

Sizing Your Reserves: Determining Relative Strength

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Topics

- **Overview of Criteria and Analytic Framework for General Obligation and Water/Sewer Sectors**
- **Summary of Factors**
- **Medians and Ratios: Presentation of Data**
- **Putting it all Together**
- **Q&A**

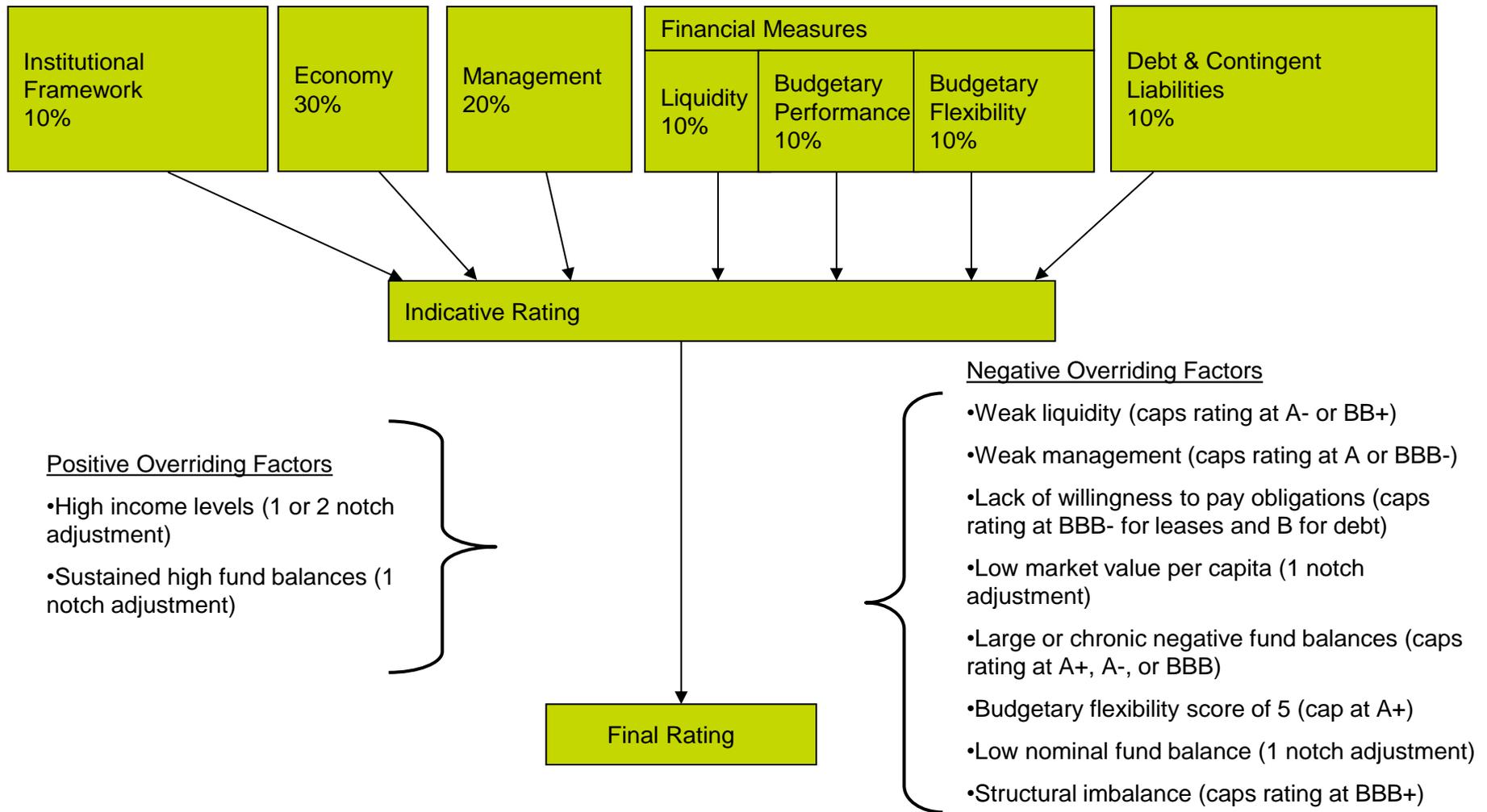
Overview

General Obligation Criteria – released Sept. 2013

The potential impact upon application:

- Affects approximately 4,000 credits (cities, counties, townships, burroughs, etc.); does not impact revenue debt, special tax debt, etc.

