U.S. Public Finance Tax-Supported State and Local Governments Ratings Criteria

A Focus on California

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Fitch Ratings

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1 Overview of Fitch’s Rating Criteria for U.S. State & Local Governments

U.S. Tax-Supported Rating Criteria

- On April 18, 2016 Fitch issued final revised rating criteria for U.S. state and local governments after an extensive comment period
- The goals of the revision were threefold:
  - Communicate Fitch's rating opinions more clearly
  - Introduce forward-looking tools
  - Continue to apply the analytical judgment that only comes from experience
- Rating changes were limited
- The criteria address the challenges that come with ensuring a thoughtful, disciplined, and consistent approach to rating a very diverse and complicated set of credits **without relying on model-based outcomes**
- Given the diverse characteristics and wide range of U.S. state and local government credits, Fitch believes there are clear limits to the degree to which data points and formulas can define them

Key Criteria Changes

- Assign issuer default ratings (IDRs)
- Re-focus four traditional areas of analytical consideration
- Publish category-specific key rating factor assessments
- Recognize more explicitly the strong operating environment for U.S. governments
- Consider more consistently a government's independent legal ability to raise revenues and areas of spending flexibility
- Evaluate issuer-specific reserve fund adequacy in the context of an individual government's revenue volatility and financial flexibility
- Introduce scenario analysis

Overview of Issuer Default Rating Framework

Sector Risk Profile					
	AAA	AA	A	BBB	BB
	Expected Rating Range Given Overall U.S. Tax-Supported Sector Profile				

Economic Base				
	An analysis of the fundamentals and drivers of an issuer's economic base serves as the foundation for all key rating factor assessments			
	Revenue framework	Expenditure framework	long-term liability burden	Operating performance
	Expectations for growth prospects for revenues	Expectations for pace of spending growth	Expectations for affordability of liabilities	Expectations for ability of revenues to support spending needs throughout economic cycles and over time
	In addition, in outlier cases where the nature of the economic base makes the issuer susceptible to an unpredictable change in profile (e.g. industry concentration, remote location), the economy can be an additional negative factor.			

Key Rating Factor Assessments					
Revenue Framework	aaa	aa	a	bbb	bb
Expenditure Framework	aaa	aa	a	bbb	bb
Long-Term Liability Burden	aaa	aa	a	bbb	bb
Operating Performance	aaa	aa	a	bbb	bb

Scenario Analysis	
	Informs operating performance assessment and communicates where the rating would be expected to remain stable throughout the economic cycle.

Final Issuer Default Rating (IDR) Outcome	
	The ultimate rating outcome is the result of consideration of issuer-specific qualitative and quantitative factors. There is no standard weighting of factors.

Source: Fitch

Rating Through The Cycle

- Fitch's focus is on forward-looking expectations rather than point-in-time assessments

- Fitch expects a government's performance to vary, potentially considerably, throughout an economic cycle

- Fitch's overarching philosophy is that ratings should not change due to normal cyclical variations, so it is only an economic cycle of unusual depth or duration that would be expected to result in a higher level of rating transition

- To support this rating approach, Fitch's scenario analysis considers issuer-specific fundamentals and potential performance under a standard economic stress, highlighting how cycles affect individual issuers differently

Scenario Analysis

Criteria Methodology

- New criteria methodology is aimed at identifying and articulating where ratings have stability, the likelihood and range of changes, and factors that can lead to change

Scenario Analysis

- Introduction of scenario analysis helps isolate characteristics that make transition more likely

Fitch Analytical Sensitivity Tool

- Fitch Analytical Sensitivity Tool (FAST) illustrates how an issuer's financial position can change through an economic cycle and the level of change considered consistent with the existing rating
- The tool supports Fitch's through-the-cycle analysis and is an important consideration in the rating process, but only one component
- The tool does not dictate a rating outcome
- The tool does not generate forecasts

Fitch Scenario Analysis (Snapshot)

