CDIAC

CALIFORNIA
DEBT AND
INVESTMENT
ADVISORY
COMMISSION

SESSION FOUR:

CREDIT QUALITY AND THE NEW DYNAMICS OF CREDIT RATINGS

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March 18, 2015
Riverside, California

Debt 2: Accessing the Market

CDIAC – Municipal Debt Essentials Seminar

Credit Quality and the New Dynamics of Credit Ratings

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March 18, 2015

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Municipal Credit
A Bank's Perspective

Overview Summary

- Typical credit/debt products offered by banks

- Analysis of Municipal Credits
  - Credit Metrics
  - Ratings and Rating Agencies
  - Disclosure & Compliance

- Updates and Outlooks
  - Pensions/OPEB/Bankruptcies/Recoveries

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 (public agency) provides payment of principal and interest.

- Direct Lending
  - Financing (fixed or variable rate) that is directly negotiated between borrower and lender (typically short-term: five to ten years).
  - Can be structured/documented as either a 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
  - Despite credit headlines on municipal entities, provides good risk adjusted return (for institutions who understand and are comfortable with this 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)

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
- Specific criteria mirrors rating agencies:
  - Economy
  - Management
  - Finances
  - Debt

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Credit Factors/Criteria

- **Economy** (Local/State/National)
  - Wealth/income levels
  - Property values
  - Business base
- **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

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Credit Factors/Criteria

▪Finances

- History of balanced budgets, operating surpluses or losses
- Prudent use of reserves and maintenance of liquidity levels
- Percentage 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

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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
- Public ratings and rating agencies are embedded in bond documents, loan and credit agreements
- Public ratings continue to be an indication of market access

Disclosure and Compliance

- The Banking and Financial Sector is heavily regulated and under more scrutiny than ever
- Compliance with Basel III, Liquidity Coverage Requirements (LCR) 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

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Updates and Outlooks

- Bankruptcy filings in recent years and Chicago’s (for example) continued downgrades continues to put a focus on pension/OPEB liabilities
- S&P comment 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

Updates and Outlooks

- General stabilization of the economic cycle suggests most cities have hit bottom; however, recovery will vary
- Rating on State of California's GO debt continues to improve based upon fiscal and cash position
- State of California budget adopted/approved on time
- Interest rates continue to remain low
- Bank costs continue to rise due to greater regulator actions

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Thank You

General Obligation Ratings

Jen Hansen
Director

California Debt & Investment Advisory Commission

March 18, 2015

Topics

- Overview of Criteria and Analytic Framework
- Summary of Factors
- Putting it all Together
- California Ratings
- Pacific Region Trends

Overview of Criteria and Analytic Framework

Introduction

The scope of the criteria

- All U.S. local government issuer credit ratings and issue ratings on General Obligation (GO) bonds issued by municipal governments that are not special purpose districts

This criteria is intended to:

- Provide transparency into our rating process
- Enhance ratings comparability
- Formalize the forward-looking rating component

The one-year implementation period ended on September 12, 2014

Improved Transparency and Comparability

This update provides transparency similar to that contained in the state criteria

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

Summary of the Factors

Local GO Criteria Factors

Institutional Framework (1 of 7 Factors)

Institutional Framework 10%

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 (Table 4)
- *Revenue and expenditure balance*: the extent to which a local governments have the ability to finance the services they provide (Table 5)
- *Transparency and accountability*: the overall institutional framework's role in encouraging the transparency and comparability of relative financial information (Table 6)
- *System support*: the extent to which local governments receive extraordinary support from a state government when the local government is under extreme stress (Table 7)

Institutional Framework (1 of 7 Factors)

Institutional Framework
10%

All governments of the same type within the same state receive the same score

- Cities and counties can differ
    - Municipalities of the same type can differ based on home rule status, population, etc.

The institutional framework scores will be reviewed and maintained on an ongoing basis

Table 3: Institutional Framework Score Outcomes	
Score Range	**Institutional Framework Score**
1 – 1.5	1 (very strong)
1.75 – 2.75	2 (strong)
3.0 – 3.75	3 (adequate)
4 – 4.5	4 (weak)
4.75 – 5	5 (very weak)
The institutional framework score results from the average of the scores for predictability, revenue and expenditure balance, transparency and accountability, and systemic support (see paragraphs 37-40). Each score receives equal weight in the average.	

