FitchRatings

County Treasurers' Association of Texas - Annual Conference

U.S. Local Government Tax-Supported Criteria

Jose Acosta, Senior Director

Sept. 20, 2018

2016 Criteria Revision Goals

1. Communicate Fitch's opinions more clearly.
2. Introduce forward-looking tools.
3. Continue to apply the analytical judgment that only comes from experience.

Limited rating changes from revised criteria

Sector Perspective - Default and Transition

- A total of 93% of tax-supported ratings are A category or higher.
- The ten year cumulative default rate for USPF credits rated in the AAA, AA and A categories is 0.07% and only occur in the A category – most of which are outside of the state & local portfolio.
- Given such low default rates, the risk of rating transition is the most important information Fitch can provide investors.
- 2016 revision (and 2018 updated) criteria methodology is aimed at identifying and articulating where ratings have stability, the likelihood and range of changes, and factors that can lead to change.
- Introduction of scenario analysis helps isolate characteristics that make transition more likely.

Key Criteria Changes

- Assign issuer default ratings (IDRs).
- Re-focus four traditional areas of analytical consideration.
- Publish category specific key rating factor assessments.
- Recognize more explicitly the strong operating environment for US governments.
- Consider more consistently a government's independent legal ability to raise revenues and areas of spending flexibility.
- Evaluate issuer-specific reserve fund adequacy in the context of an individual government's revenue volatility and financial flexibility.
- Introduce scenario analysis.

Key Criteria Changes (cont.)

- School districts
  - Place more explicit emphasis on the state operating framework.
- Dedicated tax bonds
  - Provide coverage expectations in the context of observed revenue volatility.
  - Expand legal analysis for ratings distinct from the IDR.
- Moral Obligation
  - MO pledges now recognized solely by notching down from the IDR of the MO provider.

Communicate rating opinions more clearly.

Assignment of Issuer Default Ratings

- Assign public IDRs to all state and local general purpose governments.
- IDR represents general credit quality assessment.
- IDR = unlimited tax general obligation (ULTGO) rating.
- No longer a rating distinction between ULTGO and limited tax general obligation (LTGO) ratings.
- IDR facilitates comparison of credit quality among issuers within the sector and across different sectors.

Re-Focus Four Traditional Areas of Analytical Consideration

Old Criria - Attributes	Current Criteria - Key Rating Factors
•Economy	•Revenue Framework
•Debt and Other Liabilities	•Expenditure Framework
•Finances	•Long Term Liability Burden
•Management & Administration	•Operating Performance

Fitch will publish rating category assessments for new Key Rating Factors

Overview of Rating Framework

Sector Risk Profile

AAA	AA	A	BBB	BB
Expected Rating Range Given Overall U.S. Tax-Supported Sector Profile				

Economic Base

An analysis of the fundamentals and drivers of an issuer's economic base serves as the foundation for all key rating factor assessments:

Revenue Framework	Expenditure Framework	Long-Term Liability Burden	Operating Performance
Expectations for growth prospects for revenues	Expectations for pace of spending growth	Expectations for affordability of liabilities	Expectations for ability of revenues to support spending needs throughout economic cycles and over time

In addition, in outlier cases where the nature of the economic base makes the issuer susceptible to an unpredictable change in profile (e.g. industry concentration, remote location), the economy can be an additional negative factor.

Key Rating Factor Assessments

Revenue Framework	aaa	aa	a	bbb	bb
Expenditure Framework	aaa	aa	a	bbb	bb
Long-Term Liability Burden	aaa	aa	a	bbb	bb
Operating Performance	aaa	aa	a	bbb	bb

Scenario Analysis

Informs operating performance assessment and communicates where the rating would be expected to remain stable throughout the economic cycle.

Final Issuer Default Rating (IDR) Outcome

The ultimate rating outcome is the result of consideration of issuer-specific qualitative and quantitative factors. There is no standard weighting of factors.

Key Rating Factors – Revenue Framework

	aaa	aa	a	bbb	bb
Growth Prospects for Revenues	Expectation of strong revenue growth without the need for revenue-raising measures.	Expectation of solid revenue growth in the absence of revenue-raising measures.	Expectation of slow revenue growth in the absence of revenue-raising measures.	Expectation of stagnant revenue performance in the absence of revenue-raising measures.	Expectation of declining revenue trajectory in the absence of revenue-raising measures.
Legal Ability to Raise Revenues	Independent legal ability to increase revenues without external approval is high in relation to normal cyclical revenue decline.	Independent legal ability to increase revenues is substantial in relation to normal cyclical revenue decline.	Independent legal ability to increase revenues is satisfactory in relation to normal cyclical revenue decline.	Independent legal ability to increase revenues is moderate in relation to normal cyclical revenue decline.	Independent legal ability to increase revenues is limited in relation to normal cyclical revenue decline.
Additional Considerations	In cases where an entity relies heavily on third-party funding (e.g. from a higher level of government) in support of core functions that likely would continue at the same level even without the external support, an evaluation of the associated risk informs the assessment. In addition, in rare cases, there may be other factors, such as an unusually concentrated or volatile revenue base, that have a negative effect on the assessment.				