Local Government Scenario Analysis

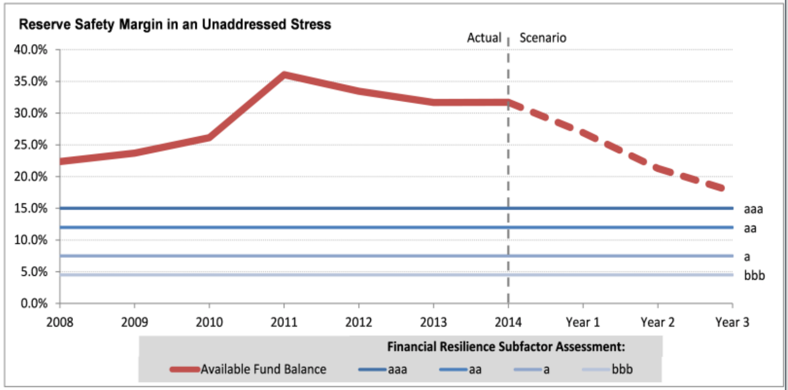
Yellow cells allow user input/override

Select an issuer:

Scenario Parameters:	Year 1	Year 2	Year 3
GDP Assumption (% Change)	-1.0%	0.5%	2.0%
Inflation Assumption (% Change)	2.0%	2.0%	2.0%
Revenue Output (% Change)	-3.0%	1.0%	4.0%
Inherent Budget Flexibility:	Midrange		

Analyst Interpretation of Scenario Results:

[If applicable, discuss factors embedded in the historical data that make the scenario appear materially more/less severe than baseline trends would dictate. For all, discuss analyst's expectations for how the issuer is likely to respond in the (baseline trend) scenario. These expectations should (1) be consistent with prior assessments of revenue and expenditure flexibility and (2) serve as the basis for the assessment of Financial Resilience Through Downturns.]



Revenues, Expenditures, and Fund Balance	Actuals: 2008	2009	2010	2011	2012	2013	2014	Scenario Output: Year 1	Year 2	Year 3
Total Revenues	66,634	67,543	67,104	73,195	75,057	76,154	79,139	76,765	77,532	80,634
% Change in Revenues		1.4%	-0.6%	9.1%	2.5%	1.5%	3.9%	-3.0%	1.0%	4.0%
Total Expenditures	65,894	68,749	66,324	67,336	69,053	74,325	76,056	77,577	79,129	80,711
% Change in Expenditures		4.3%	-3.5%	1.5%	2.5%	7.6%	2.3%	2.0%	2.0%	2.0%
Transfers In and Other Sources	2,397	2,408	2,186	2,943	2,427	2,974	3,060	2,968	2,998	3,118
Transfers Out and Other Uses	2,813	1,646	1,671	2,281	7,806	5,269	5,505	5,615	5,727	5,842
Net Transfers	-416	762	515	662	-5,379	-2,295	-2,445	-2,647	-2,730	-2,724
Bond Proceeds and Other One-Time Uses	0	0	0	0	0	0	0	0	0	0
Net Operating Surplus(+)/Deficit(-) After Transfers	324	-444	1,295	6,521	625	-466	638	-3,459	-4,326	-2,802
Net Operating Surplus(+)/Deficit(-) (% of Expend. and Transfers Out)	0.5%	-0.6%	1.9%	9.4%	0.8%	-0.6%	0.8%	-4.2%	-5.1%	-3.2%
Available Fund Balance (General Fund)	15,372	16,683	17,772	25,097	25,712	25,212	25,856	22,397	18,071	15,269
Other Available Funds (Analyst Input)										
Combined Available Funds Balance (GF + Analyst Input)	15,372	16,683	17,772	25,097	25,712	25,212	25,856	22,397	18,071	15,269
Combined Available Fund Bal. (% of Expend. and Transfers Out)	22.4%	23.7%	26.1%	36.1%	33.5%	31.7%	31.7%	26.9%	21.3%	17.6%