Source: Standard & Poor's Ratings Services.

Economic Score (2 of 7 Factors)

Economy
30%

- **Assess both the health of the asset base relied upon to provide both current and future locally derived revenues as well as the likelihood of additional service demands resulting from economic deterioration**
- **The initial score (1 through 5) is based on market value per capita and projected per capita income as a % of U.S. (Table 8)**
- **Per capita income is based on a 5-year projection**
- **Especially high income will lead to a positive override and especially low market value per capita will lead to a negative override**

	Total Market Value Per Capita				
Projected Per Capita EBI as a % of U.S. Projected Per Capita EBI	>$195,000	$100,000 to $195,000	$80,000 to $100,000	$55,000 to $80,000	≤$55,000
>150	1	1.5	2	2.5	3
110 to150	1.5	2	2.5	3	3.5
85 to110	2	2.5	3	3.5	4
70 to 85	2.5	3	3.5	4	4.5
≤70	3	3.5	4	4.5	5

Source: Standard & Poor's Ratings Services.

Economic Score Adjustments

Economy
30%

Qualitative factors with a positive impact on the initial score	Qualitative factors with a negative impact on the initial score
Participation in a larger broad and diversified economy.	Negative budget impact from demographic profile: population decrease and/or high share of dependent population (>55%) have a material negative impact on future revenue growth and expenditure needs.
A stabilizing institutional influence with a longstanding role as a major employer, such as higher education, health care, military, or large and stable corporate presence.	High county unemployment rate (>10%).
	If employment concentration where an individual sector (excluding education/health, government, and transportation, trade and utilities) represents more than 30% of the nonfarm work base, or tax base concentration where the top 10 taxpayers represent more than 35% of the tax base, the score worsens by one point. If the top 10 taxpayers exceed 45% of the tax base, the score worsens by two points.

Source: Standard & Poor's Ratings Services.

Management Score (3 of 7 Factors)

Management
20%

- **Assess the impact of management conditions on the likelihood of repayment**
- **Financial Management Assessment (FMA) is based upon our current methodology**

Table 9: Assessing the Management Score

Rounded Score	Characteristics
1 (Very strong)	FMA score of “strong” and none of the factors in score ‘4‘ or ‘5’ is present.
2 (Strong)	FMA score of “good” and none of the factors in score ‘4‘ or ‘5’ is present.
3 (Adequate)	FMA score of “standard” and none of the factors in score ‘4‘ or ‘5’ is present.
4 (Weak)	FMA score of “vulnerable” or any of the following is present: there is a financial reporting restatement that has a material negative impact; any of the conditions in score ‘5’ existed in the past three years; the structural imbalance override condition exists or existed within the past three years; or a very high debt, pension and OPEB burden.
5 (Very weak)	Regardless of the FMA score, any of the following is present: a management team that lacks relevant skills resulting in a weak capacity for planning, monitoring, and management; an auditor has delivered a going concern opinion; the government appears unwilling to support a debt or capital lease obligation; or the government is actively considering bankruptcy in the near term

Source: Standard & Poor’s Ratings Services.

Management Score Adjustments

Management 20%

Qualitative factors with a positive impact on the initial score	Qualitative factors with a negative impact on the initial score
Consistent ability to maintain balanced operations.	Frequent management turnover inhibiting a current understanding of the government's financial position and its ability to adjust, or political gridlock, or instability that brings the same results.
Government service levels are limited.	Consistent inability to execute approved structural reforms for two consecutive years.

Source: Standard & Poor's Ratings Services.

Financial Measures

- Three components factor into our assessment of a municipality's financial credit characteristics
- Budgetary flexibility, budgetary performance, and liquidity
- Each factor is weighted 10% — all financial measures together are 30%

Financial Measures		
Budgetary Flexibility 10%	Budgetary Performance 10%	Liquidity 10%

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

- Available fund balance as a % of general fund expenditures: for the most recently reported fiscal year
- When other fund balances outside of the government's general fund are available beyond the current fiscal year, they are included in the calculation
- This measure can cap a rating or it can be a positive override if extremely strong

Table 10: Assessing The Budgetary Flexibility Score					
	Available Fund Balance as a percentage of expenditures				
%	>15	8 to15	4 to 8	1 to 4	≤1
Score	1	2	3	4	5

Source: Standard & Poor's Ratings Services.

