

Exploring the Dimensions of Municipal Credits: Session Two

Credit Criteria: Historical and Current Measures of Credit Quality



October 17, 2012

San Francisco, California

The California Debt and Investment Advisory Commission

and The Bond Buyer's

Pre-Conference to

The Bond Buyer's 22nd California Public Finance Conference

“Change is the law of life, and those who look only to the past or the present are certain to miss the future.”

*John F. Kennedy (1917–1963),
35th President of the United States*

Character

The determination of a borrower to honor its obligations, including repayment of its debts.

Synonyms

- ✓ Integrity
- ✓ Honesty
- ✓ Reputation

Consistency of action
and stated intent

Antonyms

- ✓ Artifice
- ✓ Deception
- ✓ Lack of candor

Inconsistency of action
and stated intent

“A man’s indebtedness is not virtue; his repayment is.”

Ruth Benedict (1887–1948), American anthropologist

Capacity

The ability to operate the enterprise successfully enough to generate the cash needed to repay the loan.

Synonyms

- ✓ Ampleness
- ✓ Adequacy
- ✓ Endurance

Sufficient resources to repay the debt

Antonyms

- ✓ Weakness
- ✓ Impairment
- ✓ Inefficiency

Inadequate, uncertain or illiquid resources

“There was a time when a fool and his money were soon parted. Now it happens to everybody.”

*Adlai Stevenson (1900–1965),
politician, diplomat, and two-time Presidential candidate*

Capital

The investment of the borrower in its own assets or enterprise.

Synonyms

- ✓ Assets
- ✓ Resources
- ✓ Savings

The borrower's own investment—financial and psychological

Antonyms

- ✓ Liabilities
- ✓ obligations
- ✓ Indebtedness (excessive)

Insufficient investment at stake versus the amount borrowed

“If you can't make 10% on your money, drink it.”

Bernard Baruch (1870–1965), American Industrialist

Conditions

The economic and environmental forces that affect the borrower's financial condition and performance.

Synonyms

- ✓ Favorable economy
- ✓ Good business environment
- ✓ Legal & regulatory matters

The conditions usually beyond the borrower's control

Antonyms

- ✓ Weak economy
- ✓ Excessive competition
- ✓ Uncontrollable restrictions

Restrictive conditions are almost always part of municipal credit decisions

“The four most dangerous words in investing are 'This time it's different.'”

*John Templeton (1912–2008),
Investor and a pioneer of the mutual fund industry*

Collateral

The property pledged by the borrower to protect the interest of the lender.

Synonyms

- ✓ Guarantee
- ✓ Pledge
- ✓ Security

The borrower's "stands guard" as the last protection against loan loss

Antonyms

- ✓ Unsecured
- ✓ Negative pledge
- ✓ Non-recourse

Collateral usually isn't enough to offset credit extended to borrower's of poor character

"Never invest in anything that eats or needs painting."

*Billy Rose (1899–1966),
American entertainer and stenographer to Bernard Baruch*

Some Refinements to the “Cs”

□ Commerical Lender Credit Capacity:

□ Impacted by:

- Level of current overall credit exposures to California municipal issuers and shrinking universe of banks active in space.
- Weak overall economic environment in California for an extended period contributes to “California Fatigue” for some lenders.
- Further exacerbated by the fact that cost cutting fatigue has caused some California issuers to seek bankruptcy protection or to consider triggering fiscal emergencies, leading to perception of eroding issuer willingness to use general fund resources to make loan/lease payments; lenders have noticed, and this is likely to cause additional differentiation/notching between specific pledged revenue transactions and unsecured general fund transactions.
- Demonstrated willingness of issuer management and oversight boards to make the difficult but necessary financial decisions to preserve liquidity/reserves/capacity for debt repayment plays an important role in lenders’ decisions regarding differentiation of risk and allocation of credit.
- Relationships matter, because there are no longer many “credit only” lenders active in the municipal space; the financial crisis has thinned out the bank market and diminished the universe of Tier-1 rated banks, and new Basel III rules to be phased in through January 2019 will likely impact both credit availability and pricing; in such an environment, procurement driven credit RFP’s without consideration of the issuer’s current and/or prospective future relationship with the lender are not likely to be effective.