Reserve Safety Margins	Inherent Budget Flexibility: Minimal	Limited	Midrange	High	Superior
Reserve Safety Margin (aaa)	48.0%	24.0%	15.0%	9.0%	6.0%
Reserve Safety Margin (aa)	36.0%	18.0%	12.0%	7.5%	4.5%
Reserve Safety Margin (a)	24.0%	12.0%	7.5%	4.5%	3.0%
Reserve Safety Margin (bbb)	9.0%	6.0%	4.5%	3.0%	2.0%

Notes: Scenario analysis represents an unaddressed stress on issuer finances. Fitch's downturn scenario assumes a -1.0% GDP decline in the first year, followed by 0.5% and 2.0% GDP growth in Years 2 and 3, respectively. Expenditures are assumed to grow at a 2.0% rate of inflation. Inherent budget flexibility is the analyst's assessment of the issuer's ability to deal with fiscal stress through tax and spending policy choices, and determines the multiples used to calculate the reserve safety margin. For further details, please see Fitch's US Tax-Supported Rating Criteria.

A New Take on Reserve Fund Adequacy

- Fitch does not set static reserve expectations by rating level
- Reserve expectations are issuer and rating specific
- Fitch recognizes reserve levels fluctuate throughout the economic cycle
- Fitch considers reserve adequacy in the context of the issuer's ability to control revenues and spending ('inherent budget flexibility') and historical revenue volatility

Issuer Specific Reserve Fund Adequacy

Step 1: Determining Inherent Budget Flexibility

		Flexibility of Main Expenditure Items				
Legal Ability to Raise Revenues	**Factor Assessment**	aaa	aa	a	bbb	bb
	aaa	• Superior	• Superior	• High	• Midrange	• Midrange
	aa	• Superior	• High	• Midrange	• Midrange	• Midrange
	a	• High	• Midrange	• Midrange	• Limited	• Limited
	bbb	• Midrange	• Midrange	• Limited	• Minimal	• Minimal
	bb	• Midrange	• Midrange	• Limited	• Minimal	• Minimal

Source: Fitch

Issuer Specific Reserve Fund Adequacy (Cont.)

Step 2: Determining Reserve Safety Margin

- Values in the table represent multiples of the scenario revenue decline generated by the Fitch Analytical Sensitivity Tool (FAST)

		Financial Resilience Assessment				
		aaa	aa	a	bbb	bb[a]
Inherent Budget Flexibility	Superior	2.0	1.5	1.0	0.5	n.a.
	High	3.0	2.5	1.5	1.0	n.a.
	Midrange	5.0	4.0	2.5	1.5	n.a.
	Limited	8.0	6.0	4.0	2.0	n.a.
	Minimal	16.0	12.0	8.0	3.0	n.a.

[a] Not applicable (N.A.), because credits rated below investment grade are assumed to be in a situation in which either fund balance is already minimal to negative or any amount of fund balance in itself would be insufficient to keep the rating stable
Source: Fitch

