FitchRatings
KNOW YOUR RISK

The Basics of Bond Ratings:
What they are (and aren't), how they're determined, and why they matter (particularly in times of economic stress)

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What is a rating?

> 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
> Bands of credit quality

A rating is NOT:

- Buy/sell or pricing recommendation
- Judgment or statement regarding any aspect of public policy
- Political statement in favor of or against a particular person or administration
- Dictate of what should be done or how a matter should be handled

Why do ratings and rating agencies matter?

- A bridge between issuer and investor
- Increased investor knowledge and acceptance
- Current economic and capital market environments
- BOTTOM LINE: Higher ratings = lower interest costs

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Fitch market coverage

Presence	Ratings in 90 countries
Ratings	>94,000 U.S. municipal transactions / 2,900 credits
	>6,000 financial institutions
	>1,700 corporations
	105 sovereigns / 170 sub-sovereigns

The rating process

- The Beginning: Decision and documents
- The Middle: Information, contact and questions
- The End: Rating committee, communication and dissemination through the financial newswires and Fitch Ratings' website
- Appeal process, if necessary
- Surveillance
- Rating outlooks (stable, positive, negative) signal direction
- Rating watches (positive, negative, evolving) signal key event

Credit analysis

> Inter-related underpinnings of the securing revenue stream (ad valorem property taxes, enterprise revenues, lease rental payments, tax increment financing):

- Debt and capital needs
- Legal structure
- Local tax base, economy, and demographic profile
- Financial performance
- Management

Elements of credit analysis: Debt / legal structure

- Specific transaction
- Debt and capital plan
- Affordability / debt service coverage
- Pay-as-you-go practices
- Future operating costs
- Variable rate exposure
- Swaps, derivatives, etc.

Additional credit elements for lease financings

> When is a bond not debt?

> Covenant to budget and appropriate

> Incentives:

- Project essentiality
- Evidence of support
- Market value and useful life

> Risks:

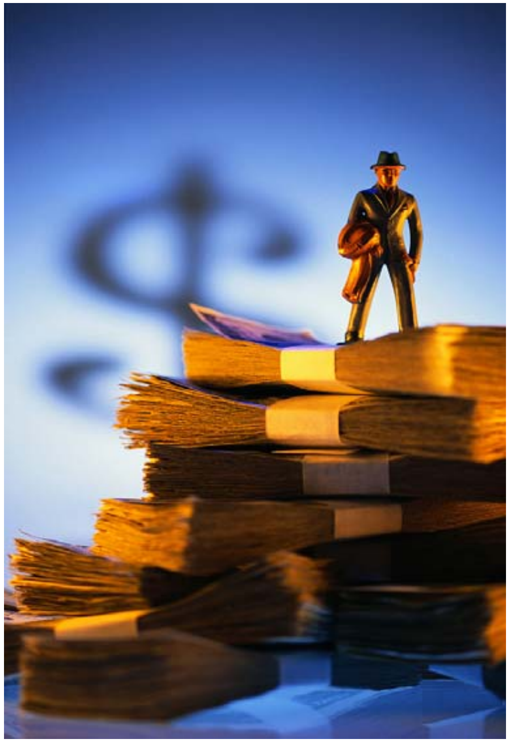
- Construction and completion risk
- Abatement
- Regularly using lease financing to avoid need for voter approval

Elements of credit analysis: Socio-economic factors

- Provides important context
- Area and local standard statistics
- Issuer-provided information
- Qualitative elements

Elements of credit analysis: Financial performance

- Past and future fiscal balance
- Revenue and expense composition
- Liquidity / cash flow
- Prudent reserves
  - Unreserved general fund balance
  - Budget stabilization fund
  - Rainy day reserve fund
- Legal restrictions
- Use of non-recurring revenues
- Contingency planning
- Investment policies



Elements of credit analysis: Management

- Strategic planning
- Written, adopted financial management policies:
  - Implemented?
  - Followed?
  - Fiscal discipline maintained even during downturns?
- Disclosure practices
- Tenure / experience
- Labor relations / pensions / other post-employment benefits
- Responses to current housing and bond market volatility
- 12 habits of highly effective finance officers

12 habits overview

1. Fund balance reserve policy / working capital reserve
   – Example: Rainy day reserve fund / reserve for economic uncertainties
2. Multiyear financial forecasting
3. Monthly or quarterly financial reporting and monitoring
4. Contingency planning policies
5. Policies regarding nonrecurring revenues
6. Debt affordability reviews and policies
7. Superior debt disclosure practices
8. Pay as you go capital funding policies
9. Rapid debt retirement policies
10. Five-year integrated capital plan
11. Financial reporting and budgetary awards
12. Compliance with Governmental Accounting Standards Board (GASB) rules.

