Fitch Ratings

CSMFO Annual Conference

Rating Methodology

Karen Ribble, Senior Director & Manager Western Region Tax – Supported Group
US Public Finance

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Fitch Tax-Supported Credit Analysis

Topics

- Rating Agency Changes Since the Financial Crisis
- Issuer Characteristics
- Interactive Key Rating Factors
- Attributes of Strong and Weak Credits
- Appendix

Rating Agency Changes Since the Financial Crisis

- Interaction with Issuers
  - Surveillance of ratings
  - Editorial Comments
  - Feedback
- Improved Transparency
- Increased Communication to the Market
- Quantitative and Qualitative Analysis

Issuer’s Characteristics

- In order to communicate to the market our objective opinion of an issuer’s creditworthiness an analyst needs to understand the common and distinct issuer characteristics
- The central issue = will the issuer repay its debt obligations and what is the relative risk
- Fitch analyzes trends in four major areas

Interactive/Dynamic Rating Factors

- Fitch's rating process involves analyzing trends in four major credit factors:
  - Economy
  - Debt and Other Long-term Liabilities
  - Finances
  - Management
- Goal is to identify actual and potential future obligations and exposures
- Major rating factors are interactive – one weakness in one may offset a positive in another (and visa versa)
- Implicit Dynamic Weighting

Quantitative and Qualitative Analysis

- Importance of metrics/quantitative
  - Objective measurements
  - Consistency
  - Comparability
- Importance of qualitative
  - Judgment
  - Unique characteristics
  - Dynamic/interactive aspects of credit factors are crucial to accurate analysis
- Holistic approach
  - Combine both

Economic Factors

Focus on Growth Prospects

- Resource base from which tax revenues are derived
- Depth and breadth of employment base
- Growth trends – employment, income, population, etc.
- Education & income levels
- Quality of life attraction
- Population/school enrollment trends

Tax Base Composition – Key Data

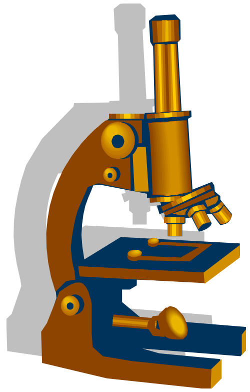
- What is happening to the local residential property market?
  - New developments: what is coming on-line, what has stalled, are developers pulling new permits?
  - Trends in prices, time on market, vacancy rates
  - Foreclosures and delinquency rates
  - Appeals
- Taxable assess valuation and market valuation trends and projections (and underlying planning assumptions)
- Property tax rates relative to neighboring jurisdictions

Debt and Other Long-Term Liabilities

- Includes bonded debt ratios, unfunded pensions and OPEB obligations
- Affordability/debt service coverage
- Exposure to short-term debt, variable-rate debt, derivatives, etc.
- Future capital needs
- Pension & OPEB

Increased Focus on Pension/OPEB Liabilities

- OPEBs are legally softer obligations and generally subject to modification by the government
- Focus of pension analysis
  - Magnitude of unfunded actuarial accrued liability (UAAL)
  - Trend in funded ratio
  - Trajectory of annual payments (including to state cost sharing systems) and budget impact
  - Actuarially Required Contribution (ARC) vs. actual contribution history
    - Management commitment to full ARC funding
    - Is the contribution actuarially calculated and fully paid?
    - What share of spending does it represent?
    - What is the resource base from which funding is derived?



Fitch-Adjusted Figures

- Key actuarial and economic assumptions
  - Ability/willingness to select reasonable assumptions
    - Discount rate/investment return assumptions: 8% is optimistic
    - Fitch adjusts discount rate/investment return assumption to 7%
    - UAAL amortization period
  - 7% investment return/discount rate assumption
    - For every 1% that the discount rate varies from 7%, the actuarial liability rises 11%
      - Funded ratio is calculated based on this higher liability level
      - Resulting funded ratio an approximation

Fitch-Adjusted Figures

Carrying cost for local governments

- Debt service + pension contribution + OPEB pay-go
  - Local governments = labor intensive
  - Vast majority in cost-sharing plans
  - Impact on resource base
- As % of spending
  - < 15% = stronger
  - > 25% = weaker

Pension Summary

Credit Positives:

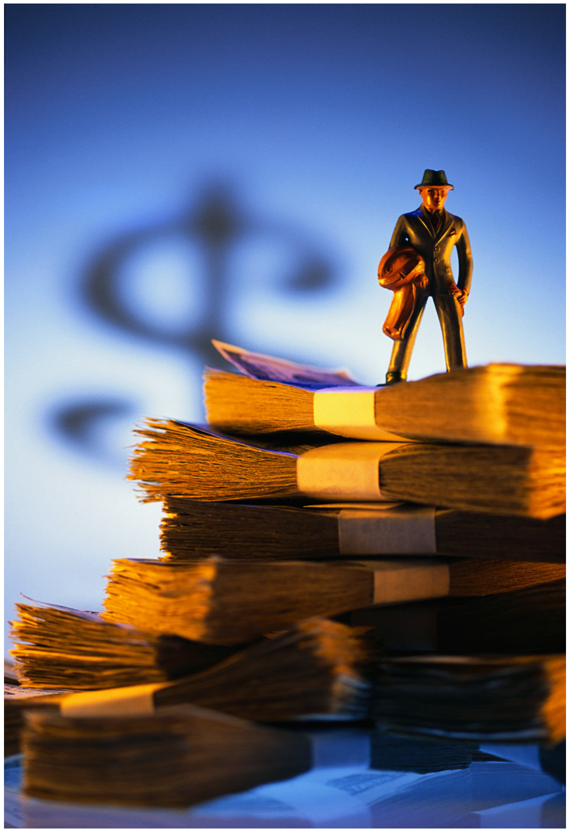
- Well-funded pension plans, reasonable assumptions
- Consistent funding of actuarially determined ARC
- Effective efforts to contain liability over time

Credit Concerns:

- High unfunded liability, liberal assumptions
- Annual contributions below the ARC
- High ARC requirements relative to budget
- Rapidly rising annual requirements

Finances

- Structurally balanced operations
- Prudent unrestricted reserves relative to revenue and expenditure flexibility/volatility
- Revenue and expense composition and trends
- Capacity to absorb spending needs
- Tax and revenue limits
- Liquidity/Cash flow
- Contingency planning



Financial Operations – Key Data

- Most recent audited financial report
- Unaudited actuals or projected results for immediate past fiscal year if CAFR not yet ready
- Next fiscal year budget (if available)
- Multi-year projections
  - How major revenues are expected to perform
  - The underlying assumptions (e.g. any political or legislative threats?)
  - Future expenditure increases (e.g. known labor cost increases, new legal mandates, future operating costs of new facilities
- “What-if” scenarios and contingency plans to address them

Financial Operations – Key Data, cont.

- Major fund balances
  - Under GASB 54, we focus on the unrestricted fund balance (committed + assigned + unassigned)
  - Interfund transfers:
    - Is the general fund supporting other funds temporarily or on an ongoing basis?
    - Are other funds supporting the general fund beyond overhead reimbursement? Any legal challenges to this?
- Reserves - Are they accounted for in the general fund or elsewhere?
- Borrowable resources
  - How much? Held in which funds?
- What other financial flexibility is available
  - What realistic options does the issuer still have to close future budget gaps?

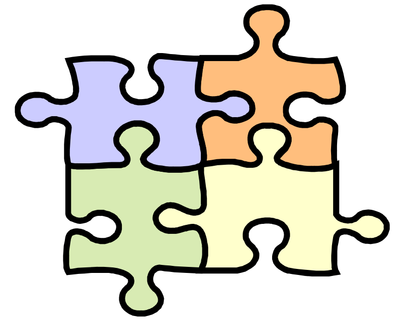
Financial Operations – Liquidity

- Balance Sheet Analysis – receivables/payables, liquidity ratios etc.
- Liquidity Trends
  - When are the low cash points during the year? Have cash levels at theose points declined in recent years? Review monthly cash flow statements if there is a concern
  - How does the issuer ensure sufficient liquidity at those points during the year (e.g. borrow from other funds or externally?)
  - What level of borrowable resources are available in other funds?
  - Is there a notable increase in cash flow borrowing?
  - Is there borrowing across fiscal years?

Management

- Ability and willingness to manage financial operations
- Institutionalized and prudent policies
  - Implemented?
  - Followed?
  - Fiscal discipline maintained even during downturns
- Budget Practices – Are they realistic, conservative?
- Clear Vision
- Ability to adapt
- Tenure/experience/effectiveness with and between elected officials
- Effectiveness with taxpayers and labor

Putting the Pieces Together



Link economy, debt, financial and management profile

View from an analysts perspective and interaction between factors

- Convey both strengths and risks
- Delineate problems and level of control over the resolution
- Take strategic approach to restoring/building financial strength and addressing long term challenges
- Shore up financial policies where needed (lessons learned)

Communication, Communication, Communication

Retaining Strong Credit Quality

- Budget realistically to conservatively
- Formulate “what-if” scenarios and develop contingency plans
- Monitor revenues and spending frequently
- Continue long-range financial planning
- Stay within financial policies where possible (use of one-time funds and reserves for operating expenditures should fall within guidelines
- Develop a framework for use and replenishment or reserves
- Keep rating agencies informed of significant changes in circumstances

Overall, identify opportunities and challenges and all of the implications, and then take appropriate action.