Scenario Analysis Example
***Superior** Inherent Budget Flexibility*

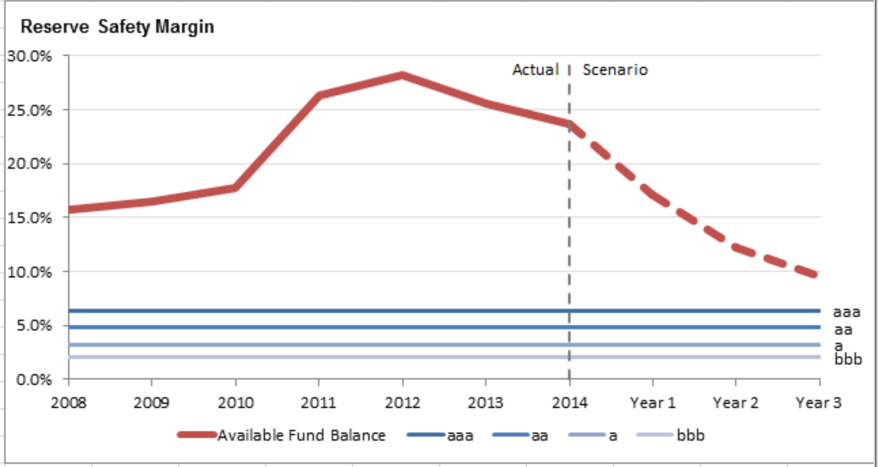
Standard Scenario Analysis - Locals

Select an issuer: Local X

Scenario Parameters:	Year 1	Year 2	Year 3
GDP Assumption (% Change)	-1.0%	0.5%	2.0%
Expenditure Assumption (% Change)	2.0%	2.0%	2.0%
Revenue Output (% Change)	-3.2%	3.5%	4.1%
Inherent Budget Flexibility	Superior		

Analyst Commentary:

[Given Analyst's knowledge of the credit, what factors support or hinder ability to maintain rating under the scenario conditions?]



Scenario Analysis Example
***Minimal** Inherent Budget Flexibility*

Standard Scenario Analysis - Locals

Select an issuer: Local X

Scenario Parameters:	Year 1	Year 2	Year 3
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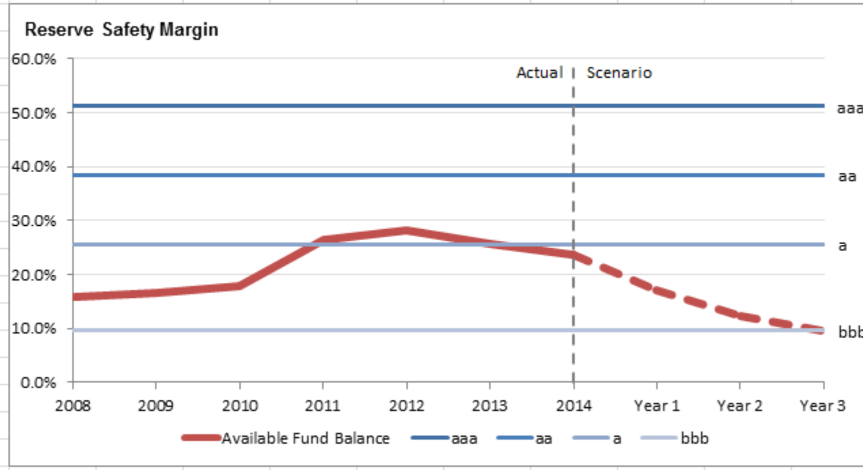
Expenditure Assumption (% Change)	2.0%	2.0%	2.0%
Revenue Output (% Change)	-3.2%	3.5%	4.1%
Inherent Budget Flexibility	Minimal		

Analyst Commentary:

[Given Analyst's knowledge of the credit, what factors support or hinder ability to maintain rating under the scenario conditions?]



Results of Criteria Implementation

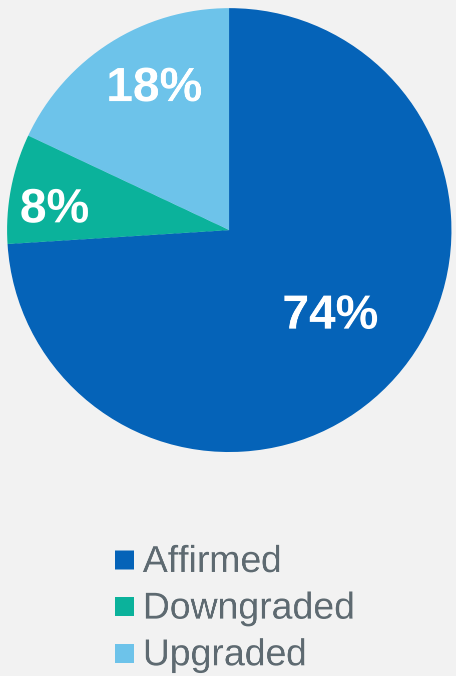
- Fitch reviewed all credits covered by its revised tax-supported rating criteria in the year following its April 2016 release

- As expected, most ratings were affirmed

- The most common reason for upgrades was the more focused consideration of the economic base and financial resilience

- In cases where ratings moved as a result of the revised criteria, the change was generally only by one notch – 95% of rating changes were of one or two notches

Issuer Rating Actions
April 2016 – April 2017



2 California Local Governments in Context

Ratings for CA Local Governments

- Fitch assesses overall government credit quality – focused on four key rating factor assessments leading to an Issuer Default Rating (IDR).

