Moody's Investors Service

New Issue: **Puerto Rico Municipal Finance Agency**

MOODY'S ASSIGNS Baa3 RATING AND STABLE OUTLOOK TO $455 MILLION MUNICIPAL FINANCE AGENCY 2008 SERIES A BONDS ISSUED BY PUERTO RICO MUNICIPAL FINANCE AGENCY

MFA HAS $1.2 BILLION IN PARITY DEBT OUTSTANDING

State
PR

Moody's Rating

ISSUE	RATING
2008 Series A Bonds	Baa3

Sale Amount	$455,240,000
Expected Sale Date	10/08/08
Rating Description	General Obligation Bond Bank

Opinion

NEW YORK, Oct 8, 2008 -- Moody's Investors Service has assigned a Baa3 rating with a stable outlook to the Puerto Rico Municipal Finance Agency (MFA) 2008 Series A Bonds, in the amount of approximately $455 million. The bonds will be issued by MFA and the proceeds will be used to acquire a pool of general obligation bonds and notes issued by municipalities in Puerto Rico from Government Development Bank for Puerto Rico (GDB). Each series of bonds issued by MFA, including the current 2008 Series A, is issued under a separate indenture and secured by a unique pool of local municipal general obligation bonds and notes as well as a debt service reserve fund. Each series also benefits from a "moral obligation" of the commonwealth of Puerto Rico (G.O. bonds rated Baa3/stable) to replenish the applicable reserve fund if drawn. Including the current transaction, MFA will have more than $1.6 billion of total debt outstanding.

The investment-grade rating assigned to the MFA's bonds reflects the following credit strengths and challenges:

Credit Strengths:

* Strong statutory framework governing all aspects of the local municipal general obligation debt process, including centralized approval and oversight of municipalities' bond issuance by GDB, centralized collection and administration of property taxes by the Municipal Revenues Collection Center (known by its Spanish acronym, CRIM), and a non-impairment covenant by the commonwealth with respect to the various protections of the framework;

* Long and favorable MFA track record, with no underlying municipal defaults and no draws against MFA bond reserves over the more than 30 years the program has been in place;

* Essential role of the MFA program in providing capital market access for the island's municipalities, which role raises the likelihood of commonwealth support under the moral obligation mechanism if needed; and

* With the enactment of a new sales tax collected by municipalities, an increase in revenues available to municipalities to pay debt service on their general obligation bonds and notes.

Credit Challenges

* Likely significant correlation of credit risk among the island's municipalities, none of which are rated on a stand-alone basis;

* Commonwealth economy has been in recession for over two years, and downturn in U.S. economy may threaten Puerto Rico's economy and finances further.

The MFA rating is closely linked to the commonwealth's rating for a number of reasons, including the lack of independent municipality ratings, likely correlation of municipal credit quality with general economic trends on the island, reliance on CRIM and GDB to manage municipal tax collections and debt payments, and the mechanism for commonwealth replenishment of the debt service reserve fund if (unexpectedly) needed. While the commonwealth's general obligation bonds have no legal claim against municipal property tax revenues, due to the lack of full separation in the structure between the credit and the commonwealth we currently view the MFA rating to be "capped" at the level of the commonwealth's G.O. rating. For more commentary on the commonwealth's current rating and outlook, please see our report dated September 3, 2008.

STRONG STATUTORY FRAMEWORK, OVERSIGHT OF MUNICIPAL DEBT ISSUANCE

The commonwealth employs several mechanisms to manage municipal finances, including statutory restrictions and requirements, oversight by GDB, and centralized property tax collection and funds administration by CRIM. The statutory limit on each municipality's debt is 10% of assessed property value, which effectively is less than 2% of current market value because assessments are based on 1958 values (with subsequent construction and improvements deflated to 1958 values). In addition, all debt issuance must be approved by GDB, which is empowered to develop and has in effect suitable regulations and criteria regarding capacity to repay. The criteria used to date have been successful in mitigating collection forecast risk and ensuring no payment defaults.

Each municipality is required to levy a special property tax sufficient to cover debt service, which tax is separate from the municipality's basic property tax levy for operations. Both levies are collected by CRIM, which also collects a separate property tax piece for the commonwealth to help pay debt service on the commonwealth's G.O. bonds. CRIM deposits both property tax levies in separate accounts held at GDB. Aggregate property tax collection rates have ranged between 89% and 93% over the 2001 to 2005 period. The special levy, which has priority in the event of taxpayer payment shortfalls, is deposited in the Redemption Fund and is applied by GDB, as trustee, to debt service on these municipal general obligation bonds and notes. The property tax levy that is used for municipal operations is deposited, together with commonwealth municipal aid payments, in the Matching Fund, which is drawn against monthly by each municipality to fund operations. In the unlikely event of a shortfall in any municipality's Redemption Fund account prior to a debt service payment date, the GDB is required to transfer the necessary funds from such municipality's Matching Fund account to make up the difference. GDB also provides municipal cash flow financing to help smooth timing differences between operating needs and Matching Fund revenue deposits.