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Appendix A: Credit Attributes

Attributes: Stronger Credits

Debt and other long-term liabilities:

- Debt per capita < $2,000; debt to market value < 2%; low debt service burden < 5% of spending
- Modest future capital/debt needs; CIP updated regularly
- Rapid debt amortization , > 65% in 10 years
- Predominantly fixed-rate debt (< 15% variable rate)
- Consistent full funding of pension ARC (UAAL < 20%)
- Effective efforts to reduce OPEB liability

Financial operations:

- Diverse, stable, broad-based, flexible sources of operating revenues
- Ample ability to adjust spending without undue service impacts
- Consistently positive operating margins
- Consistently sound reserve levels
- Substantial available liquidity without borrowing

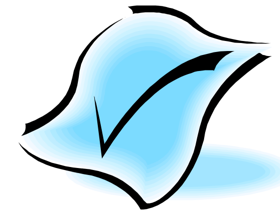
Local economy and tax base:

- Broad, diverse, stable economy
- Taxpayer concentration < 10% for top 10
- Consistent, moderate population and employment growth
- Major employer stability and diversity
- Robust wealth indicators
- Moderate tax burden relative to area and similar communities

Management and administration:

- Highly efficient decision-making process
- High performing elected officials, management
- Good management-labor relations
- Financial management: prudent policies consistently followed; conservative budgeting process; regular financial management reviews; contingency planning; long-term planning; timely reporting

Attributes: Midrange Credits



Debt and other long-term liabilities:

- Debt per capita \$2,000 - \$4,000; debt to market value 2% - 5%; debt service burden 5% - 10% of spending
- Manageable future capital/debt needs; periodic CIP
- Moderate debt amortization , 40% - 65% in 10 years
- Mostly fixed-rate debt (15% - 25% variable/short-rate)
- Consistent full funding of pension ARC (UAAL < 30%)
- Some efforts to reduce OPEB liability

Local economy and tax base:

- Fairly diverse economy
- Taxpayer concentration 10% - 15% for top 10
- Stagnant or rapidly growing population
- Moderately diverse employment base with some concentration
- Sound wealth indicators

Financial operations:

- Somewhat concentrated operating revenue with some flexibility to increase
- Some ability to adjust spending (potential service and timing impacts)
- General trend of positive operating margins
- Satisfactory reserve levels with some fluctuation
- Sound available liquidity with limited borrowing

Management and administration:

- Efficient decision-making process
- Satisfactorily performing elected officials, management
- Reasonably productive management-labor relations
- Financial management: reasonable policies usually followed; realistic budgeting process; able to make midyear adjustments; timely reporting

Attributes: Weaker Credits

Debt and other long-term liabilities:

- Debt per capita > $4,000; debt to market value > 5%
- High debt service burden > 10% of spending
- Large future capital/debt needs; no published CIP
- Slow debt amortization , < 40% in 10 years
- Predominantly fixed-rate debt (> 25% variable-rate)
- Inconsistent full funding of pension ARC (UAAL < 30%)
- Limited efforts to reduce OPEB liability

Local economy and tax base:

- Small, limited, or concentrated economy
- Taxpayer concentration > 15% for top 10
- Declining or extremely rapid population growth
- Industry or employer dominance
- Below-average wealth indicators

Financial operations:

- Severely limited revenue flexibility; revenue declines
- Little spending flexibility
- Trend of negative operating margins
- Low reserve levels without replenishment plans
- Low liquidity; reliant on short-term borrowing (< 15% of general fund receipts)

Management and administration:

- Cumbersome decision-making process
- Unsatisfactorily performing elected officials, management
- Problematic management-labor relations
- Financial management: non-existent or inconsistently followed policies; optimistic budgeting process; inflexible budget adjustment process; inadequate reporting

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Appendix B: Rating Scale

Long-term Rating Scale

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
[This is the average GO rating for local governments.]

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 cont'd

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

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New York
One State Street Plaza
New York, NY 10004

London
30 North Colonnade
Canary Wharf
London E14 5GN