

**Fitch**Ratings

**2014 SC GFOA  
Spring Conference**

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# AGENDA

- 1) FITCH 2014 OUTLOOK FOR U.S. LOCAL GOVERNMENTS
- 2) FITCH TAX-SUPPORTED CREDIT ANALYSIS

# Fitch 2014 Outlook For U.S. Local Governments

Outlook on Local Governments Is Stable

Moderate Revenue Recovery

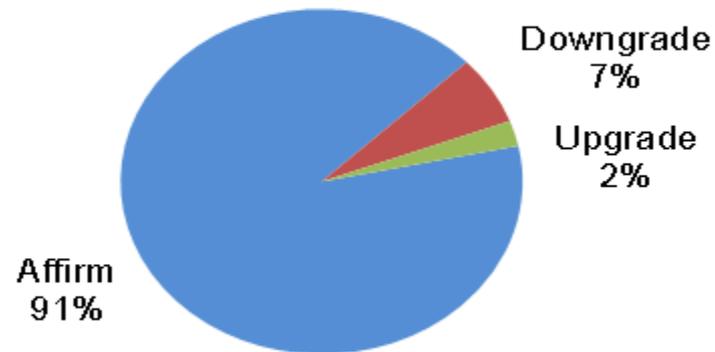
Limited Remaining Spending Flexibility

Benefit Pressures, Reforms Continue

Shifting Incentives to Pay

# 2013 Fitch Rating Actions

## Tax-Supported Rating Actions 2013



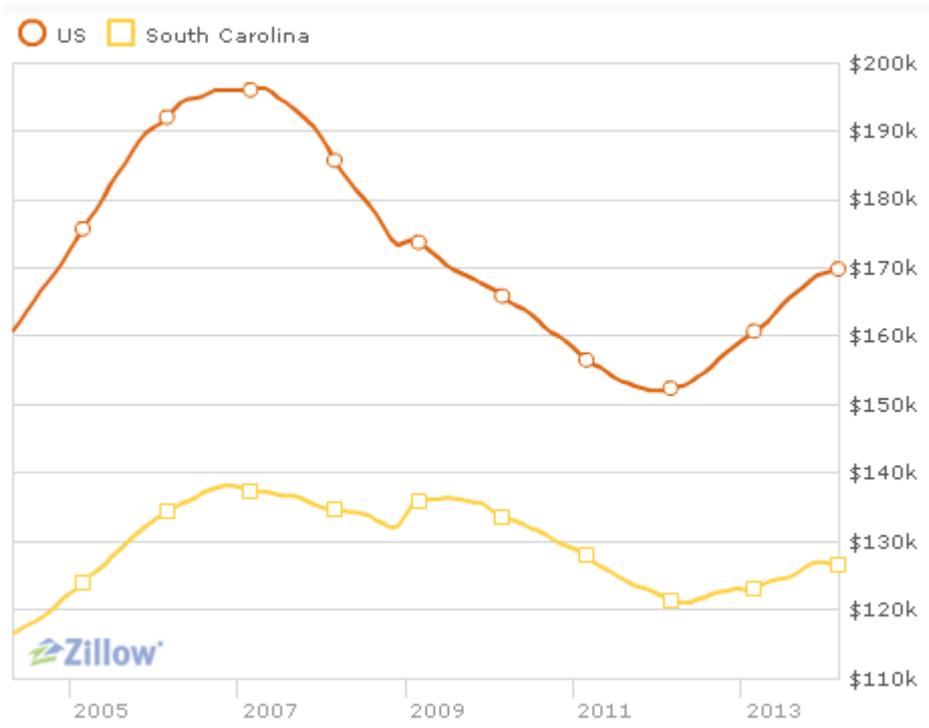


## Moderate Revenue Recovery

- Outlook for revenue performance has improved, but uncertainties remain
- Moderately expanding economy should translate to increases in most local tax revenues
- Areas that have experienced a strong housing rebound and are dependent on property taxes may see more robust growth
- No significant improvement to state aid expected
- Large federal funding cuts to states not expected

