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DEBT AND
INVESTMENT
ADVISORY
COMMISSION

CREDIT QUALITY AND THE NEW DYNAMICS OF CREDIT RATINGS

Robert Sakai
Vice President
Union Bank

Andrew Ward
Director
Fitch Ratings

Debt 2:
Accessing the Market

October 23, 2013
Oakland, California

Municipal Credit
A Bank's Perspective

October 23, 2013

Robert Sakai

Vice President

UnionBank

Overview Summary

Typical credit/debt products offered by banks

Analysis of Municipal Credits

- Credit Metrics
- Ratings and Rating Agencies
- Disclosure & Compliance

Recent News and updates/outlook

- Pensions/OPEB/Detroit

Typical Bank Credit/Debt Products

- Types of Bank credit and liquidity facilities supporting variable rate demand bonds or commercial paper:
  - Direct Pay Letters of Credit (credit facility) – support principal, interest and purchase price payments. The facility is an unconditional, irrevocable obligation of the bank with no immediate termination features.
  - Standby Bond Purchase Agreements/Lines of Credit (liquidity facility) – supports purchase price payments only. The borrower (municipality) provides payment of principal and interest.
- Direct Lending
  - Financing (fixed or variable rate) that is directly negotiated between borrower (municipality) and lender.
  - Can be structured/documented as either loan or security depending on institution's internal policies and/or regulatory limitations.

Direct Lending – a Return to Basics

- Resurgence of direct lending to municipal entities over the past several years – Why?

  - Despite credit headlines on municipal entities, provides good risk-adjusted return (for institutions who understand and are comfortable with the sector).
  - Diversifies a bank's balance sheet.
  - Reduced opportunities for traditional lending customers and need to put bank assets to work.
  - Lower-rated banks are able to participate as a lender
  - Regulatory changes (Basel III) have encouraged banks to pursue funded loans/commitments vs. contingent liabilities (letters of credit/liquidity facilities).

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Analysis of Municipal Credits

- Public Finance remains a very specialized “niche” sector
- Credit criteria/fundamentals in analysis very similar between institutions active in this sector.
- However, level of understanding relative risk and comfort with sector widely varies.
- Specific criteria mirrors rating agencies:
  - Economy
  - Management
  - Finances
  - Debt

Credit Factors/Criteria

- Economy
  - Wealth/income levels
  - Unemployment rates/Depth and diversity of employment base
  - Tax Base - Assessed valuation growth, per capita market values

- Management
  - On-time budgeting and reporting
  - Multi-year budgets and capital plans
  - Management staff stability and experience
  - Easy access to management and timely responses to questions/concerns

Credit Factors/Criteria

- Finances
  - History of balanced budgets, operating surpluses or losses
  - Prudent use of reserves and maintenance of liquidity levels
  - % of expenditures used for debt service, pension/OPEB
  - Diversity of revenue streams and financial flexibility to contain expenditures

- Debt
  - Debt levels compared to tax base (AV), Debt levels on per capita basis, debt service coverage (revenue secured or enterprise debt)
  - Capital plans and future debt issuances
  - Pension/OPEB funding levels and UAAL
  - Access to capital markets and public debt/credit ratings

Ratings and Rating Agencies

- Since 2008 Financial Crisis, less reliance on public ratings and more focus and use of internal analysis and expertise.

- Loss of “AAA’” bond insurers and using their rating/analysis as a proxy for investment grade assessment also put more focus on internal analysis and expertise.

- However, public ratings and rating agencies are embedded in bank documents, loan and credit agreements.

- Public ratings continue to be an indication of market access.

Disclosure & Compliance

- The Banking & Financial Sector is heavily regulated and under more scrutiny than ever.
- Compliance with Basel II/III, internal and external auditors (Office of the Comptroller of the Currency or OCC).
- Timeliness of receipt of financial information is significant.
- Internal & external auditors heavily scrutinize Public Finance sector due to timing of audits (i.e. within 180 days after FYE) and limited interim reporting.
- Keep rating agencies, lending institutions and investors informed.

Recent News and Updates/Outlook

- Detroit Chapter 9 filing (July 18, 2013) and Moody's downgrade of Chicago (GO from Aa3 to A3 in July) continues to put a focus on pension/OPEB liabilities; although filing and downgrade were not unexpected

- S&P comment (9-22-11) on OPEB UAAL for states: "While the unfunded OPEBs may seem large, we believe that most states will have sufficient time to address these significant long-term liabilities since the bulk of them will not occur until after the current workforce retires, and benefits are scheduled to be paid out over many years."

