

S&P's View of Best Practices

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State and Local Government



Municipal Ratings

- **Ratings opinions and analyses provide a common language for issuers and investors who are interested in the creditworthiness of issues or issuers. Our ratings may be useful to investors as a second opinion as they decide which bonds meet their individual risk tolerance and investment objectives.**
- **Ratings are typically provided upon request.**

Rating Scale – Investment Grade Categories

AAA

AA

A

BBB

With the exception of AAA, standing within these investment-grade categories can be further denoted by a + or –

General Obligation Analysis

- **Key G.O. Ratings Factors:**
 - Economy
 - Finances
 - Management
 - Debt

Economic Factors

- **Demographics**
- **Income/Wealth**
- **Property Valuation**
- **Taxpayer Base**
- **Employment**
- **Enrollment**

Financial Factors

Observing trends across multiple fiscal years

- Year end Financial Position
- Revenue trends and sources
- Reserve Levels
- Liquidity – cash assets
- Investments
- Pensions
- Budgeting

Financial Management Assessment (aka FMA)

- **S&P's analytical methodology that evaluates established and ongoing management practices and policies in the seven areas we see as most likely to affect credit quality.**
- **The FMA measures the presence of policies and whether they are formalized.**

Financial Management Assessment

Strong, Good, Standard, Or Vulnerable Based On:

- **Revenue and expenditure assumptions**
- **Budget amendments and updates**
- **Long term financial planning**
- **Long term capital planning**
- **Investment management policies**
- **Debt management policies**
- **Reserve and liquidity policies**

Structural Balance is Essential

We define structural balance as: recurring revenues that match or exceed recurring expenditures

- **Do you look at historic trends and do you use outside sources of information to ensure your revenue and expense assumptions are sound?**
- **Does your budget rely on non-recurring revenues or debt restructuring to achieve balance?**
- **Is there implementation risk that could affect your budget outcome?**
- **Are you deferring ongoing expenditures?**

Prioritized Spending and Contingency Plans

- **We feel these are good risk management tools that foster financial agility**
- **Allow governments to more easily adapt to changing revenue environments**
- **Appear both on the spending and revenue sides**
- **Should include various scenarios**

Regular Budget Monitoring

Helps identify budget weaknesses early on in the process and allows for a more proactive budget balancing response.

Features:

- **Monthly or quarterly financial updates to the school board**
- **Budget to actuals, budget variances, etc.**

Long-term Financial Planning

- **A key feature of stable financial performance. The earlier weaknesses are identified, the more effective the budget balancing response can be.**
- **Robust plans do not just straight-line revenues and expenditures.**
- **Used as a decision-making tool at budget time and other points in the year**
- **Updated at least annually, and include multiple**

Strong Liquidity Management

- **Policies focus on cash flow management**
- **Liquidity needs identified**
- **Awareness of the weakest cash flow month**
- **Also take into account exposure tied variable rate demand obligations**

Reserve Policies

Your policy should take into account:

- **Cash flow needs within the year**
- **Volatility of revenues and expenditures on a year over year basis**
- **Economic cycles**
- **Susceptibility to natural disasters, where applicable**
- **Is there a mechanism to replenish reserves, if you draw on them?**
- **What actions are you taking to bring the budget back into structural balance?**
- **How long will it take?**

Debt Factors

- **Overall Debt Burden (Past, Present, Future)**
- **Bond Retirement Schedule**
- **Debt Service As A Fixed Cost**
- **Debt Ratios**
- **Future Capital Needs**
- **Contingent Liabilities**

Contingent Liabilities

- **Pension and other postemployment benefit obligations**
- **Variable rate debt or swaps, with payment provisions that accelerate debt payment and/or liquidity needs**
- **Other activities that are accounted for off-balance sheet, or outside the general fund**

Key considerations:

- **The size of the liabilities,**
- **The potential funding challenges, and**
- **Are there long-term plans that address them?**

Debt Management Policies

- **These policies go beyond statutory debt limits**
- **Take into account contingent liabilities**
- **Include affordability measures that may limit annual debt service to a % of expenditures, debt per capita, or even to a tax rate**
- **Establish criteria for how, when, and for what projects the issuer can issue debt**
- **Address variable rate debt and swaps**

Capital Improvement Planning

- **A multi-year plan addressing ongoing maintenance as well as potential new facilities**
- **Needs and priorities are updated annually, and costs are tied into the budget and long-term financial plans**
- **Consists of a combination of pay-as-you-go financing and bonding**
- **Revenue sources are identified throughout all years of the plan**

Printed articles pertaining to this topic are available

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The Top 10 Management Characteristics Of Highly Rated U.S. Public Finance Issuers

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Top 10 List

The Top 10 Management Characteristics Of Highly Rated U.S. Public Finance Issuers

(Editor's Note: This is an updated version of an article published July 26, 2010.)

