New governor Garcia Padilla will not be able to chart a new path for pensions in Puerto Rico
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Governor-elect Alejandro García Padilla will likely not be able to stray far from the financial plan for the commonwealth laid out by his successor, Governor Luis Fortuño, said Carol Karsten and Triet Nguyen, analysts at Axios Advisors, an independent municipal research group, because Fortuño's plan was made with the input of so many rating agencies.

"I don't think the new governor is going to have as much room to maneuver as people assume," Nguyen said. "That doesn't mean that the pension problem is going away."

Actuarial reports show Puerto Rico has an unfunded pension liability of USD 30bn, about 45% of the island's gross domestic product, Center for the New Economy Policy Director Sergio Marxuach said.

The funded level of Puerto Rico's largest pension plan is less than 7%, Marxuach said. It is expected to reach net asset depletion in 2014, Karsten said.

"There are no accounting gimmicks or financial tricks that would solve this," Marxuach said.

Pension solutions: filling a USD 30bn gap

The commonwealth could reduce its pension obligations by cutting cost of living adjustments, Marxuach said, as increasing employee contributions remains unpopular.

"It's unpopular because you're essentially reducing take home pay for government works and that would also have an impact in short term consumption," Marxuach said.

Central Falls, RI, could be an example of a city that went through bankruptcy while short pension funding, said Jeremy Breindel, an advisor at NewOak Capital. But the city filed for bankruptcy before they ran out of money in the pension fund.

Puerto Rico may not even be able to file for bankruptcy, Karsten said, removing that option from the table.

The option of cutting retiree pay may also be unpalatable, Marxuach said, not to mention dependent on the strength of the collective bargaining agreements, Karsten said.

Consistent underfunding

While the downturn of the stock market in 2008 and 2009 cut into pension plan funding, the fund was set up for failure in the 1950s when it started, Marxuach said. Contributions have never been high enough to meet the obligations of the fund and politicians have historically promised more to retirees. The government is taking steps to decrease its obligations.

"All government workers that were employed by the government after January 2000, were immediately put in to a defined contribution plan," Marxuach said. "You still have a huge amount of people that are retired and a significant number of people who are still working under the old pension plan.

The economic downturn drove Fortuño to reduce the government by nearly 40,000 jobs, through early retirement and layoffs. The cuts increased the number of retirees and decreased the number of people paying into the system, further straining the pension fund, Karsten said.

The general fund will have to step up and back pension obligations if there is not enough money in the pension fund, Marxuach said. The general fund could not handle those liabilities, which would amount to 75% of costs as with municipalities and state-owned companies picking up the remainder.

As the commonwealth cuts employees in an attempt to curtail expenses, it is also cutting into the number of people that contribute to the pension, Karsten said.

“Cost cutting is meaning that the base isn’t going to grow and you have an increase in retirees,” Karsten said. The commonwealth is also beginning to mirror the US in terms of population growth, the birthrate is at 1.7% and the population declined in the 2010 census as residents moved to the continental states. “When they start to mirror the US they’re going to have the elderly populations, their pension systems are going to be overweight on people that they are paying out.”

Bond issuance and payment

Pension obligation bonds are paid each year through appropriations from the general fund, Marxuach said, giving them a similar appropriation risk to general obligation bonds, Breindel said.

“When you’re looking at the pension fund versus the pension bonds, the pension bonds are just tied to the overall municipality, it’s sort of like a quasi general obligation,” Breindel said. “Running out of pension funds will in effect drive the municipality to appropriate more funds into the pension.”

Puerto Rico may have to pay its pension obligations with this general fund as well, Marxuach and Nguyen said. What will happen when the fund has to pay both is unknown.

“On that basis we can speculate… pension fund expenses might take precedence over pension bond debt service,” Nguyen said. “That’s one of the big risks in the municipal market as a whole.”

Tapping the bond market for Puerto Rico is poised to get more difficult, as Standard & Poor’s put a slew of bonds on watch for negative downgrade after the 6 November election. The**Puerto Rico Employee Retirement System** is rated BBB- with a negative outlook. The rating agency said there is a one in three chance it will downgrade the bonds between now and early 2013. The systems bonds were rated BBB+ by Fitch in August and Baa1 by Moody’s in August 2011.

“Some of the ratings agencies are putting a lot of pressure on Puerto Rico to come up with a serious long term solution to this,” Marxuach said.

Municipalities issue pension obligation bonds because they have such low borrowing costs and can make more money from investing the proceeds of the bonds than they pay in interest, working an arbitrage, Breindel said. Puerto Rico has little incentive to issue more bonds because its borrowing costs are so high. Costs would climb even higher if the island fails to convince rating agencies that it has a long-term solution.

A USD 110m tranche of series 2008C senior pension funding bonds issued by the Employees Retirement System which mature in 2028 last traded 9 November at 98.26, yielding 6.33%, according to information on Electronic Municipal Market Access. There was USD 2.9bn of outstanding bonds 31 March, according to financial disclosures. Bondholders could not be immediately identified.

by Maryellen Tighe