

CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

MUNICIPAL DEBT ESSENTIALS DAY TWO, SESSION SIX: CREDIT QUALITY AND THE NEW DYNAMICS OF CREDIT RATINGS

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October 27, 2016

KROLL BOND RATING AGENCY, INC

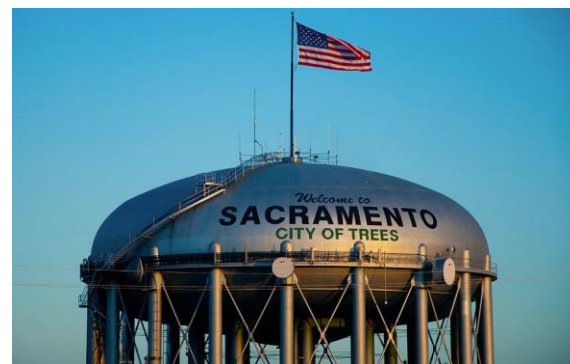
CREDIT QUALITY AND THE NEW DYNAMICS OF CREDIT RATINGS

A RATING AGENCY'S PERSPECTIVE

- What are Credit Ratings and Why are they Useful
- Credit Rating Basics:
 - NRSROs, Methodologies, Information Requests, Ratings & Outlooks, Credit Reports, Surveillance
- The Credit Rating Process: What to Expect and How to Prepare

WHAT ARE CREDIT RATINGS AND WHY ARE THEY USEFUL?

- A credit rating is an opinion by a rating agency of the credit worthiness of a bond
- Credit ratings are expressed on an alphanumeric scale relative to credit quality
- Credit ratings provide a measure of credit risk so that market participants can make appropriate investment decisions
- Credit ratings can help local governments access the capital markets and fund public projects



RATING AGENCY BASICS-CURRENT NRSROs

- Credit ratings are typically provided by a Nationally Recognized Statistical Rating Organization (NRSRO)
- NRSROs are regulated by the Securities and Exchange Commission through its Office of Credit Ratings
 - Moody's Investor Service
 - Standard & Poor's
 - Fitch Ratings
 - Dominion Bond Rating Service
 - AM Best
 - HR Ratings
 - Egan-Jones Ratings
 - Japan Credit Rating Agency
 - Morningstar (Realpoint)
 - Kroll Bond Rating Agency

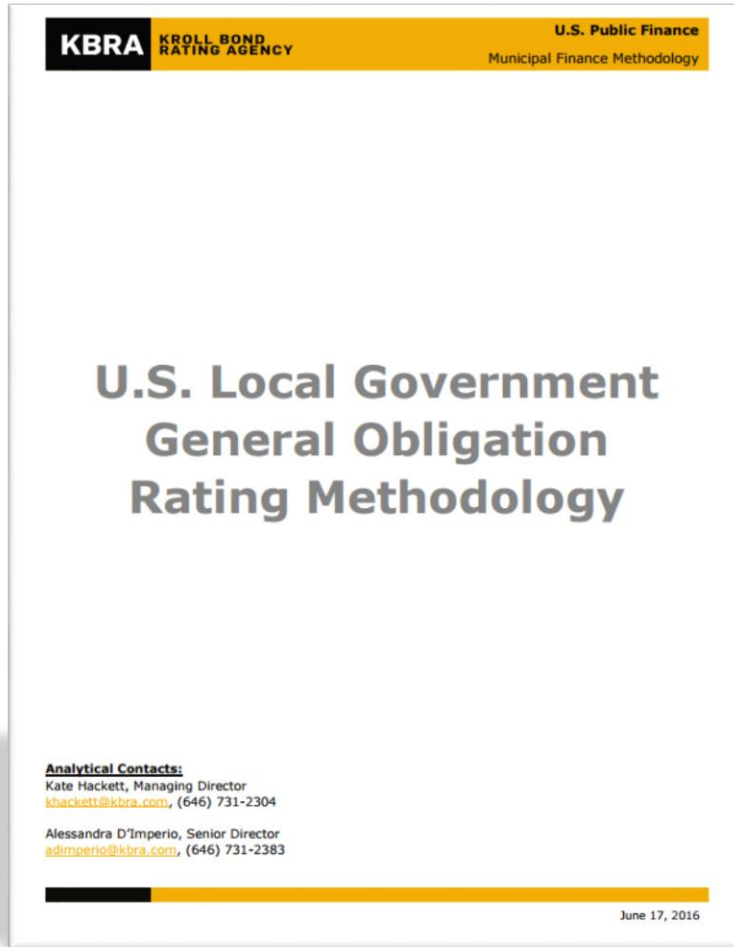
CREDIT RATING BASICS-RATING METHODOLOGIES

