the municipality's GO debt. A first lien is placed on all property taxes collected for the repayment of debt. Most municipalities have fairly sizable redemption fund surpluses that, to the extent they do not exceed the next 12 months' debt service on GO debt outstanding, can be used only for the repayment of such debt. Surpluses in excess of this amount can, at a municipality's option, be returned to the requesting municipality and used first for the payment of other statutory debts and then for general municipal purposes. Commonwealth law also provides for an equalization formula such that each municipality is guaranteed a minimum property tax revenue distribution regardless of its individual property tax collection performance.

GDB has executed a fiscal agency agreement whereby it is authorized and empowered to determine the amount and terms of the loans obtained by the participating municipalities. Furthermore, to obtain GDB approval for new municipal GO debt, participating municipalities must meet a two-tier test, which requires them to: 1) maintain a redemption fund balance and dedicated CAE property tax collections of at least 1x annual debt service, and 2) maintain 2x coverage of MADS based on the sum of their individual redemption fund balances, CAE property tax collections, basic property tax collections, and commonwealth contributions for the fiscal year preceding the fiscal year in which the proposed issue will be issued. In addition, the monitoring mechanism prompts GDB to alert Standard & Poor's if the sum of any municipality's CAE levy, redemption fund balance, and commonwealth's matching funds falls below 2x coverage of the municipality's MADS on its GO debt. This would trigger the intercept of basic operating property tax revenues and matching funds to be received by municipalities from the commonwealth.

## Pledged Revenues

Municipal property tax revenues are broken into three levies. A 1.03% of AV special property levy is paid into Puerto Rico's redemption fund, which is a GDB-held trust to make debt service payments on the commonwealth's (not the municipalities') debt. The special additional (CAE) property tax is the second part of the three levies and is the principal and intended source for the repayment of municipal GO debt. The special additional property tax is unlimited as to rate or amount, and used first for the payment of the levying municipality's GO bonds and notes. The third component of property tax is the basic property tax, levied at a maximum of 6% of the AV on all real property and 4% of the AV on real property. Since 1991, through an effort at decentralization these funds have been funneled to municipalities to provide equalization between larger and smaller municipalities. Before 1991, the basic tax was collected by the commonwealth. Commonwealth appropriations are used to equalize funding to local governments. These appropriations consist of 2.50% of net general fund revenues and 35% of net electronic lottery proceeds, up to a current annual cap of $26 million. General fund appropriations also provide reimbursement for a portion of the municipal property tax exemptions.

Municipal property tax revenues have remained relatively stable. Aggregate coverage of debt service based on the redemption fund balances and 2010 property tax collections is strong at 2.65x.

## Related Criteria And Research

- USPF Criteria: Special Tax Bonds, June 13, 2007
- USPF Criteria: Appropriation-Backed Obligations, June 13, 2007