Analytical Framework



Analytical Framework

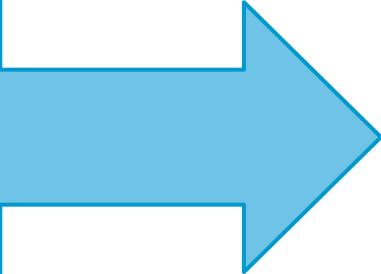
- **Score Range Descriptors for Each Framework Factor:**
 - **1 = “Very Strong”**
 - **2 = “Strong”**
 - **3 = “Adequate”**
 - **4 = “Weak”**
 - **5 = “Very Weak”**

Summary of the Factors That Affect Reserves

Local GO Criteria Factors

Financial Management Assessment

Includes Practices and policies in the seven areas most likely to affect credit quality.

- 
1. Revenue and expenditure assumptions
 2. Budget amendments and updates
 3. Long term financial planning
 4. Long term capital planning
 5. Investment management policies
 6. Debt management policies
 7. Reserve and liquidity policies

**“Strong”
or
“Good”
or
“Standard”
or
“Vulnerable”**

Financial Management Assessment

From the criteria:

<i>Reserve and Liquidity Policies</i>	
<i>Has the organization established a formalized operating reserve policy, which takes into account the government's cash flow/operating requirements and the historic volatility of revenues and expenditures through economic cycles?</i>	
<i>Strong</i>	A formal operating reserve policy is well defined. Reserve levels are clearly linked to the government's cash flow needs and the historic volatility of revenues and expenditures throughout economic cycles. Management has historically adhered to it.
<i>Standard</i>	A less defined policy exists, which has no actual basis but has historically adhered to it.
<i>Vulnerable</i>	Absence of basic policies or, if they exist, are not followed.

Management Score

Management
20%

- **Assess the impact of management conditions on the likelihood of repayment**
- **Financial Management Assessment (FMA) is based upon our current methodology**

Assessing the Management Score	
Rounded Score	Characteristics
1 (Very strong)	FMA score of “strong” and none of the factors in score ‘4’ or ‘5’ is present.
2 (Strong)	FMA score of “good” and none of the factors in score ‘4’ or ‘5’ is present.
3 (Adequate)	FMA score of “standard” and none of the factors in score ‘4’ or ‘5’ is present.
4 (Weak)	FMA score of “vulnerable” or any of the following is present: there is a financial reporting restatement that has a material negative impact; any of the conditions in score ‘5’ existed in the past three years; the structural imbalance override condition exists or existed within the past three years; or a very high debt, pension and OPEB burden.
5 (Very weak)	Regardless of the FMA score, any of the following is present: a management team that lacks relevant skills resulting in a weak capacity for planning, monitoring, and management; an auditor has delivered a going concern opinion; the government appears unwilling to support a debt or capital lease obligation; or the government is actively considering bankruptcy in the near term

Source: Standard & Poor’s Ratings Services.

Management Score Adjustments

Management
20%

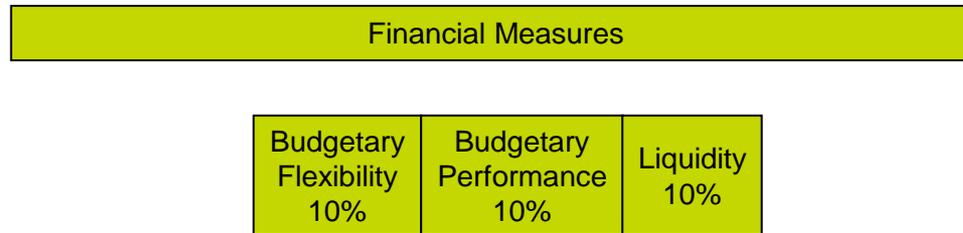
Qualitative factors with a positive impact on the initial score	Qualitative factors with a negative impact on the initial score
Consistent ability to maintain balanced operations.	Frequent management turnover inhibiting a current understanding of the government's financial position and its ability to adjust, or political gridlock, or instability that brings the same results.
Government service levels are limited.	Consistent inability to execute approved structural reforms for two consecutive years.

