
**Presenters:**

- Jane Hudson Ridley, Standard & Poor’s
- Rich Raphael, Fitch
- Bob Kurttter, Moody’s

**Date:** 05/19/2014
General Obligation Ratings
Methodology and Assumptions:

An Overview of S&P’s Local GO Criteria

Jane Hudson Ridley
Senior Director & Analytical Manager

National GFOA
May 19, 2014
Introduction

New GO criteria is intended to:
• Provide transparency into our rating process
• Enhance ratings comparability
• Formalize the forward-looking rating component

New GO criteria NOT is intended to:
• Be used as a vehicle to adjust ratings
• Change what factors we view as important
Improved Transparency and Comparability

- Greater clarity on how to derive Standard & Poor’s Ratings Services’ U.S. public finance ratings
  - Building on similar underlying principles as we currently use
  - Allows for greater understanding of how we arrive at specific ratings
  - Should aid in understanding how ratings may change given underlying conditions

- Criteria resulting in forward-looking and comparable ratings
  - Comparability across sectors and regions
Analytical Framework

Chart 1
Analytical Framework For Local GO Ratings

- Institutional Framework 10%
- Economy 30%
- Management 20%
- Financial Measures
  - Liquidity 10%
  - Budgetary Performance 10%
  - Budgetary Flexibility 15%
- Debt & Contingent Liabilities 10%

Indicative Rating

Positive Overriding Factors
- High income levels (one- or two-notch adjustment)
- Sustained high fund balances (one-notch adjustment)

Negative Overriding Factors
- Low market value per capita (one-notch adjustment)
- Low nominal fund balance (one-notch adjustment)
- Weak liquidity (caps rating at 'BBB+' or 'BB+')
- Weak management (caps rating at 'A' or 'BBB-')
- Lack of willingness to pay obligations (caps rating at 'BBB-' for leases and 'B' for debt)
- Large or chronic negative fund balances (caps rating at 'A+', 'A-', or 'BBB')
- Budgetary flexibility score of 'S' (caps rating at 'A+')
- Structural imbalance (caps rating at 'BBB+')

Potential one-notch adjustment (but not higher than cap)

Final Rating

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Summary of the Factors

Local GO Criteria Factors
Institutional Framework (1 of 7 Factors)

- Assesses the legal and practical environment in which the local government operates
- The score is based on the average of four discretely scored areas
  - **Predictability**: the extent to which a local government can forecast its revenues and expenditures on an ongoing basis
  - **Revenue and expenditure balance**: the extent to which a local governments have the ability to finance the services they provide
  - **Transparency and accountability**: the overall institutional framework’s role in encouraging the transparency and comparability of relative financial information
  - **System support**: the extent to which local governments receive extraordinary support from a state government when the local government is under extreme stress
Economic Score (2 of 7 Factors)

- Assesses health of the asset base & likelihood of additional service demands
- The initial score (1 through 5) is based on market value per capita and projected per capita income as a % of U.S. (5 year projection)
- Qualitative Adjustments
  - Broad and diverse economy
  - High Unemployment
  - Stabilizing Institutional Influence
  - High dependent population
  - Tax base or employment concentration

<table>
<thead>
<tr>
<th>Proj PC EBI as % of US Proj PC EBI</th>
<th>Total Market Value Per Capita</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$195,000</td>
</tr>
<tr>
<td></td>
<td>$100,000 to $195,000</td>
</tr>
<tr>
<td></td>
<td>$80,000 to $100,000</td>
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<td>$55,000 to $80,000</td>
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<tr>
<td></td>
<td>≤$55,000</td>
</tr>
<tr>
<td>&gt;150</td>
<td>1</td>
</tr>
<tr>
<td>110 to 150</td>
<td>1.5</td>
</tr>
<tr>
<td>85 to 110</td>
<td>2</td>
</tr>
<tr>
<td>70 to 85</td>
<td>2.5</td>
</tr>
<tr>
<td>≤70</td>
<td>3</td>
</tr>
</tbody>
</table>

Source: Standard & Poor’s Ratings Services.
Management Score (3 of 7 Factors)

- Still based on FMA
  - Strong, Good, Standard, Vulnerable
- Topics for additional focus
  - Turnover, political gridlock, etc.
  - Management capability regarding planning, monitoring and execution
  - Very high pension/OPEB burden
  - Any news stories or other conversations related to potential bankruptcy
Financial Measures

- Three components factor into our assessment of a municipality’s financial credit characteristics
- Budgetary flexibility measures
- Budgetary performance measures
- Liquidity measures
- Each factor is weighted 10% — all financial measures together are 30%
Financial Measures: Budgetary Flexibility Score (4 of 7 Factors)

- The budgetary flexibility initial score measures the degree to which the government can create additional financial flexibility in times of stress.
- Qualitative Adjustments (highlights)

+ Projections show improvement
+ Expenditure reduction flexibility
+ History of sustained high fund balances
+ Demonstrated willingness and ability to taxes

- Projections show deterioration
- Cash accounting
- High questionable receivables
- Limited capacity to raise revenues or raise cut expenditures

<table>
<thead>
<tr>
<th>Available Fund Balance as a percentage of expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>%</td>
</tr>
<tr>
<td>Score</td>
</tr>
</tbody>
</table>

Source: Standard & Poor’s Ratings Services.
Financial Measures: Budgetary Performance Score (5 of 7 Factors)

- The budgetary performance initial score measures the current fiscal balance of the government
- Qualitative Adjustments
  - Projections show improvement
  - Projections show deterioration
  - Significant historic volatility in performance (e.g., cyclical revenues)

<table>
<thead>
<tr>
<th>General fund net result (%)</th>
<th>&gt; -1</th>
<th>-1 to -5</th>
<th>-5 to -10%</th>
<th>-10 to -15</th>
<th>≤ -15</th>
</tr>
</thead>
<tbody>
<tr>
<td>(&gt; 5)</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>(-1 to 5)</td>
<td>2</td>
<td>3</td>
<td>3</td>
<td>4</td>
<td>5</td>
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<tr>
<td>(≤ -1)</td>
<td>3</td>
<td>4</td>
<td>4</td>
<td>5</td>
<td>5</td>
</tr>
</tbody>
</table>