Growth Prospects for Revenues: Metrics to Support Assessment

State Governments	Local Governments
10-year performance of tax revenues in comparison to growth in national GDP and inflation	10-year performance of general fund revenues in comparison to growth in national GDP and inflation

Note: Historical performance is used as a factor for consideration of future performance. Expectations for growth in line with or above the level of U.S. economic performance without the need for tax increases are consistent with a 'aaa' assessment; growth below U.S. economic performance but above the level of inflation, ‘aa’; growth in line with the level of inflation, ‘a’; growth below the level of inflation or flat performance, ‘bbb’; and a declining revenue trajectory, ‘bb’.

Strong Operating Environment for US Governments

- Recognition of the core features that credits in the state and local government sector share by virtue of their operation within the U.S. context.
- Most economies within the U.S. are notably strong and supportive of high ratings when considered in a global context.
- Benchmarking highlighted sample credits where we undervalue/overvalue the economy.

Independent Legal Ability to Raise Revenues

- Consideration of the range of legal limits on a government's revenue autonomy.
- Analyze legal revenue-raising ability in the context of an issuer's observed revenue sensitivity to economic downturns.
- Issuers with revenues that decline steeply in a downturn must have greater revenue raising flexibility than those with more steady performance through the cycle to achieve the same rating category assessment.
- Legal framework is a significant differentiating factor among credits with otherwise similar financial profiles in assessing the ability to manage fiscal challenges.

Expenditure Flexibility

- Local governments are labor-intensive.
- Public safety major spending sector
- Workforce evaluation highlights issuer's relative ability to control labor costs.
- Carrying costs can be a notable spending area for both states and locals.
- Carrying costs - sum of debt service, actuarially determined contributions (ADC), and OPEB – measured relative to general fund spending

Long-Term Liability Burden

- Now measured relative to personal income of local government
- Sum of direct debt, overlapping debt, and net pension liability (NPL)
- Pension liabilities considered equivalent to debt
- OPEB not included in long-term liability burden
- NPL cited in audits adjusted by Fitch to reflect assumed 6% investment rate of return
- Growth prospects / focus on affordability in near/long terms.

Operating Performance

- Financial Resilience Through Downturns
- Assessment of gap-closing capacity / financial flexibility
- How issuer functions within revenue & expenditure frameworks
- Liquidity – government-wide cash analysis
- Case study: Bernalillo County, New Mexico
- Budget Management at Times of Economic Recovery
- Implications for periods of economic downturn

A New Take on Reserve Fund Adequacy

- Understanding an issuer’s available cushion remains an important credit consideration.
- Fitch does not set static reserve expectations by rating level.
- Reserve expectations are issuer and rating specific.
- Fitch recognizes reserve levels fluctuate throughout the economic cycle.
- Fitch considers reserve adequacy in the context of the issuer’s ability to control revenues and spending (‘inherent budget flexibility’) and historical revenue volatility.

Introduce forward looking tools.

The Revenue Sensitivity Tool

- Generates the cyclical revenue change (expressed as a % change in revenues) based on a standard three-year GDP assumption that Fitch will use in scenario analysis.
- Uses historical issuer-specific CAFR revenue data, then adjusts for clear outliers so as not to skew the analysis.

Scenario Analysis

- Considers issuer specific fundamentals and potential performance under a standard economic stress highlighting how cycles affect individual issuers differently.
- Revenue Sensitivity Tool & Scenario Analysis Tool work together to highlight how an issuer’s financial position can change through an economic cycle and the level of change considered consistent with the existing rating.
- The tools support Fitch’s through-the-cycle analysis and are an important consideration in the rating process.
- The tools do not dictate a rating outcome.
- The tools do not generate forecasts.

Continue to apply the analytical judgement that only comes from experience.

People in pursuit of answers

Disclaimer

Fitch Ratings' credit ratings rely on factual information received from issuers and other sources. Fitch Ratings cannot ensure that all such information will be accurate and complete. Further, ratings are inherently forward-looking, embody assumptions and predictions that by their nature cannot be verified as facts, and can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

The information in this presentation is provided "as is" without any representation or warranty. A Fitch Ratings credit rating is an opinion as to the creditworthiness of a security and does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. A Fitch Ratings report is not a substitute for information provided to investors by the issuer and its agents in connection with a sale of securities.

Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch Ratings. The agency does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security.

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS AND THE TERMS OF USE OF SUCH RATINGS AT WWW.FITCHRATINGS.COM.

FitchRatings

FITCH RATINGS 100 YEARS
People in pursuit of answers

New York
33 Whitehall Street
New York, NY 10004

London
30 North Colonnade
Canary Wharf
London E14 5GN