Management:

- *Score cap of 4 examples:*
 - Issuer's finances have been structurally imbalanced over past 3 years
 - Debt, pension, and OPEB burden considered very high and management does not have a credible plan to address the situation
 - Caps the final rating at 'A' or one notch lower than the indicative

Financial Measures

- **Three components factor into our assessment of a municipality's financial credit characteristics**
- **Budgetary flexibility, budgetary performance, and liquidity**
- **Each factor is weighted 10% — all financial measures together are 30%**



Financial Measures: Budgetary Flexibility Score

Budgetary
Flexibility
10%

The budgetary flexibility initial score measures the degree to which the government can create additional financial flexibility in times of stress

- Available fund balance as a % of general fund expenditures: for the most recently reported fiscal year
- When other fund balances outside of the government's general fund are available beyond the current fiscal year, they are included in the calculation
- This measure can cap a rating or it can be a positive override if extremely strong

Table 10: Assessing The Budgetary Flexibility Score

Available Fund Balance as a percentage of expenditures					
%	>15	8 to15	4 to 8	1 to 4	≤1
Score	1	2	3	4	5

Budgetary Flexibility Score Adjustments

Budgetary
Flexibility
10%

Qualitative factors with a positive impact on the initial score	Qualitative factors with a negative impact on the initial score
If projections for the current year and the following year suggest a better initial score.	If projections for the current year and the following year suggest a worse initial score.
Ability to avoid financial imbalances with demonstrated capacity and willingness to cut operational spending (by more than 2%), resulting from a flexible cost structure, flexible legislation, and/or widespread political support.	High levels of questionable receivables or amounts due from other funds with deficit balances.
Existing state tax caps do not apply to the government, or the government retains substantial flexibility under the caps.	Limited capacity to cut expenditures due to infrastructure or operational needs or political resistance.
Demonstrated ability and willingness to raise taxes when needed (and voter support is usually obtained when such approval is required).	Limited capacity to raise revenues due to consistent and ongoing political resistance which can include self-imposed restrictions through charter or local initiative processes.
Timing of fiscal year and tax billing dates result in high cash with abnormally low fund balance levels.	Where cash accounting is used, the criteria use cash balances instead of fund balances and the score is worsened by one point.
Maintenance of an available fund balance exceeding 30% of general fund expenditures for the most recently reported year, the current year and the next year.	

Budgetary Flexibility: What's New?

- **Want to know all sources of reserves**
 - Highlight all accounts where 'available' reserves are kept, including those outside the general fund
 - Analysts will ask for current year figures, plus next year's projections
 - Can be last audited year plus most recent unaudited numbers
- **Other questions- delving into reserve composition**
 - Are any major receivable amounts expected to be uncollectible?
 - Planned expenditure reductions for this year and next?
 - What kind of taxing flexibility do you have, and how much could it generate? Have you increased taxes beyond inflationary levels in recent years?

Budgetary Flexibility:

- ***One important note:***
 - *Available Fund Balance of less than \$500,000*
 - *Final rating worsens by one notch*
 - *Score of 5 caps the rating at 'A+'*

The budgetary performance initial score measures the current fiscal balance of the government

- Total governmental funds net result: the most recent year's net total governmental funds on a budgetary basis as a percent of expenditures
- General fund net result: the most recent year's general fund operational balance as a percent of expenditures

Table 11: Assessing The Budgetary Performance Score

	Total Governmental Funds Net Result (%)				
General fund net result (%)	> -1	-1 to -5	-5 to -10%	-10 to -15	≤ -15
(> 5)	1	2	3	3	4
(-1 to 5)	2	3	3	4	5
(≤ -1)	3	4	4	5	5

Budgetary Performance Score Adjustments

Budgetary
Performance
10%

Qualitative factors with a positive impact on the initial score	Qualitative factors with a negative impact on the initial score
<p>Expected structural improvement: if projections for the current year and following year suggested a better initial score, the score would improve by one point. The score would improve by two points only if required adjustments to revenues or expenditures to produce the result were already approved.</p>	<p>Expected structural deterioration: if projections for the current year and following year suggested a worse initial score, the score would worsen by one or two points. To worsen by two points, expected performance must fall to the commensurate level within the current year.</p>
	<p>Deferred payments on a cash basis: in cases where good ratios hide significant underspending due to deferred payments, the deferral produces a better score.</p>
	<p>Significant historic volatility in performance because of very cyclical revenues (e.g., oil & gas or sales tax on luxury goods and/or dependence on volatile state transfers) or exposure to event-related risks, the sources of volatility remain.</p>

Budgetary Performance: What's New?