Impact of the current economic climate on municipal ratings

> Broad-based, deep and potentially prolonged recession, affecting most regions and economic sectors
  - Housing market
  - Employment levels
  - Retail sales
  - Personal income

> Some state aid reductions may be offset by federal stimulus package

> Credit markets
  - Debt composition (i.e. auction rate securities, variable rate demand obligations)
  - Need to issue/redeem short-term borrowing

Housing market

> According to Case-Schiller data, by late 2008 house prices had fallen 22% from their 2006 peak

- Fitch projects at least another 10% decline nationally, and as much as 25% in CA

> Local credits of highest concern to Fitch are those with:

- Most dramatic swings: AZ, CA, FL, NV
- Most severe auto manufacturing-related declines: MI, OH

> Concerns may be exacerbated, deferred, or eased (depending on the circumstances) by restrictions on property assessments, tax levies, and/or tax rates

Housing market metrics

- Price income ratio (PIR): Measures the ratio of median single-family home price to average household income – indication of change in affordability
- Price equalization factor: Calculates the amount by which median single family house price would have to fall to equal the average of the 1990s PIR
- House price forecasts: Five-year forecast provided quarterly by University Financial Associates (UFA) – acknowledges a greater risk in those areas which experienced rapid house price appreciations or in those areas facing other economic challenges
- LoanPerformance: Mortgage Bankers Association data on residential mortgage delinquency and foreclosure trends – provides detail on subprime adjustable rate mortgages (ARMs), negative amortization mortgages (option ARMs), loans >60 days delinquent, foreclosure rates

  - Economic effect of increased foreclosures: increases housing inventory and further depresses prices

Offsets to tax base declines

- Assessed valuation (AV) and property tax limitations in many states had been a hindrance during the boom but have, in some cases, provided some taxing margin, or at least a time lag to prepare
- In some states, operating levy growth is limited but the rate can be adjusted (e.g. FL), affording the ability to offset AV declines with rate increases
- In others, both the operating levy and the rate are limited (e.g. CA, MA, MI) so that an AV decline has a more direct impact on property taxes
- Assessment procedures in some states (notably NV) delayed the downturn impact, and provide some protection against housing price swings
  - However, most of the cushion provided by rate or levy limitations have been or will soon be eroded by the reductions in market price to date.
- Issuers of unlimited tax general obligations with no or very high limit on operating taxes (e.g. NC, NY, and VA) have the most flexibility

Employment levels

> December 2008 employment statistics from the U.S. Department of Labor, Bureau of Labor Statistics:

- Monthly decline in non-farm payroll employment: 524,000
- Job losses for the year: 2.6 million
- Number occurring in the last four months of 2008: 1.9 million
- Only private industry sector to have added substantial jobs: healthcare
- National unemployment rate: 7.2% (the highest since January 1993)
- Number of persons unemployed: 11.1 million
- Number unemployed a year earlier: 7.5 million
- Number of persons “marginally attached” to the labor force: 1.9 million
- Number a year earlier: 1.3 million
- Number of discouraged workers: 642,000
- Number a year earlier: 363,000

Credit market disruptions

- Late 2007-2008: Downgrades of bond insurers and banks
- Spring 2008: Auction rate securities
  - Failed auctions
  - Penalty rates
  - Conversions to variable rate demand obligations
- Fall 2008: Variable rate demand obligations
  - Failed remarketings
  - Bank bonds
  - Maximum interest rates
  - Accelerated amortization
  - Swap termination triggers
- Ongoing: market access issues
  - Premium rates for all but treasuries
  - Impaired ability to sell bonds and cash flow notes
  - Availability of liquidity: Fitch's 2009 rating outlook for U.S. financial institutions is negative

Impact of recession on local government revenue

- Sales tax-dependent issuers
  - Impact is more immediate and dramatic
  - Requires quick action by management to avoid growing problem
- Property-tax dependent issuers
  - In most cases, assessments that reflect 2008 housing market activity are not yet finalized
  - Most severe impact on revenue will generally begin in fiscal 2010
  - Management has more time to incorporate potential slowdown or decline, but less data available on which to base forecasts

Local government response to economic downturn

- Reduction in capital projects, particularly those funded on a pay-as-you-go basis
- Increases in fine and fee revenue
- Very few cases of tax increases, but tax base expansion considered
- Hiring/wage freezes
- Elimination of non-essential non-personnel spending
- Use of accumulated reserves in excess of policy floor (%) and other non-recurring funding sources
- Reserve reductions to levels below policy floor
- Furloughs, lay-offs, labor contract renegotiations, core service reductions
- Asset sales
- Increased cash flow borrowing, when available and economical
- Vendor payment deferrals
- Deferrals in pension and other post-employment benefits funding

Retaining strong credit quality

- Budget realistically to conservatively
- Formulate “what-if” scenarios and identify contingencies
- Monitor revenues and spending frequently
- Continue long-range financial planning
- Create a rationale for using non-recurring funds for operating expenditures
- Stay within financial policies where possible
- Maximize structural solutions
- Develop a framework for use and replenishment of reserves
- Keep rating agencies informed of significant changes in circumstances

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