U.S. public finance issuers are a varied group, but the management practices of the strongest borrowers show some distinct commonalities. Standard & Poor's Ratings Services has widely disseminated to investors and issuers its approach for assigning credit ratings in U.S. public finance (see "USPF Criteria: State Ratings Methodology," published Jan. 3, 2011; and "USPF Criteria: GO Debt," published Oct. 12, 2006, on RatingsDirect on the Global Credit Portal). We have also developed representative ranges for key ratios that factor into our analysis of tax-backed credit quality (see "USPF Criteria: Key General Obligation Ratio Credit Ranges – Analysis Vs. Reality," published April 2, 2008). Although these ratios are the foundation of the quantitative measures Standard & Poor's uses when assigning a credit rating, Standard & Poor's also relies on qualitative factors to inform our credit analysis. In 2006, Standard & Poor's released its Financial Management Assessment, which offers a more transparent assessment of a government's financial practices, as an integral part of our credit rating process (see "Financial Management Assessment," published June 27, 2006). Our view of management factors, administrative characteristics, and other structural issues facing a government entity may be an overriding factor in a rating outcome.

(Watch the related CreditMatters TV segment titled, "What Do Highly Rated U.S. Public Finance Issuers Have In Common?", dated Aug. 14, 2012.)

We view management as contributing significantly to many of the individual credit ratios, which can positively affect ratings in a number of ways. On the whole, state and local governments have made many improvements to budget structure, reserve policies, and debt management during prior periods of budget stress. Whether these practices are developed as part of a comprehensive risk management plan or individually, they have, in our view, generally enhanced government's ability to manage through downturns and have contributed to credit stability over time. Conversely, we believe that the lack of strong management can be a significant factor in a weak credit profile. In our opinion, while the economy remains a key factor in assigning a rating level, our view of management and the institutional framework is usually one of the deciding factors in fine-tuning the rating.

Overview

- Our view of a government entity's management and administrative characteristics, along with other structural issues it faces, can move a rating up or down more significantly and swiftly than any other element of a credit review.
- We've observed some distinct commonalities in the management practices of highly rated U.S. public finance issuers over the years.
- Proactive budget and liability planning, strong liquidity management, and the establishment of reserves are among the factors the strongest issuers share.

When assessing management, Standard & Poor's analyzes the political and fiscal framework that governs it, as well as

the day-to-day management procedures and policies. There could be a strong management team in place, but if there is political instability or lack of political will to make difficult decisions, we have found that management could be ineffective in many cases. Standard & Poor's also focuses on the "whole of government." Our view of oversight and management controls covering the disparate operations of a government with a focus on accountability at each department or function is critical to strong credit ratings.

The following "Top 10" list of management characteristics associated with Standard & Poor's highly rated issuers is generally applicable to state and local governments as well as to other enterprise operations of government such as water, sewer, or solid waste. The relative importance of these factors may vary from issuer to issuer. Our view of credibility is an important part of a rating review process and management assessment. Every government has challenges, but we believe that identifying problems or issues and detailing how these will be addressed establish credibility and greater transparency in the rating process.

Top 10 List

1. Focus on structural balance

In our view, a structurally balanced budget is an essential characteristic of highly rated credits. There are many views of what constitutes a balanced budget. For some governments, a budget is balanced if current revenues plus available reserves match or exceed current expenditures. From Standard & Poor's standpoint, a budget is balanced if recurring revenues match recurring expenditures. In evaluating whether or not a budget is balanced, we analyze the underlying revenue and expenditure assumptions. We might not have a positive view of a budget that relies on optimistic revenue assumptions relative to the current economic environment to meet recurring expenditures. We consider recurring expenditures all of those that are typically incurred year after year and are required as part of a government's normal ongoing operations. This includes salaries, debt service, and pension payments among others. Consistent with our analysis of revenues, expenditure assumptions that rely on debt restructuring for budgetary savings, deferral of ongoing expenditures, and saving assumptions that have significant implementation risks could also color our view of whether a budget is balanced or not.

A government's ability to maintain or quickly return to structural balance during a period of economic weakness can lead us to affirm or raise an issuer credit rating. The opposite is also true. Reliance primarily on one-time measures without the appropriate re-alignment of revenues and expenditures could cause us to lower the ratings.