- **Projections from 'Budgetary Flexibility' will also be important here**
- **Calls/meeting with analysts will include:**
 - More discussion of transfers in/out of general fund
 - More detailed conversations regarding capital expenditures and any one-time revenues, including bond proceeds
 - Existence/changes to deferred payments
 - Structural imbalance: existence of such and plans to remedy
- ***Changes from RFC:***
 - *Exhibiting characteristics of structural imbalance*
 - *Caps the final rating at 'BBB+*

Financial Measures: Liquidity Score

Liquidity
10%

The initial score measures the availability of cash and cash equivalents to service both debt and other expenditures

Initial liquidity score: combination of two measures (table 12)

- Total government cash as % of total governmental funds debt service
- Total cash % of total governmental funds expenditures

Table 12: Assessing The Liquidity Score					
	Total Government Available Cash As % Of Total Governmental Funds Debt Service				
Total Government Available Cash As % Of Total Governmental Funds Expenditures	>120	100 to120	80 to100	40 to 80	≤40
>15	1	2	3	4	5
8 to15	2	2	3	4	5
4 to 8	3	3	3	4	5
1 to 4	4	4	4	4	5
≤1	5	5	5	5	5

Liquidity Score Adjustments

Liquidity
10%

Qualitative factors with a positive impact on the initial score	Qualitative factors with a negative impact on the initial score
If projections for the current year (and the following year) suggest a better score, the score improves by one point.	If projections for the current year (and the following year) suggest a worse initial score, the score worsens by one point.
If access to external liquidity is 'exceptional' as defined in table 13, the score improves by two points; if 'strong', the score improves by one point.	If access to external liquidity is 'uncertain' as defined in table 13, the score worsens by two points; if 'limited', the score worsens by one point.
Very robust and stable internal cash flow generation capacity compared with peers in this category.	High refinancing risk over the next 24 months.
	Aggressive use of investments.
	Exposure to non-remote contingent liability risk that could come due within 12 months.

Liquidity: What's New?

- **Additional focus on**
 - Unrestricted total government cash balance
 - Most recent audit, plus current and upcoming year
 - Highly liquid investments that are not included as cash?
 - Contingent liabilities due in the next year?
 - Details of existing short term liquidity facilities
 - Direct purchase debt?
 - Frequency of non-GO debt issuance?
 - BANs outstanding that will need to be refinanced?

Liquidity: What's New? (con't)

- *Addition of positive and negative qualitative adjustments:*
 - *Factor Score impact: If projections for the current year and the following year suggest a better/worse initial score, then the score improves/worsens by one point*
- *Liquidity score of 4 caps the rating at 'BBB+'*
- *Liquidity score of 5 caps the rating at 'BB+'*
- *Non-remote contingent liabilities that reach certain levels without a credible plan to finance will trigger these caps*

Putting it all Together

Indicative Rating

Positive Overriding Factors

- High income levels (1 or 2 notch adjustment)
- Sustained high fund balances (1 notch adj)

Negative Overriding Factors

- Low market value per capita (1 notch adjustment)
- Low nominal fund balance (1 notch adjustment)

Rating Caps

- Weak liquidity (BBB+ or BB+)
- Weak management (A or BBB-)
- Lack of willingness to pay obligations (BBB- for leases and B for debt)
 - Large or chronic negative fund balances (A+, A-, or BBB)
 - Budgetary flexibility score of 5 (A+)
 - Structural imbalance (BBB+)

***** ONE NOTCH FLEXIBILITY *****

FINAL RATING!

Medians for Municipalities

- First medians report under revised general obligation criteria published January 13, 2014: Medians taken from September, 12th, 2013 through December 12th, 2013
- Over those three months, we reviewed 541 municipalities (cities, towns, boroughs, etc.); excludes counties and districts (school districts, etc.)
- Calculated these medians off raw and/or adjusted data; only one component of the rating analysis

Municipalities

Medians

Rating	No.	\$					%			
		MVPC	Proj PC EBI	FB/exp	GF op res	TGF op res	TG cash/exp	TG cash/DS	Net DD/rev	TGF DS/exp
AAA	65	157,536	150	29	2	2	45	465	87	9
AA	342	81,569	99	29	2	1	55	516	88	9
A	110	51,325	78	14	1	(2)	42	376	112	11
BBB and lower	24	51,805	73	(0)	(3)	(2)	25	292	95	10

Medians for Counties

- First medians report under revised general obligation criteria published January 13, 2014: Medians taken from September, 12th, 2013 through December 12th, 2013
- Over those three months, we reviewed 164 counties (excludes municipalities and districts such as school districts, special districts, etc.)
- Calculated these medians off raw and/or adjusted data; only one component of the rating analysis

