

#### Association of Town Finance Committees Annual Meeting October 18, 2014

U.S. Local Governments: Methodology And Assumptions - An Overview of Management Characteristics of Highly Rated U.S. Public Finance Issuers



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# Local Government Analytical Rating Framework



2 Source: Standard & Poor's Ratings Services.



### **Massachusetts Positive Credit Factors:**

Relative to national peers S&P rated Massachusetts cities/towns

- Participate in or are near exceptionally broad and diversified economies.
- Exhibit extremely strong, mature and diverse tax base.
- Have stronger household income measures
- Demonstrate stable and predictable revenue sources property tax.
- Carry sufficient budgetary reserves and budget flexibility.
- Practice good financial management.
- Show a low fixed debt burden, with most having what we consider to be an aggressive principal debt amortization schedule and no contingent liquidity risks.



#### **Massachusetts Negative Credit Factors:**

#### Relative to national peers S&P rated Massachusetts cities/towns

- Are built-out communities with many having minimal prospects for organic tax base growth.
- Older, slower-growing population than the U.S. and slower-growing employment.
- Constrained ability to raise revenues if needed due to tax caps.
- Limited flexibility in managing labor costs.
- Higher pension and retiree health liabilities.



ACBACA B CCABAC B Δ **Revisiting the Management Factor** BC B ABACB B B 

## **Revisiting the FMA:**

- Revenue and Expenditure Assumptions
- Budget Amendments and Updates
- Long-term Financial Planning
- Long-term Capital Planning
- Investment Management Policies
- Debt Management Policies
- Reserve and Liquidity Policies



#### **Revenue and Expenditure Assumptions**

Are the organizations' financial assumptions and projections realistic and well grounded from both long-term and recent perspectives?

Strong	Formal historic trend analysis is performed and updated annually for both revenue and spending; regular effort is made to determine whether revenues or expenditures will deviate from their long-term trends over the next couple of years; evidence of independent revenue forecasting exists(when possible).
Standard	Optimistic assumptions exist that, while supportable, add risk; assumptions are based on recent performance, but little evidence of questioning or validating assumptions exists.
Vulnerable	Assumptions neglect likely shortfalls, expenditure pressures or other pending issues; assumptions exist which enjoy no prudent validation.



#### **Budget Amendments and Updates**

Are there procedures for reviewing and amending the budget based on updated information and actual performance to ensure fiscal targets are met?

Strong	At least quarterly budget surveillance is maintained to identify problem areas and enable timely budget adjustments; management exhibits ability and willingness to address necessary intrA-year revenue and expenditure changes to meet fiscal targets.
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**Standard** Semiannual budget reviews exist; management identifies variances between budget and actual performance.

*Vulnerable* No formal process exists for regular review and timely updating of budget during the year.



#### **Long-term Financial Planning**

Does management have a long-term financial plan that allows them to identify future revenues and expenditures as well as address upcoming issues that might affect these?

Strong	A multi-year financial plan exists where future issues are identified and possible solutions are identified, if not implemented; revenue and expenditure decisions are made primarily from a long-term perspective. Structural balance is a clear goal.
Standard	Multi-year projections are done informally; multi-year projections are done, but without discussion of pending issues, so that issues are not addressed; some one-shot actions exist, but the long-term consequences of these actions are acknowledged and communicated.
Vulnerable	No long-term financial planning exists; operational planning is done on a year-to-year (or budget-to-budget) basis; one-shot budget fixes are used with little attention to long-term consequences.



### **Long-term Capital Planning**

Has the organization created a long-term capital improvement program?

- **Strong** A five-year rolling CIP with funding identified for all years exists and is linked to the operating budget and long-term revenue and financing strategies.
- **Standard** A five-year CIP is done, but is generally limited to projects to be funded from the current budget plus a four-year wish list; some funding for out-year projects is identified, but not all.

Vulnerable No five-year CIP exists; capital planning is done as needs arise.



# **Investment Management Policies**

Has the organization established policies pertaining to investments?

Strong	Investment policies exist and are well defined; strong reporting and monitoring mechanisms exist and are functioning.	
Standard	Informal or non-published policies exist; policies are widely communicated and followed.	
Vulnerable	Absence of informal or non-published policies	



### **Debt Management Policies**

Has the organization established policies on debt issuance; maturity and debt service structure; use of security and pledges, credit enhancement, and derivatives?