# Trend In Home Values

## Zillow Home Value Index





## Limited Remaining Spending Flexibility

- Many locals were able to achieve significant labor savings over the last few years
- Signs of labor's unwillingness to negotiate further concessions are on the increase
- Many government will be challenged to address non-personnel needs

# FITCH TAX-SUPPORTED CREDIT ANALYSIS



# Fitch Tax-Supported Credit Analysis

## Topics

- Fitch's Approach To Ratings
- Key Rating Factors
- Role of Pensions in Credit Analysis
- Attributes of Strong Credit / Weak Credits



# What is a Fitch Rating ?

- Forward looking independent assessment of credit quality
- Letter representation of the likelihood of full and timely repayment over the life of a specific financial obligation
- AAA, AA, A, BBB ... “+” and “-” to refine
- Based on issuer’s ability and willingness to pay on time
- Ability to pay - quantitative
- Willingness to pay – qualitative



# Four key credit factors: economy, finances, management and debt

Economy: resource base from which tax revenues derive

Finances: capacity to absorb spending needs

Management: ability and willingness to manage obligations

Debt and other long-term liabilities: includes bonded debt, unfunded pensions and OPEB obligations

# Economic Factors

- Resource base from which tax revenues are derived
- Depth and breadth of employment base
- Education & income levels
- Population trends





# Tax Base Composition

## What's 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
- Foreclosure and delinquency rates

## Real property tax collection rates

## Tax appeals

## Property tax rates relative to neighboring jurisdictions

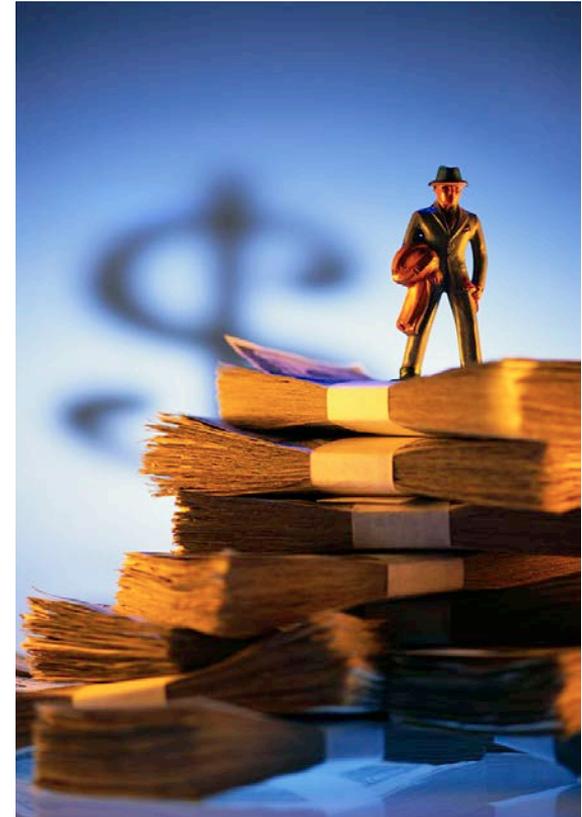
- Gauge of potential political opposition to rate increases





# The Finance Story

- Capacity to absorb spending needs
- Revenue and expense composition and trends
- Structurally balanced operations
- Liquidity / cash flow
- Prudent unrestricted reserves
- Contingency planning





# Financial Operations – Key Data Sources

**Most recent audited financial report**

**Unaudited actuals or projections if CAFR not yet ready**

**Budget**

**Multi-year projections**

- How major revenues are expected to perform
- The underlying assumptions
- Future expenditure increases (e.g. known labor cost increases, new legal mandates, future operating costs of new facilities)
- Structural gaps and planned solutions

**Cash Flow Statements**



# Financial Operations – Key Factors

## Major fund balances

- Under GASB 54, focus 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?