- Credit ratings are assigned pursuant to published rating methodologies
- Methodologies provide transparency by outlining the key rating factors for different bond types
- KBRA Public Finance methodologies are listed below

Methodologies & Models

ABS	CMBS	RMBS	Public Finance	FIG	Insurance	Funds	Corporates	Project Finance	Financial Guaranty
Date	Report Name								
06-17-2016	Public Finance: U.S. Local Government GO Methodology								
06-17-2016	Public Finance: Special Tax Revenue Bond Rating Methodology								
06-17-2016	Public Finance: U.S. Public Toll Roads, Bridges & Tunnels Revenue Bond Rating Methodology								
06-17-2016	Public Finance: U.S. Municipal Water and Sewer Revenue Rating Methodology								
06-17-2016	Public Finance: U.S. General Airport Revenue Bond Rating Methodology								
06-17-2016	Public Finance: U.S. State and Local Government Abatement Lease Rating Methodology								
06-17-2016	Public Finance: General Revenue Bond Methodology								
06-17-2016	Public Finance: General Property Tax/Assessment Revenue Methodology								
06-17-2016	Public Finance: Private, Not-For-Profit U.S. Higher Education Rating Methodology								
08-04-2014	Public Finance: U.S. State and Local Government Short Term Cash Flow Note Rating Methodology								
02-05-2014	Public Finance: U.S. State Annual Appropriation Obligation Rating Methodology								
01-02-2014	Public Finance: U.S. Rural Electric G&T Cooperative Rating Methodology								
03-28-2012	Public Finance: U.S. State General Obligation Rating Methodology								

CREDIT RATING BASICS-RATING METHODOLOGIES



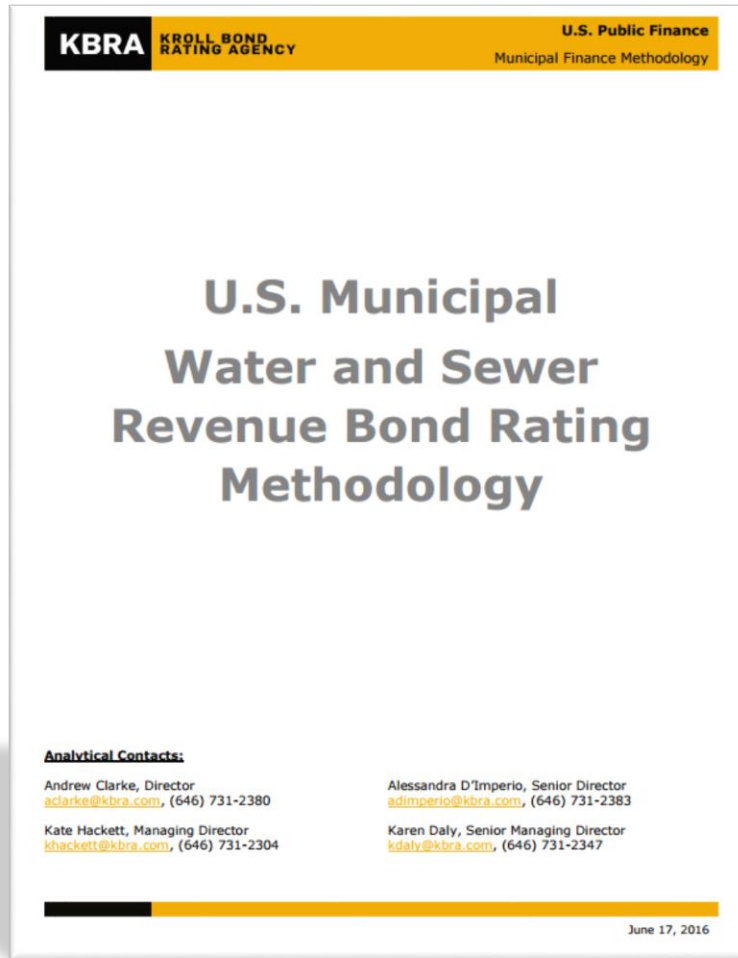
Major factors KBRA considers when rating General Obligation Bonds of local governments in the U.S.