2. Strong liquidity management

An additional credit quality factor is management's ability to manage its cash flow and identify potential issues, internal or external, that could lead to a liquidity crunch. Potential for inadequate liquidity serves as a bellwether to the risk of immediate and potentially severe credit deterioration, particularly for those with significant budget misalignments and issuers of certain types of variable-rate debt, in our view. Ultimately, the possibility of having insufficient money to meet debt obligations is at the heart of our credit analysis. In the few instances where state or local governments may encounter genuine credit distress, it is likely accompanied and possibly exacerbated by problems with liquidity. Access to additional sources of internal or external liquidity and a plan on how, when, and in what amounts to access these, are a credit positive. However, just having access to additional liquidity, either through

pooled cash or loans from other funds, is not enough. The absence of clear accountability as to where the cash is coming from or when it will be paid back could create uncertainty about the sustainability of the cash flow and the potential implications of reallocating the cash from one use to the other.

In addition, some obligors' debt profiles include liquidity risk exposure tied to variable-rate demand obligations, alternative financing products, and other debt instruments. Under some of these structures, the potential for accelerated repayment causing sudden and significant demands on an issuer's liquidity could have credit implications (see "The Appeal Of Alternative Financing Is Not Without Risk For Municipal Issuers," May 17, 2011). We have found that management teams of highly rated credits are able to limit, mitigate, or develop a careful plan to manage the potential exposure to these liquidity demands.

3. Regular economic and revenue updates to identify shortfalls early

In our experience, having a formal mechanism to monitor economic trends and revenue performance at regular intervals is a key feature of stable financial performance. This is particularly true in the case of states, which we have observed tend to exhibit revenue declines during economic downturns because they rely on personal income tax, sales tax, corporate income tax, and other economically sensitive sources. We believe that evaluating historical performance of certain revenues is important to this analysis because each government will have different leading or lagging economic indicators that signal potential revenue variance issues based on its economic structure. The earlier revenue weakness is identified in the fiscal year, the more effective, in our view, the budget balancing response can be. We think it is important to monitor upside growth as well. In our opinion, it is also important to understand a surge in revenues to determine if the trend is an aberration or something that is likely to sustain.

4. An established rainy day/budget stabilization reserve

A formalized financial reserve policy is a consistent feature of most of Standard & Poor's highly rated credits. For some governments, such a policy has been standard operating procedure for decades. Others focused attention on this as a risk management tool following the recessions of the early 1990s, 2001, and especially the Great Recession when the country experienced sustained revenue weakness that required severe budget reduction measures. In our view, reserves provide financial flexibility to react to budget shortfalls or other unforeseen circumstances in a timely manner. No one level or type of reserve is considered optimal from Standard & Poor's perspective. We have seen many different types of reserves factor into an improved government credit profile. In our view, some important factors government officials generally consider when establishing a reserve are:

- The government's cash flow/operating requirements;
- The historical volatility of revenues and expenditures through economic cycles;
- Susceptibility to natural disaster events;
- Whether the fund will be a legal requirement or an informal policy;
- Whether formal policies are established outlining under what circumstances reserves can be drawn down; and
- Whether there will be a mechanism to rebuild reserves once they are used.

In our view, the use of budget stabilization reserves is not in and of itself a credit weakness. The reserves are in place to be used. However, we believe that a balanced approach to using reserves is important in most cases, because full depletion of reserves in one year without any other budget adjustments creates a structural budget gap in the following year if economic trends continue to be weak. As they've done in the past, state and local governments are

re-examining their fund balance reserve policies to determine their adequacy and, in many cases, have adjusted their funding targets.

5. Prioritized spending plans and established contingency plans for operating budgets

We have found that contingency planning is an ongoing exercise for most highly rated governments. Prioritized spending and contingency plans have always been important risk management tools that allow state and local governments to adjust to changes in the economic and revenue environment. In our analysis, we consider whether a government has contingency plans and options to address changing economic conditions, intergovernmental fund shifts, and budget imbalance when it occurs. This would include an analysis of the following:

- What part of the budget is discretionary;
- What spending areas can be legally or practically reduced;
- The time frame necessary to achieve reductions of various programs;
- Where revenue flexibility exists; and
- An analysis of revenue under varying economic and policy scenarios.