Source: Standard & Poor’s Ratings Services.
Financial Measures: Liquidity Score (6 of 7 Factors)

- The initial score measures the availability of cash and cash equivalents to service both debt and other expenditures
- Qualitative Adjustments
  + Projections show improvement
  + Access to external liquidity
  - Projections show deterioration
  - High refinancing risk over 24 months
  - Exposure to non-remote contingent liabilities

<table>
<thead>
<tr>
<th>Table 12: Assessing The Liquidity Score</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Government Available Cash As % Of Total Governmental Funds Debt Service</strong></td>
</tr>
<tr>
<td><strong>Ttl Govt Cash as % Ttl Govt Funds Exps</strong></td>
</tr>
<tr>
<td>&gt;15</td>
</tr>
<tr>
<td>8 to15</td>
</tr>
<tr>
<td>4 to 8</td>
</tr>
<tr>
<td>1 to 4</td>
</tr>
<tr>
<td>&lt;1</td>
</tr>
</tbody>
</table>

Source: Standard & Poor’s Ratings Services.
Debt and Contingent Liability (7 of 7 Factors)

- Initial debt score: carry charge for total government and debt as % of governmental funds revenue,
- Qualitative Adjustments
  + Low debt as % of market value
  + Rapid amortization
  - High debt as % of market value
  - Significant medium term debt plans
  - Exposure to large contingent liabilities
  - High unfunded pension or OPEB

Table 14: Assessing The Debt And Contingent Liabilities Score

<table>
<thead>
<tr>
<th>Ttl Govt Funds DS as % of Ttl Govt Funds Exp</th>
<th>&lt;30</th>
<th>30 to 60</th>
<th>60 to 120</th>
<th>120 to 180</th>
<th>≥180</th>
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</thead>
<tbody>
<tr>
<td>&lt; 8</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>8 to 15</td>
<td>2</td>
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<td>4</td>
<td>4</td>
<td>5</td>
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<tr>
<td>15 to 25</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>5</td>
<td>5</td>
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<tr>
<td>25 to 35</td>
<td>4</td>
<td>4</td>
<td>5</td>
<td>5</td>
<td>5</td>
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<tr>
<td>&gt;35</td>
<td>4</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
</tr>
</tbody>
</table>

Source: Standard & Poor's Ratings Services.
Putting it all Together

Indicative Rating

Positive Overriding Factors
• High income levels (1 or 2 notch adjustment)
• Sustained high fund balances (1 notch adj)

Negative Overriding Factors
• Low market value per capita (1 notch adjustment)
  • Low nominal fund balance (1 notch adjustment)

Rating Caps
• Weak liquidity (BBB+ or BB+)
• Weak management (A or BBB-)
• Lack of willingness to pay obligations (BBB- for leases and B for debt)
• Large or chronic negative fund balances (A+, A-, or BBB)
• Budgetary flexibility score of 5 (A+)
• Structural imbalance (BBB+)

*** ONE NOTCH FLEXIBILITY ***

FINAL RATING

Source: Standard & Poor’s Ratings Services.
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Fitch Tax-Supported Credit Analysis

**Topics**

- Rating Agency Changes Since the Financial Crisis
- Issuer Characteristics
- Interactive Key Rating Factors
- Attributes of Strong and Weak Credits
- Appendix
Rating Agency Changes Since the Financial Crisis

• Interaction with Issuers
  • Surveillance of ratings
  • Editorial Comments
  • Feedback

• Improved Transparency

• Increased Communication to the Market

• Quantitative and Qualitative Analysis
Issuer’s Characteristics

• In order to communicate to the market our objective opinion of an issuer’s creditworthiness an analyst needs to understand the common and distinct issuer characteristics

• The central issue = Will issuer repay its debt obligations and what is the relative risk

• Fitch analyzes trends in four major areas
Interactive/Dynamic Rating Factors

• Fitch’s rating process involves analyzing trends in four major credit factors:
  - Economy
  - Debt and Other Long-term Liabilities
  - Finances
  - Management

• Goal is to identify actual and potential future obligations and exposures

• Major rating factors are interactive – one weakness in one may offset positive another (and visa versa)

• Implicit Dynamic Weighting
Economic Factors

• Resource base from which tax revenues are derived
• Depth and breadth of employment base
• Growth Trends- employment, income, population etc.
• Education & income levels
• Quality of life attraction
• Population/school enrollment trends
Tax Base Composition – Key Data

• What’s happening to the local residential property market?
  - New developments: what is coming on-line, what has stalled, are developers pulling new permits?
  - Trends in prices, time on market, vacancy rates
  - Foreclosure and delinquency rates
  - Appeals

• Taxable assessed valuation and market valuation trends and projections (and underlying planning assumptions)

• Property tax rates relative to neighboring jurisdictions
  - Gauge of potential political opposition to rate increases
  - Legal tax raising limits
Debt and Other Long-Term Liabilities

- Includes bonded debt ratios, unfunded pensions and OPEB obligations
- Affordability / debt service coverage
- Exposure to short-term debt, variable-rate debt, derivatives, etc.
- Future capital needs
- Pension & OPEB
Increased Focus on Pension / OPEB Liabilities

• OPEBs are legally softer obligations and generally, subject to modification by the government.