Counties

		Medians									
		\$					%				
Rating	No.	MVPC	Proj PC EBI	FB/exp	GF op res	TGF op res	TG cash/exp	TG cash/DS	Net DD/rev	TGF DS/exp	
AAA	33	111,466	127	25	2	1	43	614	58	7	
AA	94	87,846	90	35	1	1	45	673	55	6	
A	32	55,135	77	17	0	(1)	24	360	78	7	
BBB and lower	5	47,816	80	(9)	(3)	(2)	20	278	51	7	

Summary of the Factors That Affect Reserves

Water Sewer Criteria

Water & Sewer System Key Factors

- **Economic considerations;**
- **Financial data/capital improvement plan;**
- **Rate criteria;**
- **Operational characteristics;**
- **Management; and**
- **Legal provisions**

****Ratios do not tell the whole story -- they are only a portion of what Standard & Poor's uses in its analysis. Economic, administrative, structural, and other qualitative factors may outweigh any of these ratios when a rating is assigned. Numbers alone cannot determine an entity's willingness to meet its financial obligations, nor can they reveal a history of reactive or nonexistent rate adjustments or the operating restraints presented by the state/local framework.**

Income Levels – Household/Per Capita Effective Buying Income As A Percentage Of U.S. Level

- **Below 65%** → **Low**
- **65% - 90%** → **Adequate**
- **90% - 110%** → **Good**
- **110% - 130%** → **Strong**
- **Above 130%** → **Very Strong**

Debt Service Coverage

<1.0x → Insufficient

1.0x to 1.25x → Adequate

1.26x to 1.50x → Good

>1.50x → Strong

Liquidity

<30 days → Low

30 to 60 days → Adequate

60 to 120 days → Good

>120 days → Strong

Total Debt To Net Property, Plant And Equipment

<40% → **Low**

40% to 60% → **Moderate**

60% to 80% → **Moderately high**

>80% → **High**

Top 10 Customers As A Percentage Of Total Operating Revenues

<15% → **Very diverse**

15% to 25% → **Diverse**

26% to 40% → **Moderately concentrated**

>40% **Concentrated**

Fixed-Charge Coverage

<1.0x → Insufficient

1.0x to 1.20x → Adequate

1.21x to 1.40x → Good

>1.40x → Strong

Water and Sewer Sector Outlook: 2014

Overview

- In both 2013 and 2012, the upgrade-to-downgrade ratio remained at about 3 to 1, from as high as 10 to 1 in 2010.
- Of our approximately 1,500 ratings on U.S. municipal water, sewer, and drainage utility revenue-secured debt, the outlook on the vast majority of utilities remains stable.
- The utilities tend to be rated mostly 'A-' or higher although the sector is not without credit pressures. The modal, or most common rating, is 'A+'.
- Rating changes in 2013 primarily resulted from a change in utilities' financial risk profiles, but the overall number of financially distressed utilities we rate remains very small despite headlines on municipalities such as Detroit, Mich. or Jefferson County, Ala.

Medians for Water and Sewer Credit Ratios

- Last medians report for water and sewer sector published May 2013
- 1,375 issuers (that we rate) included in data
- Calculated these medians off raw and/or adjusted data; only one component of the rating analysis

U.S. Water and Sewer Credit Ratios: Medians By Rating Category

	AAA	AA	A	BBB or lower
Population	258,439	83,421	25,016	17,590
Median household EBI as % of U.S.	125	103	88	87
Unemployment rate (%)	8.0	8.6	9.0	9.4
Concentration (%)	5.1	8.1	10.1	22.1
Water rate (\$)	29.22	30.88	37.29	33.77
Sewer rate (\$)	34.05	37.97	38.28	40.05
Days' cash	448	376	269	240
Debt to plant (%)	23.3	32.2	49.5	47.8
Senior-lien DSC (x)	3.11	2.25	1.73	1.48
Total DSC (x)	2.28	1.92	1.52	1.06

EBI--Effective buying income. DSC--Debt service coverage.

Rating Trends: Water & Sewer Sector

Through December 31st, 2013:

Rating Trends In U.S. Municipal Water And Sewer Sector

--Through Dec. 31--

	2013	2012	2011	2010
Total ratings	1,509	1,406	1,270	1,178
% of ratings changed during the year	3.9	5.4	8.9	14.5
Upgrades to downgrades	2.9 to 1	3.2 to 1	4.7 to 1	10.4 to 1
Positive outlooks	26	25	13	2
Total non-stable outlooks	49	48	25	17

Other Sectors

We have criteria and other publications that discuss reserve levels for other sectors not covered here today:

- **Municipal Utility Districts (MUD's)**
- **School Districts**
- **Special Tax**
 - **Sales Tax**
 - **Hotel/Motel Tax**

Q&A

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