

## Top 10 Management Characteristics Of Highly Rated Credits In U.S. Public Finance

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Standard & Poor's Ratings Services has widely disseminated to investors and issuers its approach for assigning credit ratings in U.S. public finance. We have also developed representative ranges for key ratios that factor into our analysis of tax-backed credit quality (see "Key General Obligation Ratio Credit Ranges – Analysis Vs. Reality," published April 2, 2008 on RatingsDirect on the Global Credit Portal). These ratios are the foundation of the quantitative measures Standard & Poor's uses when assigning a credit rating. We use ratios and comparisons to fine-tune our credit analysis and help make credit distinctions. For bond issuers, we often use credit ratios as a framework for making comparisons.

In addition to quantitative factors, our view of qualitative factors inform our credit analysis. Our view of management factors, administrative characteristics and other structural issues facing a government entity may be an overriding factor in a rating outcome. We view management as contributing significantly to many of the individual credit ratios, which can positively affect ratings in a number of ways (see Financial Management Assessment criteria). Conversely, we believe that the lack of strong management can be a significant factor in a weak credit profile. In our opinion, the economy remains a key factor in assigning a rating level, but our view of management and the institutional framework is usually one of the deciding factors in fine-tuning the rating. Our opinion of the management or administrative structure of a government can move a rating up or down more significantly and swiftly than any other element of a credit review.

When assessing management, Standard & Poor's analyzes the political and fiscal framework that governs it, as well as the day-to-day management procedures and policies. There could be a strong management team in place, but if there is political instability or lack of political will to make difficult decisions, we have found that management will be ineffective in many cases. Standard & Poor's also focuses on the "whole of government." Our view of oversight and management controls covering the disparate operations of a government with a focus on accountability at each department or function is critical to strong credit ratings.

The "Top 10" list of management characteristics associated with Standard & Poor's highly rated credits is generally applicable to other enterprise operations of government such as water, sewer, or solid waste. The relative importance of these factors may vary from credit to credit. Our view of credibility is an important part of a rating review process and management assessment. Every government has challenges. We believe that identifying problems or issues, and detailing how these will be addressed establishes credibility and greater transparency in the rating process.

## Top 10 List

### **1. An established "rainy day"/budget stabilization reserve.**

A formalized financial reserve policy is a consistent feature of most of Standard & Poor's highly rated credits. Historically, such a policy has been standard operating procedure for some governments for decades. Others focused attention on this following the recession of the early 1990s, and again in 2001 when many regions of the country experienced sustained revenue weakness that required severe budget reduction measures. We expect that the recent

financial crisis and recession will likely further increase the importance that governments will place on the build up and maintenance of financial reserves. In our view, reserves provide financial flexibility to react to budget shortfalls or other unforeseen circumstances in a timely manner. No one level or type of reserve is considered optimal from Standard & Poor's perspective. We have seen many different types of reserves factor into an improved government credit profile. In our view, some important factors government officials generally consider when establishing a reserve are:

- The government's cash flow/operating requirements;
- The historic volatility of revenues and expenditures through economic cycles;
- Susceptibility to natural disaster events;
- Whether the fund will be a legal requirement or an informal policy;
- Whether formal policies are established outlining under what circumstances reserves can be drawn down; and
- Whether there will be a mechanism to rebuild reserves once they are used.

In our view, the use of budget stabilization reserves is not in and of itself a credit weakness. The reserves are in place to be used. However, we believe that a balanced approach to using reserves is important in most cases, because full depletion of reserves in one year without any other budget adjustments creates a structural gap in the following year if economic trends continue to be weak.

## **2. Regular economic and revenue updates to identify shortfalls early.**

In our experience, having a formal mechanism to monitor economic trends and revenue performance at regular intervals is a key feature of stable financial performance. This is particularly true in the case of states, which we have observed tend to exhibit revenue declines during economic downturns because they rely on personal income tax, sales tax, corporate income tax, and other economically sensitive sources. We believe that evaluating historical performance of certain revenues is important to this analysis because each government will have different leading or lagging economic indicators that signal potential revenue variance issues based on their economic structure. The earlier revenue weakness is identified in the fiscal year, the more effective, in our view, the budget balancing response can be. We think it is important to monitor upside growth as well. In our opinion, a surge in revenues is important to understand as well to determine if the trend is an aberration or something that is likely to sustain and require a mid-year adjustment.

## **3. Prioritized spending plans and established contingency plans for operating budgets.**

We have found that contingency planning is an ongoing exercise for most highly rated governments. We have observed that budgets tend to inflate in good times: governments may expand services, fund generous employee pay packages, and accelerate financing for quality-of-life projects that we believe would most likely not be considered in a slow growth or declining economic environment. In our analysis, we consider whether a government has contingency plans and options to address budget imbalance when it occurs. This would include an analysis of the following:

- What part of the budget is discretionary;
- What spending areas can be legally or practically reduced;
- The time frame necessary to achieve reductions of various programs;
- Where revenue flexibility exists; and
- A course of action on the revenue side under various economic scenarios.