- We also assess legal structures and determine if there is a rating differential – focus is on the constitutional and statutory environment and clear legal principles and precedent.

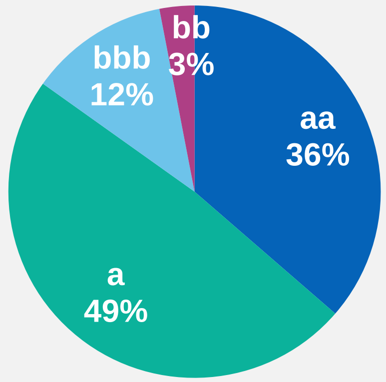
Increased Focus on Legal Structures – Special Revenues and Statutory Liens

- Statutory liens preserve bondholder rights to pledged revenues received after the municipality enters bankruptcy court
  - However, bonds are still subject to the automatic stay under the bankruptcy code, and thus potential default
  - Fitch may provide a rating uplift from the Issuer Default Rating (IDR) for the presence of a statutory lien
- Special Revenues are not subject to the automatic stay and it is expected that debt service would continue to be paid during a bankruptcy.
  - Fitch believes that under some circumstances, the property tax revenues collected to repay school district GO bonds are not exposed to district financial operations and therefore ratings are not limited by the district's IDR.

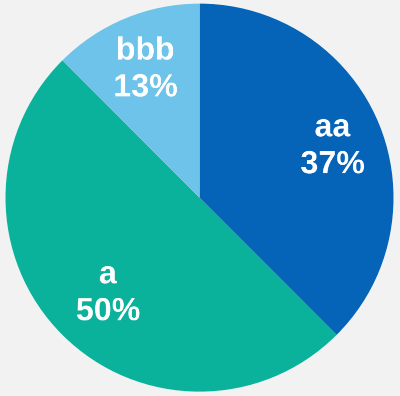
California Local Governments – Revenue Framework

- Property tax revenues for are generally the largest revenue source for California cities followed by sales taxes. TOT, UUT and in some cases business taxes can help the city's revenue base benefit from more of the economic activity than just property taxes.
- After property taxes, California counties next largest revenue source is usually intergovernmental revenues which can increase and decrease counter-cyclically so we evaluate revenue growth both with and without intergovernmental to evaluate growth prospects.
- Proposition 13 limits ability to raise revenues, resulting in lower Revenue Framework Assessments than similar governments with more flexibility on revenue raising.

Revenue Framework - California Cities



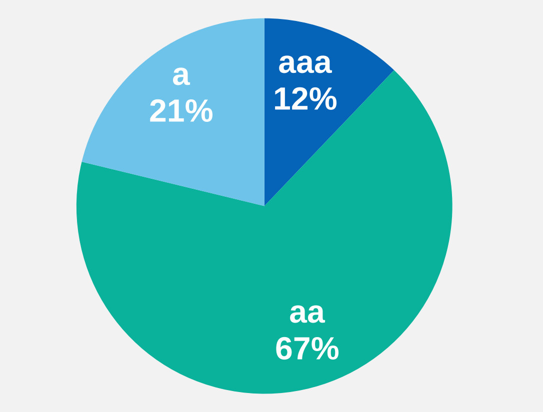
Revenue Framework - California Counties



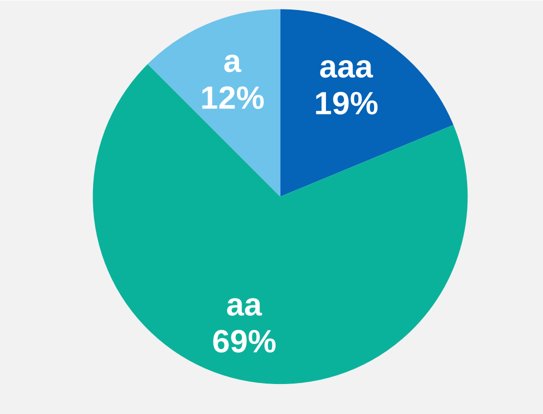
California Local Governments– Expenditure Framework