## 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





# Financial Operations – Liquidity

- **Liquidity Trends**

- When are the low cash points during the year? Have cash levels at those points declined in recent years? Provide monthly cash flow statements if there is a concern.
- How does the issuer ensure sufficient liquidity (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 – Important to Story

- Ability and willingness to manage obligations
- Institutionalized and prudent policies
  - Implemented?
  - Followed?
  - Fiscal discipline maintained even during downturns
- Budget Practices - Are they realistic, conservative?
- Ability to Adapt
- Tenure/experience/ability to work cooperatively with elected officials





# Debt and Other Long-Term Liabilities Story

- Debt levels relative property values and debt per capita
- Affordability / debt service coverage
- Rate of retirement
- Exposure to short-term debt, variable-rate debt, derivatives, etc.
- Future capital needs
- Pension & OPEB



# Debt and Other Long-Term Liabilities Story

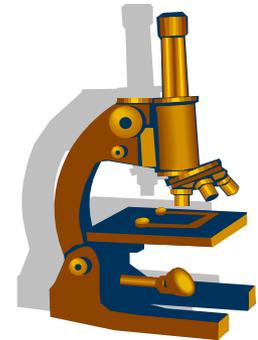
- Bonded debt, pensions and OPEB are different kinds of obligations
  - Debt: fixed obligation
    - Most governments manage closely, limit issuance and monitor affordability
  - Pensions: “softer” than debt
    - Influenced by various actuarial, economic assumptions and investment performance
    - Shared commitment with employees and other governments
  - OPEB: can be managed
- Same tax base supports all liabilities



# Increased Focus on Pensions

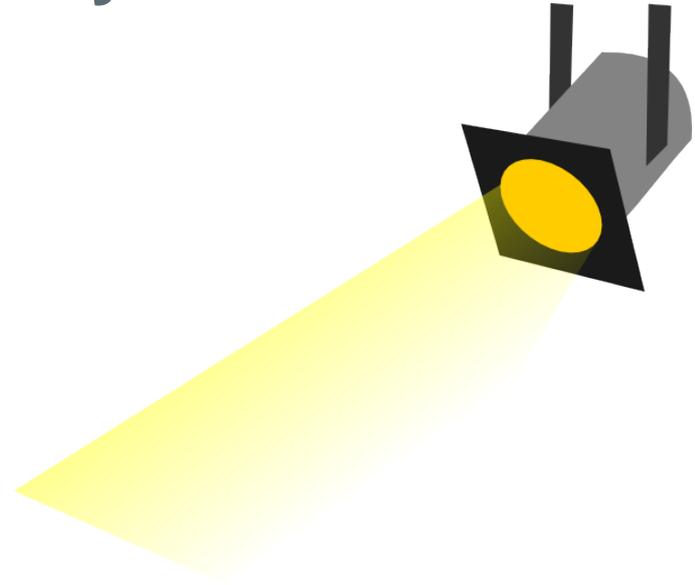
## Analytical Considerations:

- ARC vs. actual contribution history
  - Is the contribution actuarially calculated and fully paid?
  - What share of spending does it represent?
  - What is the resource base from which funding derives?
- Magnitude of the liability and trend in the funded ratio
- Key actuarial and economic assumptions
  - Discount rate/investment return assumption: 8% is optimistic
  - Fitch adjusts discount rate/investment return to 7%



# Spotlight on SC Retirement System Plan

- Full ARC funding
- Funded ratio is 64.7%
  - Investment performance assumptions
  - COLA
- Enacted pension reforms a credit positive



# Analytical Considerations

- How reforms affect long-term metrics varies
  - Immediate impacts
    - Cuts to COLAs lower actuarial liability, raise funded ratio
    - Higher employee contributions provide budgetary savings
    - Cuts to discount rates raise actuarial liability, lower funded ratio
  - Long-term impacts
    - Benefit changes to new workers improve funded ratio very slowly