• Focus of pension analysis:
  - Magnitude of unfunded actuarial accrued liability (UAAL)
  - Trend in funded ratio
  - Trajectory of annual payments (including to state cost sharing systems) and budget impact
  - Actuarially Required Contribution (ARC) vs. actual contribution history
    • Management commitment to full ARC funding
    • Is the contribution actuarially calculated and fully paid?
    • What share of spending does it represent?
    • What is the resource base from which funding is derived?
Fitch-Adjusted Figures

- Key actuarial and economic assumptions
  - Ability/willingness to select reasonable assumptions
    - Discount rate/investment return assumption: 8% is optimistic
    - Fitch adjusts discount rate/investment return to 7%
    - UAAL amortization period
  - 7% investment return/discount rate assumption
  - For every 1% that the discount rate varies from 7%, actuarial liability rises 11%
    - Funded ratio calculated based on this higher liability level
    - Resulting funded ratio an approximation
Fitch-Adjusted Figures

Carrying cost for local governments

• Debt service + pension contribution + OPEB pay-go
  - Local governments: labor-intensive
  - Vast majority in cost-sharing plans
  - Impact on resource base

• As % of spending:
  - <15% stronger
  - >25% weaker
Pension Summary

Credit positives:

- Well-funded pension plans, reasonable assumptions
- Consistent funding of actuarially determined annually required contribution (ARC)
- Effective efforts to contain liability over time

Credit concerns:

- High unfunded liability, liberal assumptions
- Annual contributions below the ARC
- High ARC requirements relative to budget
- Rapidly rising annual requirements
Finances

- Structurally balanced operations
- Prudent unrestricted reserves
- Revenue and expense composition and trends
- Capacity to absorb spending needs
- Tax and Revenue Limits
- Liquidity / cash flow
- Contingency planning
Financial Operations – Key Data

• Most recent audited financial report
• Unaudited actuals or projected results for immediate past fiscal year if CAFR not yet ready
• Next fiscal year budget (if available)
• Multi-year projections
  - How major revenues are expected to perform
  - The underlying assumptions (e.g. any political or legislative threats?)
  - Future expenditure increases (e.g. known labor cost increases, new legal mandates, future operating costs of new facilities)
  - Structural gaps and planned solutions
• “What-if” scenarios and contingency plans to address them
Financial Operations – Key Data, cont.

• **Major fund balances**
  - Under GASB 54, we focus on the unrestricted fund balance (committed + assigned + unassigned)
  - Interfund transfers:
    • Is the general fund supporting other funds temporarily or on an ongoing basis?
    • Are other funds supporting the general fund beyond overhead reimbursement? Any legal challenges to this?

• **Reserves**
  - Are they accounted for in the general fund or elsewhere?

• **Borrowable resources**
  - How much?
  - Held in which funds?

• **What other financial flexibility is available**
  - What realistic options does the issuer still have to fill future budget gaps?
Financial Operations – Liquidity

- Balance Sheet Analysis- receivables/payables, liquidity ratios etc.

- Liquidity Trends
  - When are the low cash points during the year? Have cash levels at those points declined in recent years? Provide monthly cash flow statements if there is a concern.
  - How does the issuer ensure sufficient liquidity at those points during the year (e.g. borrow from other funds or externally)?
  - What level of borrowable resources are available in other funds?
  - Is there a notable increase in cash flow borrowing?
  - Is there borrowing across fiscal years?
Management

- Ability and willingness to manage financial obligations
- Institutionalized and prudent policies
  - Implemented?
  - Followed?
  - Fiscal discipline maintained even during downturns
- Budget Practices - Are they realistic, conservative?
- Clear Vision
- Ability to Adapt
- Tenure/experience/effectiveness with and between elected officials
- Effectiveness with taxpayers and labor
Putting the Pieces Together

Link economy, debt, financial and management profile

View from an analyst's perspective and interaction between factors

• Convey both strengths and risks
• Delineate problems and level of control over the resolution.
• Take Strategic approach to restoring/building financial strength and addressing long term challenges
• Shore up Financial Policies where needed (lessons learned)
• Communication, Communication, Communication
Retaining Strong Credit Quality

- Budget realistically to conservatively
- Formulate “what-if” scenarios and develop contingency plans
- Monitor revenues and spending frequently
- Continue long-range financial planning
- Stay within financial policies where possible (use of one-time funds and reserves for operating expenditures should fall within guidelines)
- Develop a framework for use and replenishment of reserves
- Keep rating agencies informed of significant changes in circumstances

*Overall, identify opportunities and challenges and all of the implications, and then take appropriate action.*
Attributes of a Strong Credit

**Economy:**
- Broad, diverse, stable economy
- Taxpayer concentration < 10% for top 10
- Consistent, moderate population and employment growth
- Major employer stability and diversity
- Robust wealth indicators
- Moderate tax burden relative to area and similar communities

**Debt and other long-term liabilities:**
- Debt per capita < $2,000; debt to market value < 2%; low debt service burden < 5% of spending
- Modest future capital/debt needs; CIP updated regularly
- Rapid debt amortization, > 65% in 10 years
- Predominantly fixed-rate debt (< 15% variable rate)
- Consistent full funding of pension ARC (UAAL < 20%)
- Reasonable pension assumptions
- Carrying costs < 15% of spending

**Finances:**
- Diverse, stable, broad-based, flexible sources of operating revenues
- Ability to raise revenues
- Ability to adjust spending with limited service impacts
- Consistently positive operating margins
- Consistently sound reserve levels
- Substantial available liquidity without short-term borrowing

**Management and administration:**
- Highly efficient decision-making process
- Strong evidence of consistent cooperation among elected officials
- Good management-labor relations
- Financial management: prudent policies consistently followed; conservative budgeting process; regular financial management reviews; contingency planning; long-term planning; timely reporting
Attributes of a Weak Credit

**Economy:**
- Small, limited, or concentrated economy
- Taxpayer concentration > 15% for top 10
- Declining or extremely rapid population growth
- Industry or employer dominance
- Below-average wealth indicators

**Debt and other long-term liabilities:**
- Debt per capita > $4,000; debt to market value > 5%
- High debt service burden > 12% of spending
- Large future capital/debt needs; no published CIP
- Slow debt amortization, < 40% in 10 years
- Elevated levels of variable rate debt (> 25%)
- Inconsistent full funding of pension ARC (UAAL < 30%)
- Liberal assumptions
- Limited efforts to reduce OPEB liability
- Carrying costs > 25% of spending