Strong	Debt policies exist and are well defined; strong reporting and monitoring mechanisms exist and are functioning. If swaps are allowed, a formal swap management plan that follows S&P's guidelines (see the DDP) has been adopted.
Standard	Basic policies exist; policies are widely communicated and followed. If swaps are allowed there is a swap management plan in place, but it does not follow S&P's guidelines.
Vulnerable	Absence of basic policies or clear evidence that basic policies are followed. Swaps are allowed but there is no swap management plan in place, and/or there is no local (non-FA) knowledge about the swap.



## **Reserve and Liquidity Policies**

Has the organization established a formalized operating reserve policy, which takes into account the governments cash flow/operating requirements and the historic volatility of revenues and expenditures through economic cycles?

**Strong** 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.

*Standard* A less defined policy exists, which has no actual basis but has been historically adhered to it.

Vulnerable Absence of basic policies or, if they exist, are not followed.



#### **Evaluating additional Management Risks**

- Event Risk, how ably can management react to natural disasters
- Political Instability, Turnover or Gridlock
- Inability to execute approved structural reforms
- Management team lacks relevant management skills
- Timeliness of financial disclosure could alert to material negative financial restatements and/or Auditor's ongoing concern
- Is Management actively considering bankruptcy, or are they unwilling to support capital lease or appropriation debt.





Management and administrative characteristics can move a rating up or down more significantly and swiftly than any other factor.

S&P published a list of some distinct commonalities in the management practices of highly rated U.S. public finance issuers over the years.



- Some issuers view a balanced budget as:
  - current revenues + available reserves = operating expenditures
- S&P views a balanced budget as:
  - recurring revenues = recurring expenditures
- Highly rated credits:
  - Maintain or quickly return to structural balance during a period of economic weakness.
  - Are not reliant on one-time revenues to fund ongoing expenditures.



- Ability to manage cash flow and identify potential issues.
- Sufficient money to meet debt obligations.
- Access to pooled cash or interfund loan is not enough, accountability of where cash comes from and how to pay back is important.
- Liquidity risk often tie to variable rate demand obligations or other debt instruments.



- Regular intervals is a key feature of stable financial performance.
- Evaluate historical performance of key revenues is important because each government has different leading or lagging economic indicators that signal potential revenue variance issues based on its economic structure.
- It's also important to identify a surge in revenues to determine if the trend is short term or sustainable.



- Formalized financial reserve policy is a consistent feature of most S&P's highly rate credits.
- Factors to establish the level:
  - Cash flow/operating requirement
  - Volatility of revenue/expenditures, and
  - Susceptibility to a natural disaster



5. Prioritized spending plans and established contingency plans for the operating budget

- What part of the budget is discretionary vs mandatory?
- What spending could be legally or practically reduced?
- Scenario building and analysis of revenue results.



- Growing pension and OPEB pay-as-you-go and unfunded liabilities.
- Management of non-essential government operations such as stadiums, convention centers, golf course.



- Is the plan comprehensive and based on realistic assumptions?
  - Putting a general inflator across all expenditures and revenues might not work for all line items.
- Plan often has out-year gaps projected, which would allow governments to work out, in advance, the optimal method of restoring fiscal balance.



- Many highly rated governments have developed debt affordability guidelines or models, such as:
  - Debt as a percentage of market value;
  - Debt as a percentage of operating expenditures;
  - Variable rate debt does not exceed X% of total debt;
  - Amortization of debt to be no longer than X years, etc.



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

- Advantage is to lower debt service costs but also provides operating budget flexibility when the economy or revenue growth slows.
- A long term capital improvement plan that identify sources and uses of fund.



- How significant a resource commitment should be dedicated to running economic development programs and offering incentives?
- Synergies of activities to create employment, enhance diversification, and generate solid income growth.
- Coordinated effort between state and local governments.



#### Top 10 Management Characteristics of Highly Rated U.S. Public Finance Issuers

FMA Category	Example from Article
Revenue and expenditure assumptions	1
Budget amendments and updates	2, 3, 5
Long term financial planning	7
Long term capital planning	9
Investment management policies	2
Debt management policies	6, 8
Reserve and liquidity policies	2, 4

Proactive budget and liability planning, strong liquidity management, and the establishment of reserves are among the factors the strongest issuer share



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