- Governance and Management Structure and Policies
- Municipal Resource or Economic Base
 - Economic Indicators
 - Tax Base Size, Concentration and Trends
- Debt and Additional Continuing Obligations (Pension & OPEB)
 - Debt per capita
- Financial Performance and Liquidity
 - Operating Surpluses or losses
 - Diversity of Revenue Streams
 - Fund balance / Rainy Day Reserve Levels

KBRA Local G.O. Rating Determinant #1: Governance and Management

- Operating within 50 Unique State Statutory Frameworks
- Financial Management Procedures and Policies:
 - Budget Process
 - Forecasting Accuracy
 - Reporting Requirements

CREDIT RATING BASICS-RATING METHODOLOGIES



Major factors KBRA considers when rating U.S. Municipal Water and/or Sewer Utility Revenue Bonds

- Management
- Legal Mechanics and Security Provisions
 - Rate Covenant
 - Additional Bonds Test
 - Flow of Funds
- Service Area and Economy
- System Characteristics
- Financial Metrics
- Debt Structure and Capital Plan Requirements

KBRA Water/Sewer Revenue Bond Rating Determinant #1 Management

- Rate Setting Authority and Process
- Managerial Experience
- Financial Management Policies and Procedures
- Capital Plan Management

CREDIT RATING BASICS-INFORMATION REQUESTS

- KBRA will gather information necessary for credit analysis
- Examples of information collected can include
 - Budget documents
 - Management policies and procedures
 - Economic updates / tax base updates
 - Audited financials (typically most recent year and four preceding years)
 - Interim financial statements
 - Preliminary official statements or offering documents
 - Bond resolutions and / trust indenture
 - Capital plan
- KBRA will generally have an in-person meeting, site visit or a phone conversation with the issuer to discuss relevant credit factors
 - Financial advisors and / underwriters typically attend credit discussion meetings

CREDIT RATING BASICS-CREDIT RATING SCALES

Long-Term Rating Scales

KBRA's long-term credit ratings are intended to reflect both the probability of default and severity of loss in the event of default, with greater emphasis on probability of default at higher rating categories.

- AAA:** Almost no risk of loss
- AA:** Minimal risk of loss
- A:** Small risk of loss
- BBB:** Some risk of loss
- BB:** Moderate risk of loss
- B:** High risk of loss
- CCC:** Substantial risk of loss
- CC:** Near default with average recovery expectation
- C:** Near default with low recovery expectations
- D:** In default