**Finances:**
- Severely limited revenue flexibility; revenue declines
- Significant tax/revenue raising limits
- Little spending flexibility
- Trend of negative operating margins
- Low reserve levels without replenishment plans
- Low liquidity; reliant on short-term borrowing (< 15% of general fund receipts)

**Management and administration:**
- Cumbersome decision-making process
- Optimistic budget assumptions and inflexible budget amendment process
- Problematic management-labor relations
- Inconsistent support for management; voter referendum routinely fail
- Financial and debt management policies not present or not consistently followed, without plans to gain compliance
- Financial reporting delays and exceptions
2013 Fitch Rating Actions

Tax-Supported Rating Actions 2013

Affirm 91%
Downgrade 7%
Upgrade 2%
GASB Changes

Pros and cons of new accounting standards

• More complete, consistent balance sheet, income statement perspective

• Improved transparency and comparability
  - Fewer choices in arriving at reported figures
  - More consistent assumptions
  - Application to cost-sharing plan participants (largely affects locals)

• However, some provisions will weigh on funded ratios
  - Blended discount rate-when there is a depletion date
  - Assets at fair market value
  - Generally a more conservative approach to actuarial assumptions
GASB Changes

Concerns and uncertainty expressed about provisions

• Administrative cost of conversion, especially for cost-sharing plans
• Separation of funding from accounting adds to confusion
• Loss of a consistently reported ARC
• Uncertainty regarding impact on governmental decisions
Long-Term Rating Scale for Public Finance Obligations

**Investment grade**

**AAA:** Highest credit quality; lowest expectation of default risk - exceptionally strong capacity for payment of financial commitments unlikely to be adversely affected by foreseeable events

**AA:** Very high credit quality; very low default risk – very strong capacity for payment of financial commitments not significantly vulnerable to foreseeable events  [This is the average GO rating for local governments.]

**A:** High credit quality, low default risk – strong capacity for payment of financial commitments might be more vulnerable to adverse economic conditions

**BBB:** Good credit quality, currently low expectations of default risk – adequate capacity for payment of financial commitments but adverse economic conditions are more likely to impair this capacity
Short-Term Rating Scale for Public Finance Obligations

For obligations up to 36 months (e.g. TANs, RANs, TRANs, BANs)

F1+: Highest short-term credit quality and strongest intrinsic capacity for timely payment of financial commitments

F1: Very high short-term credit quality and very strong intrinsic payment capacity

F2: Good short-term credit quality and good payment capacity

F3: Fair short-term credit quality and adequate payment capacity

B: Speculative short-term credit quality, minimal payment capacity, and heightened vulnerability to adverse economic conditions

C: High short-term default risk

D: Default
Typical Relationship Between Long- and Short-term Ratings

Reflects importance of sustainable liquidity and near-term concerns within the assessment of the longer-term debt profile; actual ratings can diverge from this mapping depending on specific credit characteristics.

<table>
<thead>
<tr>
<th>Long-term ratings (investment grade)</th>
<th>Short-term rating (investment grade)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>F1+</td>
</tr>
<tr>
<td>AA+</td>
<td>F1+</td>
</tr>
<tr>
<td>AA</td>
<td>F1+</td>
</tr>
<tr>
<td>AA-</td>
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<td>F1</td>
</tr>
<tr>
<td>A-</td>
<td>F2 or F1</td>
</tr>
<tr>
<td>BBB+</td>
<td>F2</td>
</tr>
<tr>
<td>BBB</td>
<td>F3 or F2</td>
</tr>
<tr>
<td>BBB-</td>
<td>F3</td>
</tr>
</tbody>
</table>
Rating Outlooks and Watches

Rating Outlooks:

Expected movement in primary credit factors over next 24 months

- **Stable**
- **Positive** if credit characteristics trending positive (must be reviewed within 12 months)
- **Negative** if credit characteristics trending negative (must be reviewed within 12 months)
- **Evolving** if credit characteristics a mix of positive and negative (must be reviewed within 12 months)

Rating Watches:

Heightened probability of a rating change; event-driven; either exact rating implications of an event are undetermined, or the rating implications are known but the triggering event has yet to occur (e.g. regulatory approval); must be reviewed within six months

- **Positive** if potential upgrade
- **Negative** if potential downgrade
- **Evolving** if ratings might be raised, lowered, or affirmed
Review Cycle

Six month review:
- All rating watches
- Long-term ratings ‘B+’ and below
- Short-term ratings ‘F2’ and ‘F3’

12 month review:
- Rating outlook negative, positive, or evolving
- Long-term ratings ‘BBB’ and ‘BB’ categories
- Short-term ratings ‘F1+’ and ‘F1’ (if debt term longer than 12 months)

24 month review:
- Ratings ‘AAA’, ‘AA’, and ‘A’ categories, rating outlook stable
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Outlook for Local Governments and Revised GO Methodology

Bob Kurtter, Managing Director
GFOA Annual Conference
Minneapolis, Minnesota
May 19, 2014
US Local Government Outlook Revised to Stable

Key drivers:

- The housing market has stabilized in most of the country
- Property taxes have stabilized since downturn
- State funding arrangements have mostly stabilized
- Local governments are controlling costs, though pension burdens are a drag for many
- Reserve fund balances have stayed healthy
- The stable outlook applies to most of the sector, but pockets of credit pressure remain
The Housing Market has Stabilized in Most of the Country

Local Government Revenues Expected to Continue Recovering

Source: Moody’s Analytics, US Census Bureau
Property Taxes have Proven their Durability

Property Taxes Anchor Stable Local Government Ship

Source: US Census Bureau
State Funding Arrangements Have Mostly Stabilized

States Reducing Local Aid to help Eliminate Budget Gaps

Fiscal 2006-2013

Source: National Association of State Budget Officers
Local Governments are Controlling Costs, Reducing Staff

State and Local Governments Re-Size After Recession

*2013 data as of September
Source: Bureau of Labor Statistics
Fund Balances Have Remained Healthy