- Combination of natural pace of revenue growth compared to natural pace of spending growth.
- Carrying costs and labor environment play a key role in expenditure framework assessment:
  - Statutory and contractual environment limits flexibility (requirement to meet and confer, potential for binding arbitration or staffing requirements) though localities generally have legal ability to control headcount.
  - Pension system changes in many cases have been offset by changes to return assumptions and mortality updates resulting in pension costs rising more steeply than revenues or most other expenditures..

Expenditure Framework - California Cities



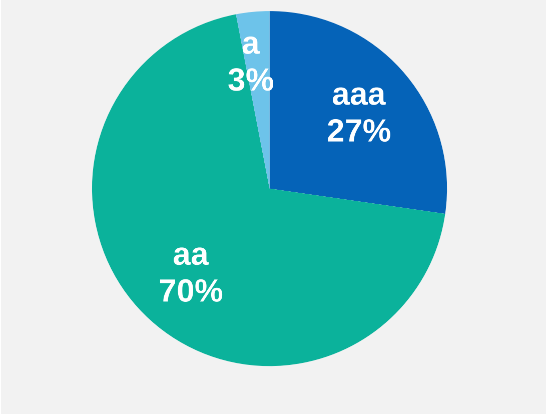
Expenditure Framework - California Counties



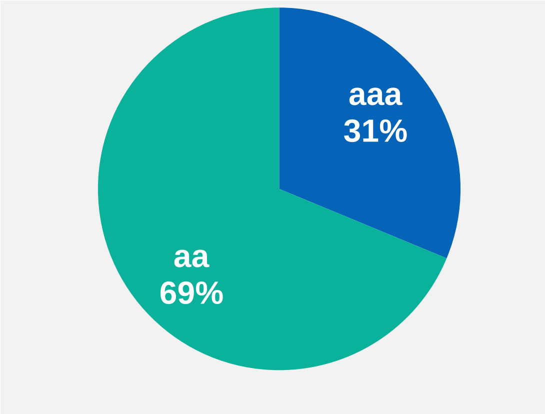
California Local Governments – Long-Term Liabilities

- Overlapping debt and Pension liabilities typically drive rating factor assessments for California locals locals.
  - OPEB noted as a long-term liability concern in specific instances where burden is material.

Long Term Liabilities - California Cities



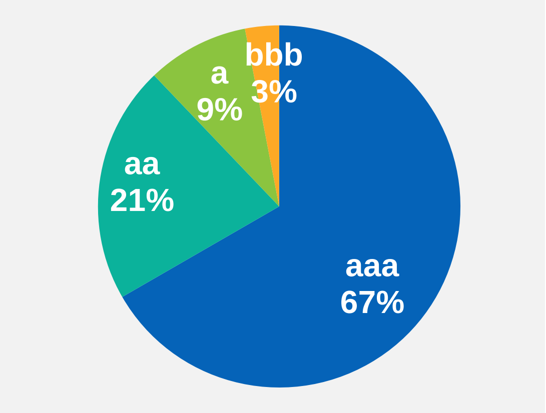
Long Term Liabilities - California Counties



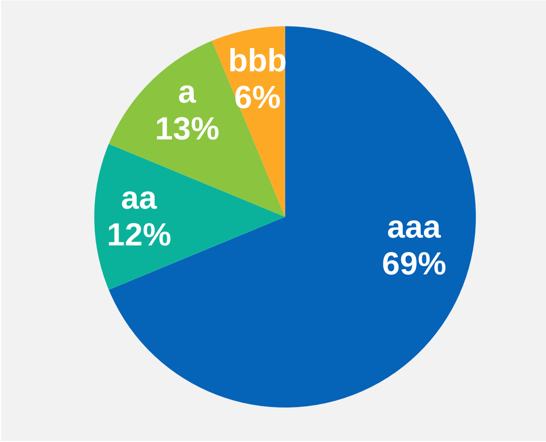
California Local Governments – Operating Framework

