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Research Update:

Government Development Bank for Puerto Rico Downgraded To 'BB/B' From 'BBB-/A-3'; Ratings Remain On CreditWatch Negative

Primary Credit Analyst:

Sunsierre Newsome, New York (1) 212-438-2421; sunsierre.newsome@standardandpoors.com

Secondary Contacts:

E.Robert R Hansen, CFA, New York (1) 212-438-7402; robert.hansen@standardandpoors.com

Bernard De Longevialle, New York (1) 212-438-0287; bernard.delongevialle@standardandpoors.com

Carmen Y Manoyan, New York (1) 212-438-6162; carmen.manoyan@standardandpoors.com

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Overview

- The Government Development Bank for Puerto Rico (GDB) has experienced constrained market access, which has led to a material deterioration in its liquidity profile, in our view. GDB also has high exposure concentration to the Commonwealth of Puerto Rico and other government related entities. The Commonwealth of Puerto Rico continues to experience weak economic trends, a persistent fiscal deficit, and high levels of debt and retirement liabilities.
- As a result, we are lowering our long-term issuer credit rating on the Government Development Bank for Puerto Rico (GDB) to 'BB' from 'BBB-' and lowering our short-term issuer credit rating to 'B' from 'A-3'. The ratings remain on CreditWatch with negative implications.
- In a related action, we lowered the Commonwealth of Puerto Rico general obligation (GO) and appropriation debt ratings to 'BB+' from 'BBB-' and placed the ratings on CreditWatch with negative implications.
- The CreditWatch negative reflects the currently limited market access of both the Commonwealth and GDB, which could lead to further deterioration in GDB's liquidity position. Should there be a successful significant bond issuance, we could remove the ratings from CreditWatch.

Rating Action

On Feb. 4, 2014, Standard & Poor's Ratings Services lowered its long-term issuer credit rating on the Government Development Bank for Puerto Rico (GDB) to 'BB' from 'BBB-' and its short-term issuer credit rating to 'B' from 'A-3'. We initially placed the ratings on CreditWatch with negative implications on Jan. 24, 2014. The ratings remain on CreditWatch with negative implications.

(We will host a webcast at 4pm EST on Feb. 4, 2014, to discuss the rating actions on both GDB and the Commonwealth of Puerto Rico. Information on registration can be found on the "Webcasts & Events" page at SPRatings.com.)

Rationale

The downgrade reflects GDB's constrained market access, which has led to a material deterioration in its liquidity position. It also reflects GDB's high business and loan exposure to the Commonwealth of Puerto Rico, whose creditworthiness has deteriorated, and other government related entities.

GDB, which is providing permanent and bridge financing to the local public sector, is experiencing a steady deterioration in its liquidity position. Public-sector loans have increased, while public-sector deposits, which constitute the bulk of the bank's deposit base, have declined materially. We estimate GDB's loan-to-deposit ratio to be, currently, higher than 160%, demonstrating a structural funding reliance on market access. We could see some inflows of public-sector deposits in the coming months as a result of a proposed bill authorizing GDB to require certain public-sector entities to transfer their deposits, which are currently held at private local banks, to GDB. Potential related deposit inflows are unlikely to be significant enough, in our opinion, to materially improve GDB's liquidity position.

In our opinion, GDB currently has a reduced ability to fund the Commonwealth's liquidity needs in the coming quarters without accessing the markets. Issuances by either GDB or the Commonwealth have been modest in recent quarters. For example, on Dec. 27, 2013, GDB placed \$110 million of notes yielding 8% with the Puerto Rico State Insurance Fund Corp., a government entity that provides workers compensation. Although we expect GDB or the Commonwealth to access the market in the near future, this will likely be more difficult and significantly more expensive than in the past, in our view. The other liquidity sources of GDB are primarily related to its investment portfolio. The \$2.8 billion investment portfolio, as of Sept. 30, 2013, consists primarily of U.S. Treasury securities, U.S. agency securities, mortgage-backed securities, and money market investments. About half of the portfolio is pledged, which leaves more than \$1 billion, by our calculation, available as collateral to obtain secured funding. GDB is not regulated and supervised by the Federal Reserve Board or the Federal Deposit Insurance Corp., and the bank currently is not a member of any Federal Home Loan Bank (FHLB). Therefore, it cannot borrow from an FHLB, nor does it have access to a central bank for contingent liquidity. This exacerbates the pressure on our assessment of its liquidity, given the company's current funding constraints.

As a result, we are revising our liquidity assessment to "moderate" from "adequate" (as our criteria describe the terms). GDB's funding is "below average." These two factors combined cap the stand-alone credit profile at 'bb'.

We also believe that the deterioration in the creditworthiness of the Commonwealth has weakened the bank's business position. The bulk of GDB's balance-sheet activities are tied to the Commonwealth, either by extending loans to the government and other government related entities, or by collecting public-sector deposits. As a consequence, we have lowered our business position score to "weak" from "moderate."

The current pressures experienced by the Commonwealth heighten the risk of GDB's heavy loan portfolio concentration to the Commonwealth. Loans also tend to be outside, with GDB's 20 largest borrowers making up the majority of the loan portfolio. Many of the Commonwealth's agencies and instrumentalities have had losses from operations, which could affect their ability to repay their

outstanding loan balances. However, GDB has entered into fiscal oversight agreements with some of its largest borrowers to allow the bank to more closely monitor these entities' finances. Still, nonperforming assets have doubled over the past few years. Although specific revenue sources fund the repayment of private loans--most of which are nonperforming--budgetary constraints and the weak fiscal state of Puerto Rico could limit payment. As a consequence, we have also revised our risk position score to "weak" from "moderate."

Although we view GDB as a government-related entity based on our view that the link between GDB and the Commonwealth is very strong, we do not ascribe uplift to our ratings because of the one notch rating difference with the Commonwealth GO rating. GDB plays a very important role for the government, given that it provides funding to the Commonwealth and other Puerto Rican public corporations and that it is a fiscal agent to the Commonwealth and its instrumentalities.

CreditWatch

The ratings remain on CreditWatch with negative implications. The current pressures on funding access that the Commonwealth is experiencing weaken GDB's liquidity profile. Our ratings reflect expectations that either GDB or the Commonwealth will access the market in the near future. We would view a debt placement by either GDB or the Commonwealth of \$1 billion or more as an important credit stabilizing factor. We could further lower the ratings if the bank failed to raise additional funding in the coming months or to otherwise improve cash flows. We expect to resolve or address the CreditWatch within the next couple of months.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	BB/Watch Neg/B	BBB-/Watch Neg/A-3
Bank Holding Company Rating		
SACP	bb	bbb
Anchor	bbb+	bbb+
Business Position	Weak (-2)	Moderate (-1)
Capital and Earnings	Very Strong (+2)	Very Strong (+2)
Risk Position	Weak (-2)	Moderate (-1)
Funding and Liquidity	Below average and moderate (-1)	Below average and adequate (-1)
Support	0	0
GRE Support	0	0
Group Support	0	0
Sovereign Support	0	0

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