Source: Moody’s Investors Service
Pockets of Pressure Remain

**Stressed Sectors**

- **New Hampshire**: Subsidies for nursing homes will pressure financial performance of counties.
- **New Jersey**: Along with a lagging economic recovery, declining fund balances and limited revenue increase will weigh on cities and counties.
- **New York**: Both cities and counties are facing rising pension and healthcare costs.
- **Pennsylvania**: While coping with declining state aid, many issuers are also coping with strained tax bases and rising costs.
- **Rhode Island**: Cities continue to deal with weak revenue and economic growth and large pension liabilities.
- **Florida**: Still recovering from the downturn, tax levels are still suppressed and many issuers still need to achieve structural balance.
- **Kentucky**: Schools are strained by lease issues.
- **Illinois**: Pension pressures weigh on cities, while delayed state aid is worrisome for school districts.
- **Indiana**: State aid is being held flat and raising property taxes has become more difficult.
- **Michigan**: Cities are coping with shrinking tax base and revenues. Schools face lower enrollment and lower state aid.
- **California**: Significant revenue raising constraints and pension liabilities are above average due to generous benefits.
- **Nevada**: Not yet recovered from the downturn, tax levels have not rebounded and budgets are still cut.

*Source: Moody's Investors Service*
Local Govn’t Ratings Mostly Held Steady Through Downturn

Percentage of Total Ratings

- Same
- Downgraded
- Upgraded

80.1% of ratings remained the same, 13.7% were downgraded, and 6.2% were upgraded.

Source: Moody’s Investors Service

20 Largest States by Downgrade %

- Michigan (349)
- California (460)
- Oregon (102)
- New Jersey (443)
- Ohio (438)
- Pennsylvania (267)
- North Carolina (119)
- Tennessee (114)
- South Carolina (110)
- Texas (765)
- Wisconsin (404)
- Massachusetts (263)
- New York (839)
- Washington (212)
- Connecticut (145)
- Illinois (511)
- Iowa (121)
- Minnesota (374)
- Georgia (102)
- Arizona (106)
- Connecticut (145)

Source: Moody’s Investors Service
New Local Government GO Methodology & Scorecard

Goals of New Methodology:
- Update prior methodology to reflect recent trends & key issues, including pensions
- Develop quantitative scorecard

Purpose and Use of the Scorecard:
- Enhances the transparency of our rating process
- Captures the key considerations that correspond to particular rating categories
- Not an exhaustive list of factors that we consider in every local government rating
- Each subfactor is a quantitative metric
- May notch up or down from scorecard-indicated rating based on additional factors
- Scorecard acts as a starting point for a more thorough and individualistic analysis
- Final rating is determined by a Rating Committee
General Obligation Bonds – Rated Universe

- GO is the most commonly used security by local governments in the US
- Methodology focuses on local government ratings based on the “typical” general obligation unlimited tax pledge
- We rate approximately 8,300 local government GO credits
- Strong sector due to the potency of the ad valorem taxing power, amortizing debt structures, and overall stable institutional frameworks
- Current ratings range from Aaa to Caa3
  - Sector median is Aa3
  - Only 2% rated Baa1 or below
## New GO Scorecard

### Changes from Previous Methodology:

<table>
<thead>
<tr>
<th>Factor 1</th>
<th>Factor 2</th>
<th>Factor 3</th>
<th>Factor 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economy/Tax Base</td>
<td>Finances</td>
<td>Management</td>
<td>Debt/Pensions</td>
</tr>
<tr>
<td>30%</td>
<td>30%</td>
<td>20%</td>
<td>20%</td>
</tr>
</tbody>
</table>

- Was 40%          | Unchanged     | Unchanged     | Was 10%       |
## New GO Scorecard

### Rationale for Changes:

<table>
<thead>
<tr>
<th>Factor 1</th>
<th>Factor 2</th>
<th>Factor 3</th>
<th>Factor 4</th>
</tr>
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<tr>
<td>30%</td>
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<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Was 40%</td>
<td>Unchanged</td>
<td>Unchanged</td>
<td>Was 10%</td>
</tr>
</tbody>
</table>

Change in Weightings:

- Factor 1 weighting lowered to reduce the influence of tax base size
- Factor 4 weighting increased to include a specific quantitative measure for pensions
### GO Scorecard – Factors, Sub-factors and Weights

<table>
<thead>
<tr>
<th>Factors &amp; Sub-Factors</th>
<th>Weights</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Factor 1: Economy/Tax Base</strong></td>
<td>30%</td>
</tr>
<tr>
<td>Full Value (market value of taxable property)</td>
<td>10%</td>
</tr>
<tr>
<td>Full Value per Capita</td>
<td>10%</td>
</tr>
<tr>
<td>Median Family Income</td>
<td>10%</td>
</tr>
</tbody>
</table>

| **Factor 2: Finances**                                    | 30%     |
| Fund Balance as % of Operating Revenue                    | 10%     |
| 5-Year Dollar Change in Fund Balance as % of Revenues     | 5%      |
| Cash Balance as % of Revenues                            | 10%     |
| 5-Year Dollar Change in Cash Balance as % of Revenues     | 5%      |

| **Factor 3: Management**                                 | 20%     |
| Institutional Framework                                  | 10%     |
| Operating History: 5-Year Average of Operating Revenues / Operating Expenditures | 10%     |

| **Factor 4: Debt/Pensions**                               | 20%     |
| Net Direct Debt / Full Value                              | 5%      |
| Net Direct Debt / Operating Revenue                       | 5%      |
| 3-Year Average of Moody’s Adjusted Net Pension Liability / Full Value | 5%      |
| 3-Year Average of Moody’s Adjusted Net Pension Liability / Operating Revenues | 5%      |
## GO Scorecard – Notching Factors