- Financial outlook for States generally stable but stability at local level varies

Recent News and Updates/Outlook

- General stabilization of the economic cycle (S&P report, “U.S. Public Finance Report Card: Ratings on Most California Cities Likely Hit Bottom in 2012” 1-29-13.)
- Rating on State of California’s GO debt raised to “A” on improved fiscal and cash position by S&P (1-31-13)
- State of California budget adopted/approved on time
- State of California Note sale at 40 year record low yields (August 2013)

Supporting Reports/Reference Material

- Moody's Special Comment "U.S. Municipal Bond Defaults and Recoveries, 1970-2011" March 7, 2012
- Moody's Special Comment "Semi-annual Performance Statistics Update: 2012 H1" August 29, 2012
- Moody's Special Report "The U.S. Municipal Bond Rating Scale: Mapping to the Global Scale and Assigning Global Scale Ratings to Municipal Obligations" March 29, 2007, excel data
- Barclays Capital Municipal Research Special Report "States' Pensions: A manageable Longer-Term Challenge" May 18, 2011
- Wells Fargo Securities: Municipal Securities Research, Municipal Commentary "On Detroit, General Obligations and Public Pensions" July 19, 2013

Referenced Reports (continued)

- United States Government Accountability Office “State and Local Government Pension Plans, Economic Downturn Spurs Efforts to Address Costs and Sustainability” March 2012
- National Association of State Retirement Administrators “Issue Brief: State and Local Government Spending on Public Employee Retirement Systems” February 2012
- Fitch Ratings “Tax Supported Special Report: Enhancing the Analysis of U.S. State and Local Government Pension Obligations” February 17, 2011
- Standard & Poor’s “Criteria – Governments – U.S. Public Finance: Key General Obligation Ratio Credit Ranges – Analysis vs. Reality” April 2, 2008
- Standard & Poor’s “Municipal Bankruptcy: Standard & Poor’s Approach and Viewpoint” October 4, 2012

Introduction to Municipal Bond Ratings

Fitch Ratings

Andrew Ward
Director, U.S. Public Finance
Fitch Ratings
Andrew.Ward@FitchRatings.com
415/732-5617

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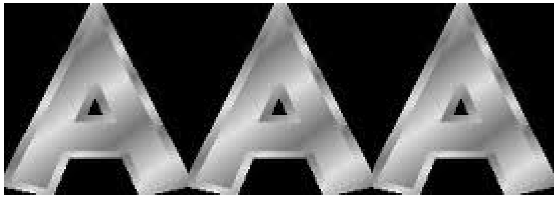
What is a Rating?

- Forward-looking **independent opinion** on issuer’s relative vulnerability to default
- Letter representation of the **likelihood of full and timely repayment** over the life of a specific financial obligation



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

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

Long-term Rating Scale for Public Finance Obligations

Non-investment grade

BB: Speculative; elevated vulnerability to default risk, particularly in the event of adverse economic conditions over time

B: Highly speculative; material default risk - while financial commitments are currently being met, capacity for future payments is vulnerable to economic deterioration

CCC: Default is a real possibility

CC: Default is probable

C: Default is imminent or inevitable

D: Default

A Rating is NOT:

- Buy/sell or pricing recommendation
- Prediction of specific percentage of default likelihood over given time period, or possible loss severity in the event of a default (focus = vulnerability to default)
- Judgment or statement regarding any aspect of public policy
- Political statement in favor of or against a particular person, party or public policy
- A ‘report card’ on government or management performance

Rating Process

The Rating Process

- The Beginning: Information Gathering
- The Middle: Rating Committee
  (A debate and a vote. Drew doesn't decide!)
- The End: Communication and dissemination
  (We really work for investors.)
- Surveillance: Ongoing reporting requirements by issuer