SECURED BY FULL FAITH AND CREDIT OF MUNICIPALITIES

While the special additional tax is the primary and intended source of payment for the municipal bonds, and is unlimited as to the rate the municipalities can impose on taxable properties, the bonds are secured by the full faith and credit of the municipalities. Thus all available revenues of the municipalities are available to pay debt service on the bonds. The implementation of a sales tax in the commonwealth, and the requirement that municipalities levy a sales tax on its residents, has increased the revenues available to the payment of debt service on their bonds.

FUNDS ADMINISTRATION PROBLEM DISCOVERED IN 2001

The protection provided by the Redemption Fund and Matching Fund provisions described above necessarily relies heavily on the quality of administration and oversight provided by CRIM and GDB. The record in this regard, however, is not free from blemish. During 2001, CRIM discovered that over a period of years it had allowed excessive property tax disbursements to a number of municipalities, including San Juan and Ponce, resulting in a significant accumulated Matching Fund deficit of $166 million as of the end of fiscal 2000. Significantly, this included $138 million that had been improperly transferred from the Redemption Fund. The deficit was ultimately covered by a loan from GDB, and there was no draw necessary against MFA reserves. The GDB loan is being repaid by the affected municipalities over a 30-year period through increased commonwealth appropriations and, if necessary, the municipalities' operating tax levies - i.e., effectively on a subordinate basis to their G.O. bonds. CRIM reports that administration of the Matching Fund has been much-improved in recent years, in part reflecting enhanced quarterly monitoring procedures and annual independent audits.

SURPLUS FUNDS TYPICALLY AVAILABLE, BUT NOT REQUIRED, IN EACH MUNICIPALITY'S REDEMPTION FUND

Application of GDB's capacity-to-repay loan approval criteria has historically resulted in the accumulation of excess funds in each municipality's Redemption Fund account. In most cases, the excess funds currently amount to one to two times next year's expected debt service payment. Effectively, the excess funds function as a reserve against potential property tax collection forecast risk, and are one reason that the intercept of matching funds has never been necessary. Legislation passed in 2001 permits municipalities to withdraw redemption fund monies in excess of the next year's scheduled debt service payment, subject to approval by GDB. Withdrawn funds must, however, be used for eligible capital purposes, in effect defraying additional debt issuance.

MFA'S IMPORTANT CAPITAL ACCESS ROLE ENHANCES LIKELIHOOD OF COMMONWEALTH

FINANCIAL SUPPORT

The MFA enabling statute specifically authorizes, but does not obligate, the commonwealth to replenish any draws made against a debt service reserve fund established in connection with MFA bonds (a "moral obligation" commitment). Upon certification of a necessary replenishment amount, the statute requires the Secretary of the Treasury to apportion and pay such amount from any available unencumbered available funds, or, if such funds are not available, to notify the Director of the Budget, who is required to include an appropriation request in the next annual budget submitted to the legislature.

Since its establishment, the MFA program has served as the primary source of public bond market access for Puerto Rico's municipalities, from the smallest communities to the largest - i.e. San Juan, which represents about 12% of the island's population and a larger share of total employment. At present, no municipalities have stand-alone Moody's credit ratings, and many could have difficulty accessing the public market without a program such as MFA's. In Moody's view, the important role played by MFA increases the likelihood that the commonwealth would provide financial support to the bond pool program, if necessary, through the debt service reserve fund replenishment mechanism.

MFA's bonds are issued under separate indentures, resulting in unique and separately secured bond pools, although there is a significant overlap of borrowers in each of the pools. The Municipality of Carolina represents the largest individual concentration in the 2008 pool/indenture, at approximately 22% of principal, followed by San Juan at about 7%. The top seven borrowers account for almost 60% of the total principal amount.

Outlook

The rating outlook for MFA's bonds is stable, reflecting the stable outlook assigned to the commonwealth's G.O. bonds. The MFA rating is linked to the commonwealth's rating for several reasons, including the lack of independent municipality ratings, likely high correlation of municipal credit quality with general economic trends on the island, reliance on CRIM and GDB to administer municipal tax collections and debt payments, and the mechanism for commonwealth replenishment of MFA reserves, if needed. While the commonwealth's G.O. bonds have no legal claim against municipal property tax revenues, we currently view the MFA rating to be "capped" at the level of the commonwealth's G.O. rating. This does not mean that we expect that the rating on the MFA bonds will necessarily move with the rating of the commonwealth.

What could move MFA's rating up?

* Upgrade of the commonwealth's G.O. rating.

* Increased separation between MFA credit structure and the commonwealth.

What could move MFA's rating down?

* Downgrade of the commonwealth's G.O. rating.

* Failure of GDB oversight of municipal borrowing process, leading to reduced debt service coverage by redemption fund balances.

* Material decline in CRIM's overall property tax collection rate.

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