Budgetary Flexibility Score Adjustments

Budgetary Flexibility 10%

Qualitative factors with a positive impact on the initial score	Qualitative factors with a negative impact on the initial score
If projections for the current year and the following year suggest a better initial score.	If projections for the current year and the following year suggest a worse initial score.
Ability to avoid financial imbalances with demonstrated capacity and willingness to cut operational spending (by more than 2%), resulting from a flexible cost structure, flexible legislation, and/or widespread political support.	High levels of questionable receivables or amounts due from other funds with deficit balances.
Existing state tax caps do not apply to the government, or the government retains substantial flexibility under the caps.	Limited capacity to cut expenditures due to infrastructure or operational needs or political resistance.
Demonstrated ability and willingness to raise taxes when needed (and voter support is usually obtained when such approval is required).	Limited capacity to raise revenues due to consistent and ongoing political resistance which can include self-imposed restrictions through charter or local initiative processes.
Timing of fiscal year and tax billing dates result in high cash with abnormally low fund balance levels.	Where cash accounting is used, the criteria use cash balances instead of fund balances and the score is worsened by one point.
Maintenance of an available fund balance exceeding 30% of general fund expenditures for the most recently reported year, the current year and the next year.	

Source: Standard & Poor's Ratings Services.

Financial Measures: Budgetary Performance Score (5 of 7 Factors)

Budgetary Performance 10%

The budgetary performance initial score measures the current fiscal balance of the government

- Total governmental funds net result: the most recent year's net total governmental funds on a budgetary basis as a percent of expenditures
- General fund net result: the most recent year's general fund operational balance as a percent of expenditures

Table 11: Assessing The Budgetary Performance Score

	Total Governmental Funds Net Result (%)				
General fund net result (%)	> -1	-1 to -5	-5 to -10%	-10 to -15	≤ -15
(> 5)	1	2	3	3	4
(-1 to 5)	2	3	3	4	5
(≤ -1)	3	4	4	5	5

Source: Standard & Poor's Ratings Services.

Budgetary Performance Score Adjustments

Budgetary Performance 10%

Qualitative factors with a positive impact on the initial score	Qualitative factors with a negative impact on the initial score
Expected structural improvement: if projections for the current year and following year suggested a better initial score, the score would improve by one point. The score would improve by two points only if required adjustments to revenues or expenditures to produce the result were already approved.	Expected structural deterioration: if projections for the current year and following year suggested a worse initial score, the score would worsen by one or two points. To worsen by two points, expected performance must fall to the commensurate level within the current year.
	Deferred payments on a cash basis: in cases where good ratios hide significant underspending due to deferred payments, the deferral produces a better score.
	Significant historic volatility in performance because of very cyclical revenues (e.g., oil & gas or sales tax on luxury goods and/or dependence on volatile state transfers) or exposure to event-related risks, the sources of volatility remain.

Source: Standard & Poor's Ratings Services.

Financial Measures: Liquidity Score (6 of 7 Factors)

Liquidity
10%

The initial score measures the availability of cash and cash equivalents to service both debt and other expenditures

Initial liquidity score: combination of two measures (table 12)

- Total government cash as % of total governmental funds debt service
- Total cash % of total governmental funds expenditures

Table 12: Assessing The Liquidity Score					
	Total Government Available Cash As % Of Total Governmental Funds Debt Service				
Total Government Available Cash As % Of Total Governmental Funds Expenditures	>120	100 to120	80 to100	40 to 80	≤40
>15	1	2	3	4	5
8 to15	2	2	3	4	5
4 to 8	3	3	3	4	5
1 to 4	4	4	4	4	5
≤1	5	5	5	5	5

Source: Standard & Poor's Ratings Services.