<table>
<thead>
<tr>
<th>Description</th>
<th>Direction</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Economy/Tax Base</strong></td>
<td></td>
</tr>
<tr>
<td>Institutional presence</td>
<td>up</td>
</tr>
<tr>
<td>Regional economic center</td>
<td>up</td>
</tr>
<tr>
<td>Economic concentration</td>
<td>down</td>
</tr>
<tr>
<td>Outsized unemployment or poverty levels</td>
<td>down</td>
</tr>
<tr>
<td>Other analyst adjustment to Economy/Tax Base factor (specify)</td>
<td>up/down</td>
</tr>
<tr>
<td><strong>Finances</strong></td>
<td></td>
</tr>
<tr>
<td>Outsized contingent liability risk</td>
<td>down</td>
</tr>
<tr>
<td>Unusually volatile revenue structure</td>
<td>down</td>
</tr>
<tr>
<td>Other analyst adjustment to Finances factor (specify)</td>
<td>up/down</td>
</tr>
<tr>
<td><strong>Management</strong></td>
<td></td>
</tr>
<tr>
<td>State oversight or support</td>
<td>up/down</td>
</tr>
<tr>
<td>Unusually strong or weak budgetary management and planning</td>
<td>up/down</td>
</tr>
<tr>
<td>Other analyst adjustment to Management factor (specify)</td>
<td>up/down</td>
</tr>
<tr>
<td><strong>Debt/Pensions</strong></td>
<td></td>
</tr>
<tr>
<td>Unusually strong or weak security features</td>
<td>up/down</td>
</tr>
<tr>
<td>Unusual risk posed by debt/pension structure</td>
<td>down</td>
</tr>
<tr>
<td>History of missed debt service payments</td>
<td>down</td>
</tr>
<tr>
<td>Other analyst adjustment to Debt/Pensions factor (specify)</td>
<td>up/down</td>
</tr>
<tr>
<td><strong>Other</strong></td>
<td></td>
</tr>
<tr>
<td>Credit event/trend not yet reflected in existing data sets</td>
<td>up/down</td>
</tr>
</tbody>
</table>
Applying the Analytical Factors

- Analysts score each subfactor in the grid
- The weighted average of the analyst-assigned scores will determine a raw score that maps to Moody’s rating scale → the grid-indicated rating
- Analyst and Rating Committee will determine any notching factors → the adjusted scorecard rating
- The final public rating may differ from the adjusted scorecard rating
GO Methodology and Scorecard: Next Steps

Impact on Ratings:

- 256 ratings were placed under review as a result of the new methodology
  » 52% for upgrade and 48% for downgrade (132 and 124, respectively)
  » Total credits placed under review represent 3% of our rated universe
- We will complete a full review of each of these credits, including a conversation with the issuer
- The reviews could take up to six months, but we hope to complete the vast majority of them much sooner
Summary of Credits Placed Under Review

Profile of a typical credit on review for **Upgrade:**
- A/Baa-rated credit with small full value
- Stable financial operations, and/or
- Limited debt/pension burden

Profile of a typical credit on review for **Downgrade:**
- Aaa/Aa-rated credit with large full value
- Less stable financial operations, and/or
- Significant debt/pension burden
Summary of Credits Placed Under Review

- Most of the credits under review for upgrade are currently rated in the A-range, with some in the Baa-range.
- Credits under review for downgrade are generally rated in the Aa-range, though some are Aaa.

<table>
<thead>
<tr>
<th>Current Rating</th>
<th>Review for Upgrade</th>
<th>Review for Downgrade</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aaa</td>
<td>0</td>
<td>25</td>
</tr>
<tr>
<td>Aa</td>
<td>10</td>
<td>88</td>
</tr>
<tr>
<td>A</td>
<td>83</td>
<td>11</td>
</tr>
<tr>
<td>Baa</td>
<td>39</td>
<td>0</td>
</tr>
</tbody>
</table>
Appendix

Moody’s Analysis of Local Government Pension Obligations
Pensions are a growing source of credit pressure

» Liabilities and costs continue to grow across the public sector
  – Demographic trends, imprudent benefit increases, contribution shortfalls, and “lost decade” in the stock market
  – On reported actuarial basis, unfunded liabilities in 2011 were $800 billion, more than doubling since 2005
  – Negative credit impact is compounded by recent years’ slow recovery of tax revenues

» Pensions a key driver in several high profile downgrades
  – States: CT, HI, IL, KY, NJ, PA, PR
  – Local governments: 29 outliers identified through application of Moody’s adjustments
  – 18 downgraded, including several major cities: Cincinnati, Minneapolis, Chicago
Four principal adjustments to as-reported pension data

» Allocate liabilities of cost-sharing plans to participating government employers based on their proportionate shares of total plan contributions

» Discount accrued actuarial liabilities (AAL) using a high-grade (Aa quality) corporate bond index rate as of the date of valuation

» Use fair or market value of assets (MVA) instead of smoothed asset value to calculate *Moody’s adjusted net pension liability* (adjusted AAL minus MVA)

» Calculate a standardized annual amortization metric related to the adjusted net pension liability, on a 20-year level dollar basis
Wide variation in pension burdens relative to revenue for 50 largest local governments

» Adjusted net pension liabilities of the “top 50” range from 678% to 11% of operating revenues (fiscal 2011)

» Fiscal 2011 reporting of top 50 encompasses actuarial valuations from June 2009 to December 2011

» Adjusted discount rates range from 4.40% to 6.05%
Contributions and actuarial costs have grown onerous for some local governments

- Contributions relative to actuarial requirements include Moody’s allocation of cost-sharing plans. Most local governments with cost-sharing exposure make full contractual contributions, though not necessarily tied to actuarial costs.