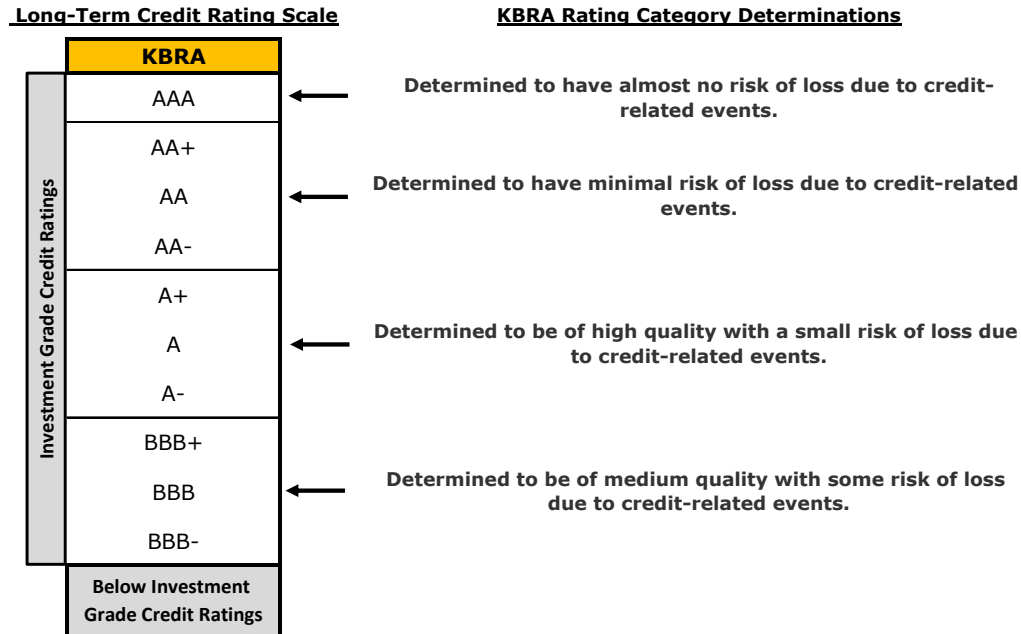
Short-Term Rating Scales

KBRA's short-term ratings typically indicate an ability to meet obligations of three years or less. As compared to long-term ratings, greater emphasis is placed on an obligor's liquidity profile and access to funding.

- K1:** Very strong ability to meet short-term obligations
- K2:** Strong ability to meet short-term obligations
- K3:** Adequate ability to meet short-term obligations
- B:** Questionable ability to meet short-term obligations
- C:** Little ability to meet short term-obligations
- D:** In default on short-term obligation

CREDIT RATING BASICS-RATINGS AND OUTLOOKS

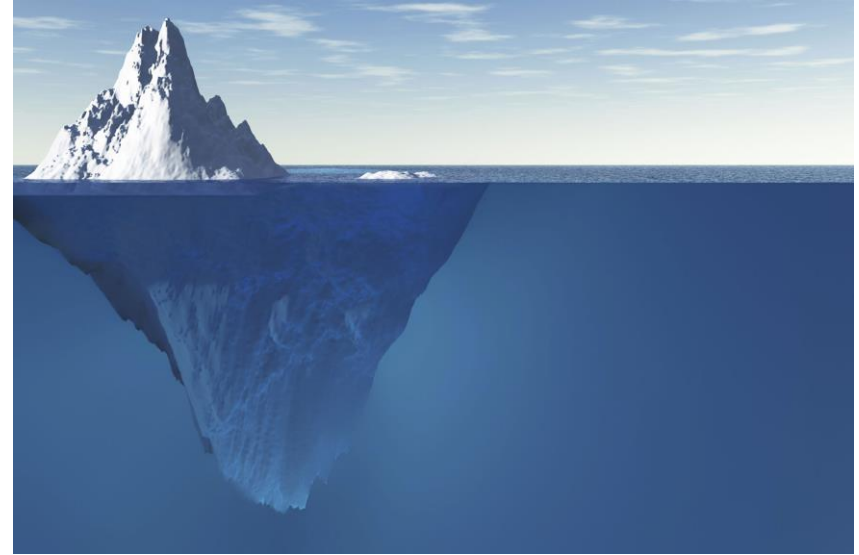
- Rating agencies generally assign long-term credit ratings in accordance with the following rating scales:



- Rating agencies may append modifiers (-,+1,2,3) to indicate, respectively, upper and lower risk levels within the broader rating categories.
- Rating Outlooks are assigned to long-term ratings as an indication of the likely direction of an issuer's rating over the medium term (generally a two year time horizon)
 - Positive, Negative, Stable, Developing

CREDIT RATING BASICS—DEVELOPING A RATING

- Conduct due diligence on all relevant credit factors
- Prepare financial spreads, calculate financial and debt ratios, calculate pension burden
- Formulate a credit opinion
- Prepare a credit rating report and rating committee materials
- Hold a credit committee to discuss credit factors and vote on credit rating
- Communicate rating to issuer