- The adequacy of an issuer's financial flexibility and reserves is considered in the context of its inherent budget flexibility and the magnitude of the decline in revenue an issuer might experience in a typical economic downturn
- Revenue sensitivity analysis produced via Fitch Analytical Sensitivity Tool (FAST)
- Analytical interpretation of scenario analysis is key to the assessment and rating outcome.
- Budget management practices examined for adherence to reserve and other financial policies, deferral of required spending, and timeliness of financial information, among other factors

Operating Performance - California Cities



Operating Performance - California Counties



California City Ratings and Assessments

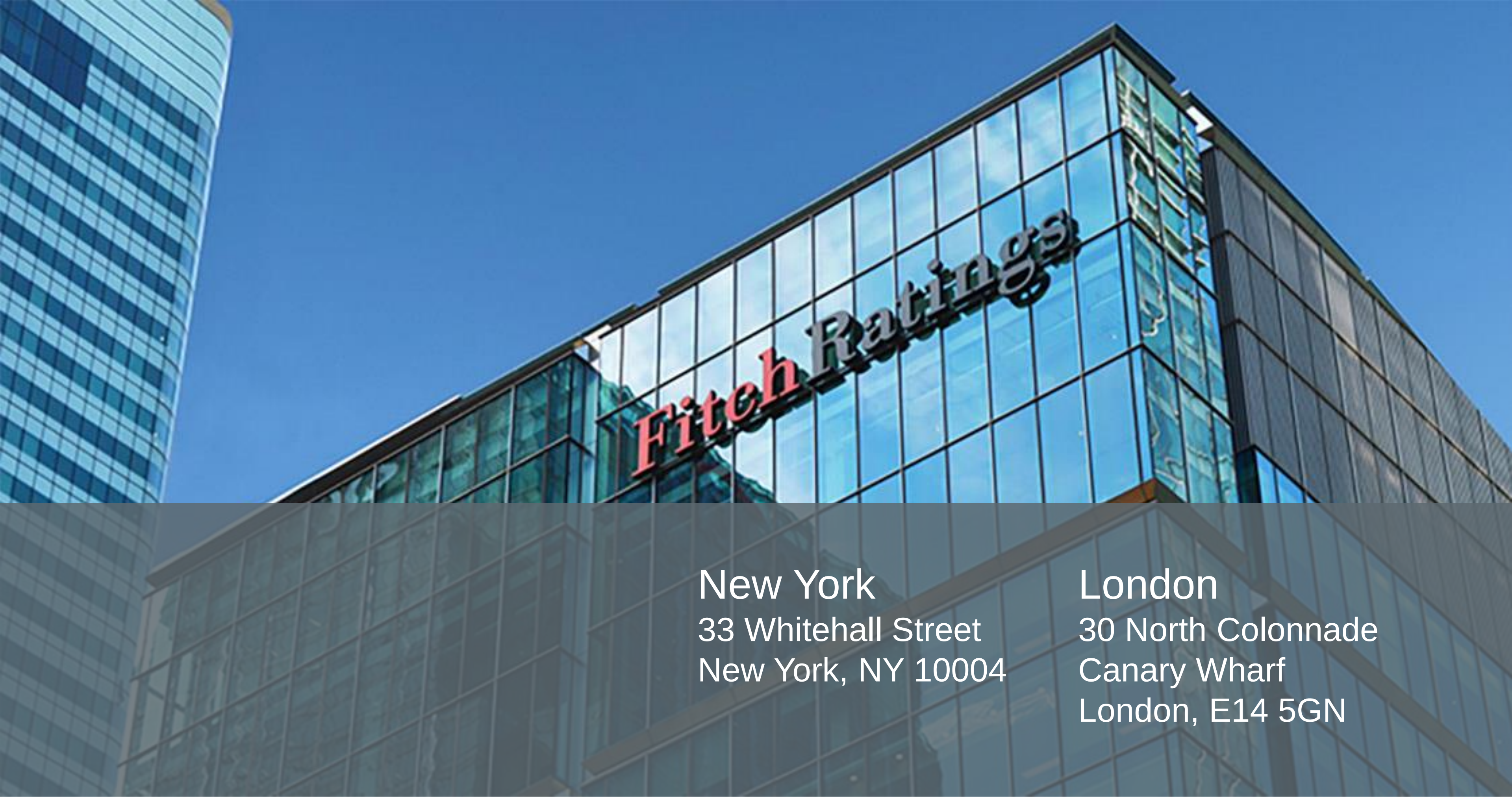
Cities	IDR	Revenue Framework	Expenditure Framework	Long Term Liability	Operating Performance
Anaheim	AA+	a	aa	aa	aaa
Beverly Hills	AAA	aa	aaa	aa	aaa
El Monte	A	bb	a	aa	aaa
El Paso De Robles	AA	a	aa	aaa	aaa
Fresno	A	bbb	aa	aaa	aaa
Gilroy	AA	a	aa	aa	aaa
Glendale	AA+	aa	aa	aa	aaa
Hayward	AA+	a	aa	aa	aaa
Huntington Beach	AAA	aa	aa	aaa	aaa
Indio	AA-	a	aa	aa	aa
Lodi	AA	bbb	a	aa	aaa
Long Beach	AA	a	aa	aa	aaa
Los Angeles	AA-	aa	a	aa	aa
Lynwood	BBB+	bbb	a	aa	bbb
Menlo Park	AAA	aa	aaa	aaa	aaa
Modesto	AA-	a	aa	aaa	a