6. Strong long-term and contingent liability management

In our view, recognition and management of long-term and contingent liabilities are characteristics of highly rated credits. We continue to incorporate governmental liability management into our rating analysis, as we have for decades, with an emphasis on how liabilities are managed over time (see "Contingent Liquidity Risks In U.S. Public Finance Instruments: Methodology And Assumptions," March 5, 2012). In particular, Standard & Poor's views pension and other postemployment benefit obligations as long-term liabilities (see "The Decline In U.S. States' Pension Funding Decelerates, But Reform And Reporting Issues Loom Large," June 21, 2012; and "The OPEB Burden Varies Widely Among U.S. States," published Sept. 22, 2011). While the funding schedule for pension and OPEB can be more flexible than that for a fixed-debt repayment, it can also be more volatile and may cause fiscal stress if not managed, in our opinion. The size of the unfunded liabilities and the annual costs associated with funding them, relative to the budget, are important credit factors in our review of state and local governments. Currently, pension systems are undergoing the most significant level of reform in decades, which we view as a credit positive and highlights the importance of managing these liabilities. We will continue to differentiate credits where these long-term liabilities are large and growing, contributions are less than required, and there has been limited action on reform initiatives.

Non-essential areas of government operations and services that may fall out of the traditional general fund focus could also result in contingent liabilities and create budget pressures, if not properly managed. Stadiums, convention centers, and health care entities, as well as various other enterprise operations, could also cause funding challenges at the local level, even when there is no clear guarantee or legal responsibility for the government to provide funding. At the state level, we believe that local government fiscal difficulties can increase and become a funding and policy challenge for the state.

7. A multiyear financial plan in place that considers the affordability of actions or plans before they are part of the annual budget

In our analysis, we consider whether this plan is comprehensive. During a sustained economic recovery, we see program enhancements and tax reductions as typical. We believe that pension funds that performed at record levels provided incentive to expand or enhance benefits. Elected officials will be ultimately responsible for the decisions

necessary to restore out-year budget balance. In our view, even when there is legal authority to raise taxes, there may not be a practical ability to do so because it can be politically unpopular. Having detailed information on costs associated with various policy decisions can provide greater transparency to the budget process, in our view. We consider multiyear planning as an important part of this process. Standard & Poor's realizes that the out-years of a multiyear plan are subject to significant change. They provide a model to evaluate how various budget initiatives affect out-year revenues, spending, and reserve levels. These plans will often have out-year gaps projected, which we believe allows governments to work out, in advance, the optimal method of restoring fiscal balance.

8. A formal debt management policy in place to evaluate future debt profile

In the past decade, many states and local governments have developed debt affordability guidelines or models, which we regard as a positive development. This affordability analysis generally includes a systematic review of existing and proposed debt, and how they will affect a government's future financial profile. In many cases, these policies address exposure to variable-rate debt, swaps, and other contingent liabilities. They can also include criteria for when refunding bonds are allowed, amortization periods, and what types of projects can be funded through debt issuance. The affordability measures are typically tied to a government's revenues or expenditures, debt per capita, and debt per capita as a percent of either gross state product (states) or market value (local governments). The impact of these policies on a long-term credit rating will depend on our view of how the government establishes and uses the policies, and the track record in adhering to the affordability parameters established in the policies, especially during economic downturns. We believe the process enhances the capital budgeting and related policy decisions regarding debt issuance and amortization. In our view, these policies have moderated leverage at the state and local level.

9. A pay-as-you-go financing strategy as part of the operating and capital budget

In our opinion, pay-as-you-go financing can be a sound financing policy. Not only does it lower debt service costs, but it also provides operating budget flexibility when the economy or revenue growth slows. We see the use of pay-as-you-go financing as a more significant funding option when tax revenue growth is uncertain, given the fact that pay-as-you-go financing may provide additional budget flexibility in an uncertain revenue environment. Depending on the government's overall balance-sheet profile, we believe that the government can achieve a better match between nonrecurring revenues and nonrecurring expenditures if it uses this type of financing.

10. A well-defined and coordinated economic development strategy

In addition to historical economic trends, we consider each government's economic development initiatives and future growth prospects as they are likely to affect future revenue-generating capacity. Effective economic development programs typically take a long time to implement. We believe that the question for many state and local governments now is not whether there should be a formal economic development program, but rather how significant a resource commitment should be dedicated to running these programs and offering incentives. These are government policy decisions involving cost benefit analysis that are generally outside the credit rating process. However, if these economic development programs and strategies create employment, enhance diversification, and generate solid income growth, they could have a positive effect on a government credit rating over the long term. To the extent that there is a net revenue benefit to a government, this could also be a positive credit factor. We have seen economic development programs expand in the past 20 years with strategies increasingly becoming regional in nature, with a more coordinated approach between state and local governments.

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