- We view contribution shortfalls, including those from cost-sharing exposure, as a driver of structural budget imbalance. Contribution shortfalls also correlated with higher ANPLs.
Lower liabilities, higher costs for pensions in 2014

» Adjusted liabilities will decline, but remain high relative to past years
  – Rising interest rates - bond index discount rate up 90 bps in 2013
  – Strong investment performance - largest public funds exceed assumed returns by as much as 6.3% in fiscal 2013

» Four factors driving elevated costs relative to municipal budgets
  – Substantial buildup of unfunded liabilities over past decade
  – Timing lags in actuarial methods and budget rules
  – Perennial contribution shortfalls relative to actuarial requirements
  – Deferred amortization approaches
Despite liability improvements, budget costs are elevated

» Factor one: substantial unfunded liability buildup over last decade on a nominal basis and relative to active payrolls
Despite liability improvements, budget costs are elevated

» Factor two: budgetary timing lags and asset smoothing mitigate the immediate impact of 2013 investment performance

<table>
<thead>
<tr>
<th>Pension Plan(s)</th>
<th>Actuarial Valuation Date</th>
<th>Report Release</th>
<th>Determines Employer Contributions for Fiscal Year ended</th>
</tr>
</thead>
<tbody>
<tr>
<td>CalPERS Local Government Plans</td>
<td>Jun-11</td>
<td>Oct-12</td>
<td>Jun-14</td>
</tr>
<tr>
<td>Michigan Public School Employees’ Retirement System</td>
<td>Sep-12</td>
<td>May-13</td>
<td>Jun-15</td>
</tr>
<tr>
<td>Cincinnati Retirement System</td>
<td>Dec-12</td>
<td>May-13</td>
<td>Dec-14</td>
</tr>
<tr>
<td>Educational Retirement Board of New Mexico*</td>
<td>Jun-13</td>
<td>Nov-13</td>
<td>Jun-14</td>
</tr>
<tr>
<td>San Diego City Employees’ Retirement System</td>
<td>Jun-13</td>
<td>Dec-13</td>
<td>Jun-15</td>
</tr>
</tbody>
</table>

*Employer contributions as a percent of covered payroll are determined by statute, explaining the overlap of report availability and contributions.
Despite liability improvements, budget costs are elevated

» Factor three: contribution shortfalls relative to annual required contributions (ARCs) are widespread, and increase future amortization requirements

» Many large multi-employer plans do not collect actuarially-determined employer contributions in aggregate

» 21 of 50 largest cost-sharing plans collected less than 90% of plan ARC in fiscal 2012
Despite liability improvements, budget costs are elevated

» Factor four: cost methods often backload contributions

» ARCs are not comparable, nor always prudent methods to reduce leverage of the plan sponsor – amortization methods are an important consideration

» For example, the level % of payroll approach can generate negative amortization
  – even when required contributions are made
  – With “open” amortization applied to this method, the UAAL is never paid down - unless offset with larger experience gains

### Pension Amortization Methods Can Backload Costs and Actually Increase UAALs

<table>
<thead>
<tr>
<th>Assumptions:</th>
<th>30 Years, 7.75% Discount Rate,</th>
<th>30 Years, 7.75% Discount Rate,</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2 % Salary Growth</td>
<td>4% Salary Growth</td>
</tr>
<tr>
<td>Method</td>
<td>Level % - Closed</td>
<td>Level % - Open</td>
</tr>
<tr>
<td>Initial UAAL</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Number of Years With Negative Amortization</td>
<td>6</td>
<td>30</td>
</tr>
<tr>
<td>Year 15 UAAL</td>
<td>$935,097</td>
<td>$1,097,985</td>
</tr>
<tr>
<td>Year 30 UAAL</td>
<td>$0</td>
<td>$1,205,570</td>
</tr>
</tbody>
</table>

Source: Moody’s
Meaning of new GASB standards for Moody’s pension analysis

» Moody’s fundamental approach to evaluating pensions will remain unchanged
  » Our adjustments already measure net liability exposure relative to capacity to pay
  » A comparable discount rate adjustment will still be needed
  » Cost-sharing plan allocations will be viewed from an economic perspective
  » Adding unfunded liability to the reported government-wide balance sheet has no effect on our analysis

» Timely and sufficient audited financial information is required to maintain ratings
  » Advance preparation for GASB changes will help avoid non-timely audits

» Ramifications of new “pension expense” for net revenue bond covenants must be explored by issuers and their bond counsels
# Moody’s Pension Adjustments Compared with New GASB Standards

<table>
<thead>
<tr>
<th></th>
<th>Moody’s</th>
<th>GASB</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Implementation Date</strong></td>
<td>April 2013</td>
<td>No later than Fiscal 2015 reporting</td>
</tr>
<tr>
<td><strong>Net Liability Measure</strong></td>
<td>“Moody’s Adjusted Net Pension Liability” (ANPL)</td>
<td>“Net Pension Liability”</td>
</tr>
<tr>
<td><strong>Asset Smoothing</strong></td>
<td>Eliminate in favor of market or fair value</td>
<td>Eliminate in favor of market or fair value</td>
</tr>
<tr>
<td><strong>Discount Rate</strong></td>
<td>Common high-grade corporate bond index rate as of the actuarial valuation date</td>
<td>Plan-specific investment return, blended with muni bond index depending on funding history</td>
</tr>
<tr>
<td><strong>Duration of Accrued Liabilities</strong></td>
<td>Currently assumed at 13 years; When available under new GASB disclosures, will use plan-specific duration in adjustments</td>
<td>Sensitivity analysis showing impact of +/- 1% change in assumed discount rate (i.e. a proxy for plan duration)</td>
</tr>
<tr>
<td><strong>Cost-sharing plan allocation</strong></td>
<td>Estimated based on proportionate share of total plan annual contributions; Proportionate shares disclosed under new standards will be used, provided Moody’s views them as reasonable</td>
<td>Proportionate share aligns with method used by plan for determining contributions</td>
</tr>
<tr>
<td><strong>Annual Costs</strong></td>
<td>Amortize ANPL over 20 years on a level dollar basis with no adjustments to Normal Cost; Historical contributions relative to plan reported actuarial requirements also considered</td>
<td>No longer provides standard for annual funding</td>
</tr>
<tr>
<td><strong>Reporting and accounting requirement?</strong></td>
<td>No</td>
<td>Yes, replaces GASB 25 and 27</td>
</tr>
</tbody>
</table>

**Presenters:**

- Kathleen Aho, Springstead, Inc.
- Nancy Winkler, City of Philadelphia, PA
- Lois Scott, City of Chicago, IL

**Date:** 05/19/2014
Credit Ratings – Issuer Panel

- City of Philadelphia – Nancy Winkler
  Rating case study, newer rating agencies

- City of Chicago – Lois Scott
  Rating case study, University of Chicago Project, managing your rating agency relationship

- Springsted Incorporated – Kathleen Aho
  Changing criteria and small to mid-sized issuers, preparing a presentation, managing your rating agency relationship
What is a bond rating?