CREDIT RATING PROCESS— DYNAMIC CREDIT RATING TOPICS

■ Defined Benefit Pension Plans

- KBRA incorporates the net pension liability and budgetary obligation of pension funding into its analysis of an issuer's debt and debt-like obligations

■ Municipal Bankruptcy

- KBRA will generally provide an assessment of bankruptcy risk
- KBRA may utilize outside counsel with specialized knowledge in the field of municipal bankruptcy

■ Bank Loans / Direct Lending

- KBRA will generally ask that issuers disclose and provide details regarding bank loans and direct lending products

■ Interest Rate Swaps / Derivative Products

- KBRA will generally ask that issuers provide details related to any interest rate swaps or other derivatives products

CREDIT RATING BASICS- CREDIT REPORTS & SURVEILLANCE

- KBRA credit reports communicate our views
- Reports vary in terms of depth and length but will generally include the following:
 - Issuer Details
 - Bond Security
 - Use of Proceeds
 - Credit Strengths and Weaknesses
 - Factors that could Change the Rating
- KBRA credit ratings are monitored to help ensure accuracy
- KBRA generally conducts an in-depth surveillance update on an annual basis
 - Credit rating update via phone call or meeting
- A credit rating update can also be triggered by certain credit related events
 - Unexpected Credit Events: Natural Disasters

CREDIT RATING PROCESS – WHAT TO EXPECT

- Timeline depends on issuer complexity
- Credit Ratings are communicated to the issuer before the investor community
 - Discuss the relevant factors leading to the rating decision
- KBRA allows issuers to review credit report to confirm factual content
- Rating Agency Fees:
 - Analysts focus solely on credit issues and are prohibited from any and all discussions related to fees

CREDIT RATING PROCESS – INVESTOR ACCESSIBILITY

Accessible to Investors

KBRA provides transaction reports in usable formats directly to a list of over 5,000 market participants.

KBRA Research is accessible from multiple sources at no additional cost including:

1. www.kbra.com

- On average, each Public Finance rating report is downloaded by over **150** users

2. Bloomberg Terminals

- Reports are tagged to issue and issuer – **CN <Go>**
- Ratings are available on issue description – **DES <Go>**

JPMBB 2013-C12 A1 Not Priced Yield --/--
As of -- Collateral 100.0% CMBS 4.1% (Assumed) Prepay OCPY WAL 2.75

Search	Actions	Settings	Feedback	Page 1	News
1) Periodic Report: JPMBB 2013-C12 Jul 2013				CFL	07/19
2) KBRA CMBS: JPMBB 2013-C12 Final Ratings				KBS	06/25
3) KBRA CMBS: UPDATED JPMBB 2013-C12 Pre-Sale Report				KBS	06/24

CMBS Menu JPMBB... Mtge DES Message

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See Page 3 for Additional Comments

Bloomberg **SECURITY DESCRIPTION** Page 1 of 3
JPMBB 2013-C12 A1 1.0847% 7/15/45

CUSIP: 46639NAL5 Issuer: JPMBB COMMERCIAL MORTGAGE SECURITIES T... Pro 17 Docs
Series 2013-C12 Class A1 Exp Mty 5/15/18
CMBS-CONDUIT: SEQUENTIAL PAYER

CURRENT		ORIGINAL ISSUE	
Jul13	100,563,155	USD	101,691,000
" Fact	.988909093	WAL	2.8Yr @ OCPY
Coupon	1.0847%	1st coupon	1.0847%

RATINGS	
S&P	AAA
MDY	Aaa
KBRA	AAA

1% CLEANUP CALL
Lead Mgr: Joint

CREDIT RATING PROCESS – HOW TO PREPARE

General Best Practice Guidelines

- Review the methodology and rating reports of similar issuers
- Have a presentation prepared covering relevant rating factors
- Ask KBRA to prepare and send specific credit related questions prior to the credit meeting
- Be prepared to candidly discuss credit challenges
- If necessary, clarify questions that are being asked to help ensure transparency
- Follow-up on any questions not answered during the credit discussion

CREDIT QUALITY AND THE NEW DYNAMICS OF CREDIT RATINGS

Thank You

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