Bond Ratings and the Rating Process

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Fundamentals of Debt Financing
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Bond Rating Overview

> A rating is:
  – An indication of credit quality
  – An assessment of the issuer’s willingness and ability to meet its debt obligations on a timely basis
  – Based on qualitative and quantitative factors
  – A letter-based system, ranging from a high of AAA to a low of D, with an investment grade floor of BBB-

> A rating is not:
  – A judgment of a particular official or administration
  – An endorsement of public policy
  – A mandate on how a particular matter should be handled
Major Credit Factors

> All are inter-related
  – Debt and capital plan
  – Financial performance
  – Management, administrative, and legal factors
  – Local tax base and economy
Debt and Capital Plan

> Main credit considerations
  – Type of debt
  – Repayment structure
  – Debt burden – key ratios
  – Future capital and debt needs
  – Debt policies and practices
Types of Debt

- New issue security
- Outstanding debt included on the balance sheet
  - General obligations (limited or unlimited)
  - Appropriation-backed debt
  - Dedicated tax bonds
  - Non self-supporting enterprise debt
  - Capital leases
  - Pension obligation bonds
  - OPEB obligation bonds
Repayment Structure

> 5- and 10-year amortization rates
> Ascending, level, or descending debt service
> Fixed vs. variable rate
> Swaps
> Designated (but not pledged) funds allocated for repayment
Debt Burden

> Key ratios:
  - Net direct debt per capita
  - Net direct debt as % of taxable market value
  - Overall debt per capita
  - Overall direct debt as % of taxable market value
  - Debt service as % of revenues
  - % of capacity remaining under debt limit or current authorization, if any
Future Capital and Debt Needs

> Long-term capital improvement plan (CIP)
  - Usually 5-6 years
  - Should be comprehensive and realistic in scope
  - Should address growth-related, replacement, and rehabilitation/major maintenance needs
  - Should be flexible enough to accommodate changing conditions
  - Funding sources may or may not be fully identified
  - Some include operating costs of new capital projects

> Definition of capital vs. operating expense

> Amount and type of planned debt
  - General obligation bonds, dedicated taxes require voter approval in many states

> Use of excess operating funds for pay-as-you-go funding for capital needs
Debt Policies and Procedures

- Debt limits – legal or self-imposed
- Debt affordability policies
- Amortization rate targets
- CIP reviewed on regular cycle (annually or biennially)
- Pay-as-you-go funding policies
- Variable rate/swap guidelines
Financial Operations

- Revenue Analysis
- Expenditure Analysis
- Balance Sheet Analysis
- Key Financial Ratios
- Financial Policies and Procedures
Revenue Analysis

> Revenue diversification
  - Level of property tax dependence
  - Volatility of, and dependence on, other revenue sources
    > Sales and use taxes
    > Other taxes (e.g. income, utility, tourism, fuel)
    > Intergovernmental (state, federal) revenues
> Nature of transfers in from other funds
> Tax rate flexibility, if any
> Potential additional revenue sources
> Historical revenue performance
> Revenue projections
Expenditure Analysis

> Service responsibilities
  > Determined by:
    > level of government (city, county, school district)
    > type of community (urban, rural, suburban)
    > state delegation of responsibilities (e.g. schools, social services)
> Mandated (e.g. consent orders, contractual obligations) vs. discretionary spending
> Fixed (e.g. debt service, pensions) vs. flexible spending
> OPEB pay-go vs. ARC
> Historical growth rates of total spending and in individual categories
> Nature of transfers out to other funds
> Projected spending growth
Balance Sheet Analysis

- Trend in liquidity, cash flow borrowing needs
- Tax collection schedule
- Trends in and quality of accounts receivable
- Due to/from other funds
- Fund balance level and reservations/designations
Key Financial Ratios

- Unreserved fund balance as % of spending (including transfers out and other uses of funds)
- Net income/deficit as of spending (annual and trend)
- Property (or other, as appropriate) tax as % of revenues
- Intergovernmental aid as % of revenues
- Debt service as % of spending
- OPEB annually required contribution (ARC) vs. pay-go amount
- Pension and OPEB ARC as % of budget
- Quick ratio (cash and liquid investments over current liabilities)
Management, Administrative, and Legal Factors