The “Anti–” Five Cs of Credit

Complacency:

“Don’t worry, public agencies always pay their debts; besides, it’s an essential asset.”

Carelessness:

“We don’t need to “overanalyze” this agency, the rating agencies and/or the insurers have already done it for us.”

Communication lapses:

“We don’t need to focus on current financials, the CAFR will be here in January.”

Contingencies:

“What’s to worry about, most public borrowers usually figure out a way to manage through.”

Competition:

“Everyone else is doing it; besides, the yield is really good, and we need the yield.”

Is there a Sixth “C”?

- The unprecedented speed and the dimension of the changes occurring since the onset of the Great Recession now argue for the consideration of a sixth “C,”—change
- Change is often disruptive, always dynamic, and usually resisted.

LESSON: if change is inevitable, then be proactive.

Litigant, n. A person about to give up his skin for the hope of saving his bones.

*Ambrose Bierce (1881–1911),
American journalist and editorialist
From “The Devil’s Dictionary”*

Another New “C” Worth Considering

□ Communication:

- Lenders’ easy access to current information contributes to quick turnarounds, good pricing, and issuer-friendly documentation.
- Lenders start with rating agency analysis then “fill in the blanks” with borrower provided data and other data.
- Credit criteria, information, and disclosure information requirements for commercial lenders are different from those of bond investors.
- Bank lenders consider it vitally important to have direct interface with their municipal clients.
- Keep in touch with relationship lenders on a regular basis, regardless of whether or not there is a current new borrowing need (lenders hate surprises).
- Provide easy access to publicly available back-up information, including:
 - CAFR’s, CIP’s, Budgets, etc
 - Current board minutes/presentations containing mid-year analysis/discussion of countermeasures
- Forward looking projections are a best practice (Good example: City of San Diego Five Year Financial Outlook posted on website and updated annually).
- Receipt of Rating Agency Presentations enhances lenders’ credit analysis.
- Adequate time is needed for credit analysis and approval, therefore tight turnaround times on credit RFPs work to the issuer’s detriment.

50 Reasons “Why Not”

1. We've never done it before.
2. Nobody else has ever done it.
3. It has never been tried before.
4. We've tried it already.
5. Another organization has tried it before.
6. We've been doing it this way for years.
7. It won't work in a small organization like ours.
8. It won't work in a large organization like ours.
9. It won't work in our organization.
10. Why change it; it's working fine.
11. The boss will never buy into it.
12. It needs further study.
13. Our peers (competitors) are not doing it.
14. It's too much trouble to change.
15. Our organization is different.
16. The ad department says it won't work.
17. The sales department says it won't work.
18. The service department says it won't work.
19. The janitor says it won't work.
20. It can't be done.
21. We don't have the money.
22. We don't have the personnel.
23. We don't have the equipment.
24. The union will scream.
25. It's too visionary.
26. You can't teach an old dog new tricks.
27. It's too radical.
28. It's not my responsibility.
29. It's not my job.
30. We don't have the time.
31. It will make other procedures obsolete.
32. Customers won't buy it.
33. It's contrary to policy.
34. It will increase overhead.
35. The employees will never buy it.
36. It's not our problem.
37. I don't like it.
38. You're right, but
39. We're not ready for it.
40. It needs more thought.
41. Management won't accept it.
42. We can't take the chance.
43. We'd lose money on it.
44. It takes too long to pay out.
45. We're doing all right as it is.
46. It needs a committee to study it.
47. The competition won't like it.
48. It needs sleeping on.
49. It won't work in this department.
50. It's impossible.