#### **4. A formalized capital improvement plan in order to assess future infrastructure requirements.**

Historically, highly rated credits typically have had a long-term capital improvement program that comprehensively assesses the infrastructure requirements of the government and a plan to fund these requirements over a five or more years. We have found that having a realistic plan that is comprehensively developed and updated annually is a common characteristic of most highly rated local governments. We believe that developing these programs for state government is difficult because the scale of projects and the scope of responsibilities are very broad. Many have accomplished this task despite these obstacles, which we view as a positive credit factor. In our analysis, we also consider the extent to which a government has incorporated the impact of capital projects on the operating budget for the short- and long-term. We see governments as continuing to move into non-traditional projects, whether they are economic development (contributing infrastructure to a developer or industry) or quality of life (stadiums and parks, to cite a few). Based on what we have seen, these projects generally come with an upfront budget cost, but can have multiyear budget impacts. Projects can be sold as self-supporting, but in our view may potentially be a drain on taxing resources.

#### **5. Long-term planning for all liabilities of a government, including pension obligations, OPEB and other contingent obligations and comprehensive assessment of future budgetary risks.**

The nature of government services can create unexpected contingent obligations, or "off balance sheet" liabilities that could ultimately affect taxing resources. Unfunded pension liabilities have been disclosed in detail for years and we believe this disclosure has enhanced the transparency of funding obligations in both the current year, and future years. We believe that disclosure of this liability has also focused attention and planning on ways to improve funding levels over time. We believe that GASB Statement 45, which requires disclosure of liabilities associated with other post employment benefits (OPEB), should also highlight some significant future liabilities for many governments. Given the rate of growth in health insurance costs and current demographic trends, greater transparency in this area should allow for advance development of funding and management solutions, in our opinion. We believe that other areas of government operations and services have also resulted in budget pressure that may fall out of the traditional general fund focus. In our view, hospital and nursing home operations, as well as various other enterprise operations have caused funding challenges at the local level, even when there is no clear legal responsibility for the government to provide funding. At the state level, we believe that local government fiscal difficulties can increase and become a funding challenge for the state.

#### **6. A formal debt management policy in place to evaluate future debt profile.**

Over the past decade, we have seen many state and local governments develop debt management policies and debt affordability measures. The impact of these policies on a long-term credit rating will be dependent on our view of how the policies are established and used by the government, and the track record in adhering to the affordability parameters established in the policies. We believe the process enhances the capital budgeting and related policy decisions regarding debt issuance and amortization.

#### **7. A pay-as-you-go financing strategy as part of the operating and capital budget.**

In our opinion, pay-as-you-go financing can be a sound financing policy. Not only does it lower debt service costs, but also it provides operating budget flexibility when the economy or revenue growth slows. We see the use of pay-as-you-go financing as a more significant funding option when tax revenue growth is uncertain, given the fact that pay-as-you-go financing may provide additional budget flexibility in an uncertain revenue environment. Depending on the government's overall balance sheet profile, we believe that a better match can be achieved between non-recurring revenues and non-recurring expenditures if this type of financing is used.

**8. A multiyear financial plan in place that considers the affordability of actions or plans before they are part of the annual budget.**

In our analysis, we consider whether this plan is comprehensive. During a sustained economic recovery, we see program enhancements and tax reductions as typical. We believe that pension funds that performed at record levels provide incentive to expand or enhance benefits. Elected officials will be ultimately responsible for the decisions necessary to restore out-year budget balance. We consider multiyear planning as an important part of this process. In our view, even when there is legal authority to raise taxes, there may not be a practical ability to do so because it is politically unpopular. Standard & Poor's realizes that the out-years of a multiyear plan are subject to significant change. They provide a model to evaluate how various budget initiatives affect out-year revenues, spending and reserve levels. These plans will often have out-year gaps projected, which we believe allows governments to work out, in advance, the optimal method of restoring fiscal balance.

**9. Effective management and information systems.**

In our analysis, we consider investing in systems that improve the efficiency and effectiveness of a government unit and enhance overall service delivery as a positive financial management tool. We believe that investment in financial management and information technology infrastructure has been significant during the past decade. To the extent that these changes improve financial reporting and monitoring capabilities, we view them as enhancing transparency and as a positive credit factor.

**10. A well-defined and coordinated economic development strategy.**

In our experience, economic development programs have expanded rapidly over the last 20 years. We believe that the question for many state and local governments now is not whether there should be a formal economic development program, but rather how significant a resource commitment should be dedicated to running these programs and offering incentives. These are government policy decisions involving cost benefit analysis that are generally outside the credit rating process. However, if these economic development programs and strategies create employment, enhance diversification, and generate solid income growth, they could have a positive effect on a government credit rating over the long-term. To the extent that there is a net revenue benefit to a government, it could also be a positive credit factor. We have seen economic development strategies increasingly become regional in nature, with a more coordinated approach between state and local governments.

## **Related Criteria And Research**

- USPF Criteria: GO Debt, Oct. 12, 2006
- USPF Criteria: Key General Obligation Ratio Credit Ranges – Analysis Vs. Reality, April 2, 2008
- USPF Criteria: Financial Management Assessment, June 27, 2006

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