- Best management practices
- Pension/OPEB funding strategies
- Property assessment policy
- Tax policy
- Political, taxpayer, and labor environment
Best Management Practices – “12 Habits”

> • Fund balance reserve policy/working capital reserves.
> • Multiyear financial forecasting.
> • Monthly or quarterly financial reporting and monitoring.
> • Contingency planning policies.
> • Policies regarding nonrecurring revenue.
> • Debt affordability reviews and policies.
> • Superior debt disclosure practices.
> • Pay-as-you-go capital funding policies.
> • Rapid debt retirement policies (greater than 65% in 10 years).
> • Five-year capital improvement plan integrating operating costs of new facilities.
> • Financial reporting and budgeting awards.
> • Compliance with Governmental Accounting Standards Board rules.
Pension/OPEB Funding

> Pension funding level and amortization of unfunded actuarial accrued liability (UAAL) – with or without debt

> Planning for OPEB
  - Compliance with GASB statement 45 by specified future date
    > Obtain actuarial valuation
    > Report funding status on government-wide statement
    > Report liability in notes to financial statement
  - Strategies to address the liability
    > Benefits review and potential adjustment

> Funding level
  - ARC vs. pay-go
  - Trust or no trust
  - Debt
Property Assessment Process and Tax Policy

> Property revaluation cycle
> Assessment ratios
> Tax collection procedures
> Current and total tax collection rates
> Philosophy on and history of tax increases
> Competitiveness of tax rates
> Local tax limitations; taxpayer sentiment
> Diversification of revenue sources
Labor Environment

- Union vs. right-to-work state
- Results of past contract negotiations
  - Salary, benefit changes
  - Work rule changes
  - Lay-offs, early retirements
- Major upcoming labor issues
Economy and Tax Base

- Economic drivers
- Tax base considerations
- Concentration
- Wealth and income measures
- Economic development
Economic Drivers

> Why is this place here?
  – Urban, suburban, or rural
  – Tourism-based, industrial, agricultural, service-oriented, etc.

> Population level and trends

> Major employers, taxpayers

> Employment by sector

> Job growth trends

> Unemployment rates and resident employment trends
Tax Base Considerations

- Growth in assessed and market value
- Residential vs. non-residential property values
- Commercial and industrial vacancy rates
- Trend in building permits as % of market value
- Tax delinquency rate
- Housing market trends
  - Volume
  - Prices
  - Mortgage delinquencies and foreclosures
  - Trends in related employment and revenues
Economic and Tax Base Concentration

- Risk inherent in dependence on one employer, taxpayer, or industry
- Concentration within industry
- Historical cyclicality
- Investment levels by major employers/taxpayers
Wealth and Income Levels

> Key indicators:
  – Market value per capita
  – Per capita personal and/or money income as % of state and nation
  – Median household income as % of state and nation
  – Income growth trends
  – Retail sales per capita
  – Poverty rate
Economic Development

- Coordinated planning efforts
- Incentive programs
- Types and quality of amenities, such as schools, parks, and road access
- Measurable results
Bond Rating Process

- Documentation
- Communication
- Feedback
Documentation

> Required:
  - Preliminary official statement (or near-final draft)
  - Most recent audited financial statements -- at least three, preferably comprehensive annual financial reports (CAFRs)
  - Current or upcoming year’s budget
  - Most recent long-term capital improvement plan

> If applicable and/or available
  - Most recent monthly or quarterly financial update
  - Long-term financial planning document
  - Pertinent ordinances, sample ballots
  - Maps, details of economic development efforts, taxpayer survey results, etc.
Communication

> Meeting options:
  – Conference call
  – Visit to Fitch’s offices
  – Site visit

> Informal interaction
  – Two-way street
  – Communication of significant events
  – Questions and Comments
Feedback

- Dialogue throughout process
- Rating notification will include discussion of identified strengths and risks
- Appeal process if necessary