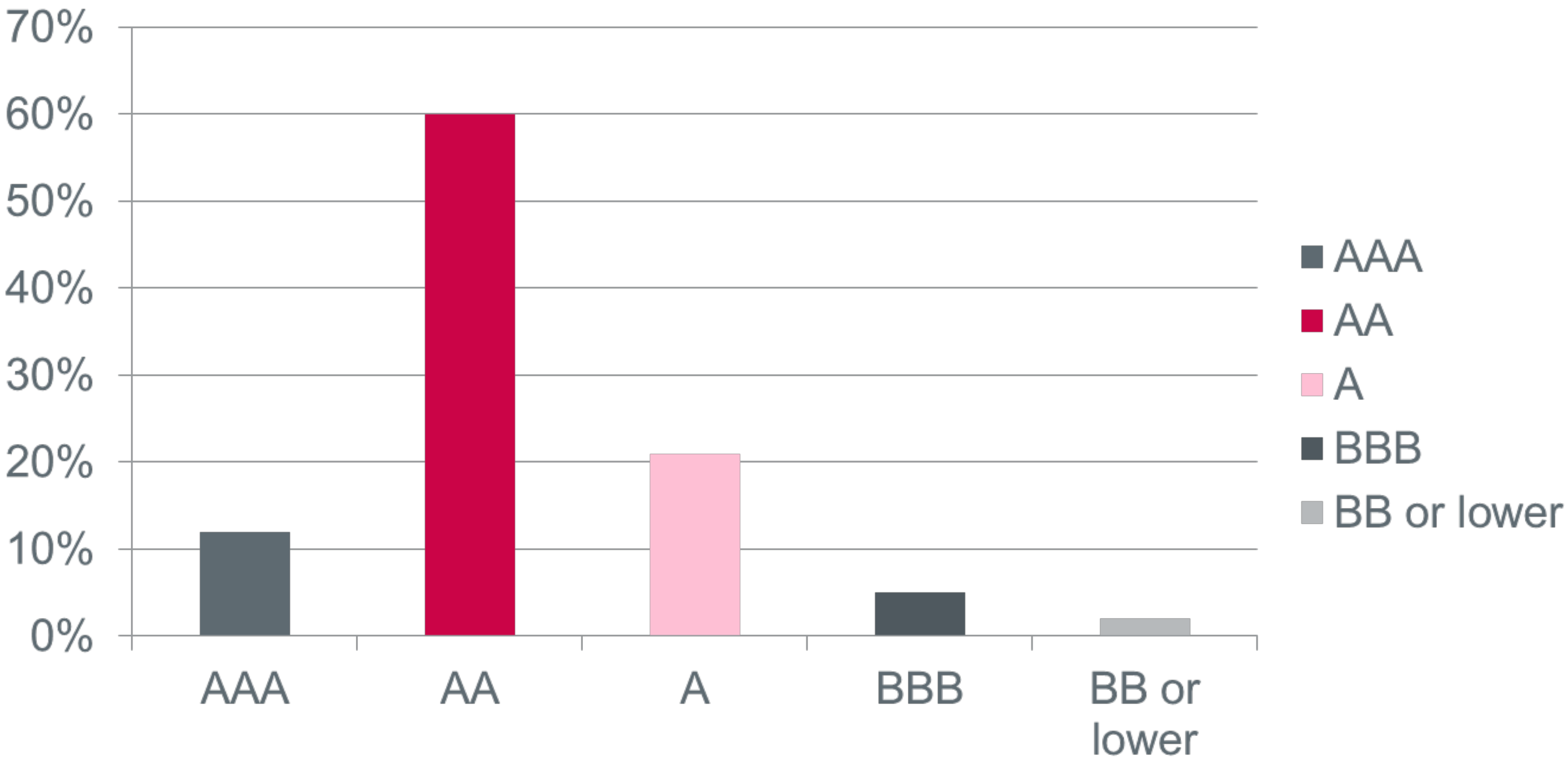
Tax-Supported Rating Criteria

To determine the credit quality of a tax-supported security, Fitch considers four major factors, their trends, and how they interact:

1. Debt and other long-term liabilities
2. Economy and tax base
3. Financial operations
4. Management and administration

The rating factors are not weighted evenly or in any formulaic manner.

U.S. Tax-Supported Ratings Distribution: 2012



How Do California Credits Stack Up?

Entity	Rating*	Outlook	Entity	Rating*	Outlook
Minneapolis	AAA	Stable	San Diego	AA-	Stable
San Diego County	AAA	Stable	Los Angeles	AA-	Stable
USA	AAA	Negative	China	A+	Stable
San Jose	AA+	Stable	California	A	Stable
United Kingdom	AA+	Stable	Bank of America	A	Stable
New York State	AA	Positive	Fresno	BBB+	Negative
San Francisco	AA	Stable	Ford Motor Co.	BBB-	Stable
Wal-Mart Stores Inc.	AA	Stable	Greece	B-	Stable
Sacramento	AA-	Stable	Detroit	C	

