



## **Bond Ratings and the Rating Process**

Rebecca Moses, Associate Director

California Debt and Investment Advisory Commission

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 cyclicity
- > 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



**Fitch Ratings**

*www.fitchratings.com*

**New York**

One State Street Plaza  
New York, NY 10004  
+1 212 908 0500  
+1 800 75 FITCH

**London**

101 Finsbury Pavement  
London  
EC2A 1RS  
44 20 7417 4222