Liquidity Score Adjustments

Liquidity
10%

Qualitative factors with a positive impact on the initial score	Qualitative factors with a negative impact on the initial score
If projections for the current year (and the following year) suggest a better score, the score improves by one point.	If projections for the current year (and the following year) suggest a worse initial score, the score worsens by one point.
If access to external liquidity is 'exceptional' as defined in table 13, the score improves by two points; if 'strong', the score improves by one point.	If access to external liquidity is 'uncertain' as defined in table 13, the score worsens by two points; if 'limited', the score worsens by one point.
Very robust and stable internal cash flow generation capacity compared with peers in this category.	High refinancing risk over the next 24 months.
	Aggressive use of investments.
	Exposure to non-remote contingent liability risk that could come due within 12 months.

Source: Standard & Poor's Ratings Services.

Debt and Contingent Liability (7 of 7 Factors)

Debt & Contingent Liabilities
10%

Initial debt score: combination of two measures (table 14)

- Total governmental funds debt service as a percentage of expenditures
  - Measures the annual fixed cost burden that debt places on the government
- Net direct debt as a percentage of total governmental funds revenue
  - Measures the total debt burden on the government's revenue position rather than the annual cost of the debt, which can be manipulated by amortization structures

Table 14: Assessing The Debt And Contingent Liabilities Score

	Net Direct Debt As % Of Total Governmental Funds Revenue				
Total Governmental Funds Debt Service As A % of Total Governmental Funds Expenditures	<30	30 to 60	60 to 120	120 to 180	≥180
< 8	1	2	3	4	5
8 to 15	2	3	4	4	5
15 to 25	3	4	5	5	5
25 to 35	4	4	5	5	5
≥35	4	5	5	5	5

 Source: Standard & Poor's Ratings Services.

Debt and Contingent Liability Adjustments

Debt & Contingent Liabilities
10%

Qualitative factors with a positive impact on the initial score:	Qualitative factors with a negative impact on the initial score:
Overall net debt as a percentage of market value below 3%.	Overall net debt as a percentage of market value exceeding 10%.
Overall rapid annual debt amortization, with more than 65% coming due in10 years.	Significant medium-term debt plans produce a higher score when included.
	Exposure to interest-rate risk or instrument provisions that could increase annual payment requirements by at least 20%.
	Unaddressed exposure to large unfunded pension or OPEB obligations leading to accelerating payment obligations over the medium term that represent significant budget pressure (see paragraph 82). If there is a plan to address the obligations, the final score worsens by one point; otherwise the score worsens by two points.
	Speculative contingent liabilities or those otherwise likely to be funded on an ongoing basis by the government representing more than 10% of total governmental revenue.

 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.

California – New GO Criteria

Cities and Counties reviewed under the new criteria.

No movement: 59%

One Notch movement up: 33%

One Notch movement down: 8%

***As of June 5, 2014**

California Counties

Ratings	Counties	Percent
AAA	9	24.3%
AA+	5	13.5%
AA	6	16.2%
AA-	9	24.3%
A+	6	16.2%
A	2	5.4%
A-	0	0%
BBB+	0	0%
BBB	0	0%
BBB-	0	0%
Total	37	100%

***As of June 5, 2014**

California Cities

Ratings	Cities	Percent
AAA	48	23.8%
AA+	44	21.8%
AA	28	13.9%
AA-	40	19.8%
A+	18	8.9%
A	13	6.4%
A-	1	0.5%
BBB+	4	2.0%
BBB	2	1.0%
BBB-	1	0.5%
BB+	1	0.5%
BB	1	0.5%
CCC+	1	0.5%
Total	202	100%

California School Districts

Ratings	Schools	Percent
AAA	17	2.8%
AA+	17	2.8%
AA	56	9.2%
AA-	136	22.4%
A+	290	47.7%
A	75	12.3%
A-	12	2.0%
BBB+	1	0.2%
BBB	2	0.3%
BBB-	2	0.3%
Total	608	100%

***As of June 5, 2014**

2015 Credit Conditions Favor Local Governments
Pacific (Alaska, California, Hawaii, Oregon, Washington)

- Local governments can look to continue their trend of strengthening credit quality, in our view.
- Surging housing construction in fiscal 2015 is helping to boost local property values and contributing to job growth and construction-related retail sales. New construction is projected to slow median home price growth to less than 2%, with uneven pockets of growth.
- Projected employment growth of just over 2% in 2015, nevertheless, we expect the rate of job growth to slow slightly compared with 2014..
- Income inequality is a growing concern in California with state revenues tied to volatile revenue streams.

Q&A

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