* Ratings as of 9/15/2013

Comparing Two California Cities

Criteria Section	City A	City B
Economy	-Activity concentrated in technology industry	-Diverse commercial center
	-High incomes (MHI @ 153% of national level) -Below average poverty rate (11.1%)	-Average incomes (MHI @ 95% of national level) -Elevated poverty rate (20.2%)
	-Unemployment runs lower than national average, but tends to be volatile. (9.3% for 2012).	-Chronically elevated unemployment due to low educational attainment (12.1% for 2012)
	- Mature tax base suffered modest declines in recession. -No worrisome concentration (top 10 taxpayers @ 3.8%)	-Mature tax base suffered minor declines in recession. -No signs of concentration (top 10 payers @1.7%)

Comparing Two California Cities

Criteria Section	City A	City B
Debt	-Debt burden is high at 5.7% of AV.	-Debt burden is moderate at 3.9% of AV.
	-Amortization is slow with 39% repaid in 10 years.	-Amortization is moderate with 59% repaid in 10 years.
	-Significant, but fairly typical pension liabilities with some inadequately funded plans.	-Significant, but fairly typical pension liabilities with some inadequately funded plans.
	-Large OPEB liabilities, but implementing plan to prefund. Ongoing reform efforts.	-Significant OPEB liabilities, but with meaningful prefunding. Ongoing reform efforts.
	-Carrying costs of pension, OPEB and debt are high at 28.6% of governmental funds.	-Carrying costs of pension, OPEB and debt are moderate at 20.4% of governmental funds.

Comparing Two California Cities

Criteria Section	City A	City B
Finances	-Close to structural balance, but with spending pressures	-Structurally imbalanced, but improving
	-Diverse revenues -Positive recent revenue trends -Very limited revenue raising flexibility	-Diverse revenues -Positive recent revenue trends -Very limited revenue raising flexibility
	-Expenditure flexibility “reduced” with fixed costs above average	-Expenditure flexibility “very constrained” due to political and labor environment
	-Strong reserve position (unrestricted fund balance of 26.1% of spending in 2012).	-Healthy reserves (11.9% of spending) that are expected to decline, but remain adequate

Comparing Two California Cities

Criteria Section	City A	City B
Management	-Strong, professional management with good long-term planning and policy framework.	-Professional management with good long-term planning and policy framework. -Some history of overly optimistic budgeting.
	-Solid financial reporting. -Robust disclosure.	-Solid financial reporting. -Robust disclosure.
	-Political/labor environment is complex, but city has long record of managing pressures well.	-Political/labor environment is difficult, and management has struggled to implement desired financial changes.
Rating	AA+/Stable	AA-/Stable

Assessment of Management and Administration

Management practices and actions can positively or negatively influence the previous major credit factors, affording stronger ratings to entities with limited economic or financial resources or weaker ratings to more diverse or affluent communities

- **Long-term planning**
  - Financial forecasts, conservative budget assumptions
  - Capital
- **Ability to discuss risks fluently**
- **Written, adopted financial management policies**:
  - Fund balance minimums and limits on spending rainy day reserves
  - Matching of one-time revenues, expenses
  - Policies followed?
- **Regular financial monitoring**
  - Frequent budget reviews to identify budget gaps as early as possible
  - Governing board actively updated
- **Disclosure practices**
- **Tenure / experience**
- **Governance**
  - Ability to reach consensus and offer real financial oversight.
- **Labor relations**
  - History of labor actions/impasses or an inability to achieve needed labor cost reductions versus a record of matching labor costs with available resources in a generally productive working relationship.

Management “Red Flags”

- Opaque management/governance (e.g. between special districts or authorities and the city/county government)
- Unable to explain variances either between budgeted and actual results or actual results from one fiscal year to the next
- Budgeting or economic assumptions appear overly aggressive
- Risk-taking that appears to be outside the norm (e.g. buying land in the hopes of flipping it to a developer, complicated derivatives)
- Misalignment between management and elected officials.
- Inability of policymakers to make necessary decisions.

Disclosure "Red Flags"

- Failure to file disclosure reports
- Late release of audited financial data
- Qualified audit opinion
- Deficiencies or material weaknesses in internal controls
- Inability to provide standard data (e.g. unaudited year-end results, reasonably robust statistical section of audit)
- Non-compliance with standard government accounting practices

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Fitch Ratings

New York
One State Street Plaza
New York, NY 10004

London
30 North Colonnade
Canary Wharf
London E14 5GN