California City Ratings and Assessments (cont'd)

Cities	IDR	Revenue Framework	Expenditure Framework	Long Term Liability	Operating Performance
Newport Beach	AAA	aa	aa	aaa	aaa
Oakland	A+	bbb	a	aa	aa
Pasadena	AA+	aa	aa	aa	aaa
Pittsburg	AA-	a	aa	a	aa
Riverside	AA	a	aa	aa	aa
Rocklin	AA+	a	aa	aaa	aaa
Sacramento	AA-	a	a	aa	aa
San Diego	AA	a	aa	aa	aaa
San Francisco	AA+	aa	aa	aa	aaa
San Jose	AA+	a	a	aa	aaa
San Luis Obispo	AA+	a	aa	aa	aaa
San Rafael	AA	a	aa	aaa	aa
Santa Cruz	AA+	a	aa	aaa	aaa
Santa Monica	AAA	aa	aaa	aa	aaa
Vista	AA+	a	aa	aa	aaa
West Hollywood	AAA	aa	aaa	aa	aaa
Yountville	AA-	aa	aa	aa	aaa

California County Ratings and Assessments

County	IDR	Revenue Framework	Expenditure Framework	Long Term Liability	Operating Performance
Alameda County	AAA	a	aaa	aa	aaa
Fresno County	A+	bbb	aa	aa	a
Kern County	A+	a	a	aa	aa
Los Angeles County	AA	a	aa	aa	aaa
Marin County	AAA	aa	aa	aaa	aaa
Mendocino County	A+	a	aa	aa	a
Monterey County	AA+	aa	aa	aa	aaa
Orange County	AA+	a	aa	aaa	aaa
Riverside County	AA-	a	aa	aa	aa
Sacramento County	A-	bbb	a	aa	bbb
San Bernardino County	AA	aa	aa	aa	aaa
San Diego County	AAA	aa	aaa	aa	aaa
San Luis Obispo County	AAA	a	aaa	aaa	aaa
Santa Clara County	AAA	aa	aa	aa	aaa
Sonoma County	AA+	a	aa	aaa	aaa
Ventura County	AA+	aa	aa	aaa	aaa



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