- An opinion by a rating agency on the credit worthiness of a bond issue
  - Rating is determined by issue’s credit characteristics
  - General obligation ratings often viewed by issuers as a report card

- Major bond rating agencies
  - Standard & Poor's Rating Services (S&P) 95% of ratings
  - Moody’s Investor Services (Moody’s) worldwide*
  - Fitch Ratings (Fitch)

* Municipal and corporate ratings
Why do you care about them?

- **Primary - Financial implications**
  - Higher rating = lower interest rate
  - Higher rating = lower underwriting costs

- **Ancillary - Bragging rights**
  - Outside, independent perspective on how you are doing
  - Can be a reward for good management and tough decisions
  - Source of pride
# Borrowing Cost Implications

<table>
<thead>
<tr>
<th>Maturity</th>
<th>Aaa/AAA</th>
<th>Aa/AA</th>
<th>A/A</th>
<th>Baa/BBB</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 years</td>
<td>1.25%</td>
<td>1.35%</td>
<td>1.70%</td>
<td>2.25%</td>
</tr>
<tr>
<td>10 years</td>
<td>2.30%</td>
<td>2.50%</td>
<td>2.95%</td>
<td>3.60%</td>
</tr>
<tr>
<td>15 years</td>
<td>2.80%</td>
<td>3.00%</td>
<td>3.50%</td>
<td>4.15%</td>
</tr>
<tr>
<td>20 years</td>
<td>3.15%</td>
<td>3.40%</td>
<td>3.85%</td>
<td>4.45%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Increment</th>
<th>.10 - .25%</th>
<th>.35 - .50%</th>
<th>.55 - .65%</th>
</tr>
</thead>
</table>

85
Newly published G.O. criteria

- **S & P**
  - Implemented October 2013
  - New criteria do **not** apply to schools
  - A review of all issuers is being done
    - Target completion date – 12 months
    - Projected 30% upgrades, 10% downgrades, 60% unchanged

- **Moody’s**
  - Implemented January 2014
  - 256 issuers that may change are being reviewed
    - Target completion date – 90 to 180 days
    - 132 potential upgrades and 124 potential downgrades
Newly published G.O. criteria

- Fitch
  - No formal revision made to their existing criteria, but refined on an ongoing basis.

All issuers will undergo more frequent formal reviews even if debt isn’t issued
What gets measured is consistent among agencies

- Economy
- Entity financial characteristics
- Management and institutional framework
- Debt and pensions
How weighting of factors differs

Moody's Rating Factors

- Up from 10%
- Down from 40%

Standard & Poor's Rating Factors

- Economy/Tax Base: 10%
- Finances: 30%
- Management & Institutional: 30%
- Debt: 30%
New published criteria – impact on issuers

- More consistency in approach
- Focused training for rating analysts
- More quantitative, specific approach
- More demanding credit interviews, particularly the initial review following implementation
- Modifications to and specific delineation of credit factors
  - Identifies what is being looked at, import
  - More reliance on factual statistics vs. improvements-in-process
Ratings under new criteria

- Issuer conference
- Agency develops a “score” for the credit
- Score is adjusted by qualitative factors
- Rating cap is applied, if applicable (S&P)
- Internal credit committee assesses analysis
- Result provided to issuer, draft report provided
- 2 hour window to review draft report
- Rating released, report provided to the market
Preparing for a rating

- Time your issue appropriately
  - Release of key data, such as CAFR
  - Major events, such as significant debt retirement
  - Major events, such as legislative action

- Review your previous credit reports and rating conference notes

- Review current events that may be significant – good or bad
Preparing for a rating

- Request a copy of the scorecard, both the initial one and the one that goes to the credit committee
- Understand the rating factors
- Translate your data into information that aligns with the factors
  - How do you best position yourself in weak areas?
  - How do you communicate your strengths?
Preparing for a rating

○ Have you made a purposeful decision about who needs to attend?
  • Elected/appointed official?
  • Chief administrator?
  • Chief finance person √
  • Community development?
  • Property Assessor?
  • Other experts?
    • City hospital finance director
    • Public works director
    • Parks and recreation director
Preparing for a rating

- Do you have a list of key topical areas that will be covered, information to address those areas, speaking points?

- Know what key points you need to make so they don’t get overlooked

- You may receive questions in advance
  - Look beyond the facts of the question – what is trying to be addressed?
  - Develop answers to them
Preparing for a rating

- The best preparation for a rating happens over the course of routine business
  - Good financial reporting, with checkpoints for your Board/Council
  - Long range capital and financial planning
  - Policies that guide decisions/actions in key areas, and demonstrated adherence to those policies
  - Good communication to Board/Council/Citizens about entity’s actions and condition
  - Demonstrable evidence of ability and willingness to manage; agility
Managing the relationship

- Decide if your issuance pattern merits a formal, ongoing communication plan
- Assemble the right team – day-to-day and at conference time
- Focus your message – where’s the beef?
- Avoid surprises – communicate challenges and plans to address them
- Play it straight
Managing the relationship

- You’ve decided a rating is worthwhile, invest in it
  - Know which of the factors impact your rating and how
  - Financial reports vary. Explain your operations in a way that translates to accurate credit evaluation
  - Identify weaknesses and address those you control before rating time
    - Management
    - Debt management
    - Long-range strategic planning