# GASB Changes

## Pros of new accounting standards

- Improved transparency and comparability of financial reporting for pension
  - Application to cost-sharing plan participants (largely affects locals)
  - Fewer choices in arriving at reported figures
  - Disclosure of significant plan assumptions and methods

## Concerns expressed about provisions

- Administrative cost of conversion, especially for cost-sharing plans
- Provisions impacts on funded ratios
  - Blended discount rate
  - Assets at fair market value

# Key Takeaways

- Fitch has always considered the health of the state plans when assigning the local ratings
- GASB 67/68 does not represent a ‘new burden’
- Extends only to financial reporting, not to actuarial funding
- Rating emphasis will remain on the sustainability of the plan and the issuer’s funding commitment
- While SC RS is not well funded, plan provisions are not overly generous and the unfunded liability is relatively moderate

# Attributes of a Strong Credit

## Economy:

- 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

## 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%)
- Carrying costs < 15% of spending

## Finances:

- 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 short-term borrowing

## Management and administration:

- Highly efficient decision-making process
- Strong evidence of consistent cooperation among elected officials
- Good management-labor relations
- Financial management: prudent policies consistently followed; conservative budgeting process; regular financial management reviews; contingency planning; long-term planning; timely reporting

# 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 of reserves
- Keep Fitch informed of significant changes in circumstances

***Overall, a willingness to consider what’s happening and all of the implications, and then take appropriate action.***

# Attributes of a Weak Credit

## Economy:

- 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

## Debt and other long-term liabilities:

- Debt per capita > \$4,000; debt to market value > 5%
- High debt service burden > 12% of spending
- Large future capital/debt needs; no published CIP
- Slow debt amortization, < 40% in 10 years
- Elevated levels of variable rate debt (> 25%)
- Inconsistent full funding of pension ARC (UAAL < 30%)
- Limited efforts to reduce OPEB liability
- Carrying costs > 25% of spending

## Finances:

- 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
- Optimistic budget assumptions and inflexible budget amendment process
- Problematic management-labor relations
- Inconsistent support for management; voter referendum routinely fail
- Financial and debt management policies not present or not consistently followed, without plans to gain compliance
- Financial reporting delays

# Research Reports

- Local government outlook
  - “2014 Outlook: U.S. Local Government,” December 2013
- Rating criteria and related research
  - “Tax-Supported Rating Criteria”, August 2012
  - “U.S. Local Government Tax-Supported Rating Criteria”, August 2012
- Approach to analyzing the impact of pension liabilities
  - “Local Government Pension Analysis”, April 2013

The logo for Fitch Ratings, featuring the word "Fitch" in a red serif font and "Ratings" in a black serif font.

**Fitch**Ratings

## **Appendix: Rating Scales**

# Long-Term Rating Scale for Public Finance Obligations



## 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

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# Rating Outlooks and Watches

## Rating Outlooks:

Expected movement in primary credit factors over next 24 months

- **Stable**
- **Positive** if credit characteristics trending positive (must be reviewed within 12 months)
- **Negative** if credit characteristics trending negative (must be reviewed within 12 months)
- **Evolving** if credit characteristics a mix of positive and negative (must be reviewed within 12 months)

## Rating Watches:

Heightened probability of a rating change; event-driven; either exact rating implications of an event are undetermined, or the rating implications are known but the triggering event has yet to occur (e.g. regulatory approval); must be reviewed within six months

- **Positive** if potential upgrade
- **Negative** if potential downgrade
- **Evolving** if ratings might be raised, lowered, or affirmed



# Review Cycle

## Six month review:

- All rating watches
- Long-term ratings 'B+' and below
- Short-term ratings 'F2' and 'F3'

## 12 month review:

- Rating outlook negative, positive, or evolving
- Long-term ratings 'BBB' and 'BB' categories
- Short-term ratings 'F1+' and 'F1' (if debt term longer than 12 months)

## 24 month review:

- Ratings 'AAA', 'AA', and 'A' categories, rating outlook stable



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