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The Top 10 Management Characteristics Of Highly Rated State And Local Borrowers

Primary Credit Analysts:
Robin L Prunty, New York (1) 212-438-2081; robin.prunty@spglobal.com
Geoffrey E Buswick, Boston (1) 617-530-8311; geoffrey.buswick@spglobal.com

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U.S. public finance government borrowers are a varied group, but those with the strongest credit profiles have a lot in common when it comes to management practices. Our rating criteria (available at www.standardandpoors.com) show that in addition to heavily quantitative measures, we also rely on qualitative factors to inform our credit analysis. Among these are our Financial Management Assessment (FMA), which offers a more transparent assessment of a government's financial practices. Indeed, 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 that are the foundation of our quantitative analysis. Management's policies and behaviors can positively affect ratings in a number of ways.

On the whole, state and local governments have made many improvements to budget structure, reserve policies, and debt management over time. Whether these practices were developed as part of a comprehensive risk management plan or individually, they have, in our view, generally enhanced a government's ability to manage through downturns and have contributed to credit stability. We also believe that the lack of strong management can be a significant factor in a weak credit profile. So while the economy is obviously a key factor in assigning a rating level to a government issuer, our view of management is usually one of the deciding factors in fine-tuning the rating.

Overview

- We've observed some distinct commonalities in the management practices of highly rated U.S. public finance government issuers over the years.
- Our view of a government entity's management and administrative characteristics, along with other structural issues it faces, can move a rating up or down significantly and swiftly.
- Proactive budget and debt/liability planning, strong liquidity management, and the establishment of reserves are among the factors the strongest issuers share.

The qualitative part of our analysis looks not only at the institutional and legal framework that the borrower operates in, but its day-to-day management procedures and policies. There could be a seemingly strong management team in place, but if management lacks the willingness to make difficult decisions, it may wind up being ineffective.

The following "Top 10" list of management characteristics associated with S&P Global Ratings' highly rated borrowers is generally applicable to state and local governments. The relative importance of these factors may vary from issuer to issuer. Our view of credibility is an important part of a rating review process and management assessment. Every government has challenges, but we believe that identifying problems or issues and detailing how these will be addressed establish credibility and greater transparency in the rating process.

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Top 10 List

1. Focus on structural balance

In our view, a structurally balanced budget is an essential characteristic of highly rated credits. There are many views of what constitutes a balanced budget. For some governments, a budget is balanced if current revenues plus available reserves match or exceed current expenditures. From S&P Global Ratings' standpoint, a budget is balanced if recurring revenues match recurring expenditures. In evaluating whether a budget is balanced, we analyze the underlying revenue and expenditure assumptions. We might not have a positive view of a budget that relies on optimistic revenue assumptions relative to the current economic environment to meet recurring expenditures. We consider recurring expenditures all of those that are typically incurred year after year and are required as part of a government's normal ongoing operations. This includes salaries, debt service, and actuarially determined pension payments among others. Consistent with our analysis of revenues, expenditure assumptions that rely on debt restructuring for budgetary savings, deferral of ongoing expenditures or infrastructure requirements, insufficient funding for retirement liabilities, and saving assumptions that have significant implementation risks could also color our view of whether a budget is balanced or not.

2. Strong liquidity management

An additional credit quality factor is management's ability to manage its cash flow and identify potential issues, internal or external, that could lead to a liquidity imbalance. Potential for inadequate liquidity serves as a bellwether to the risk of immediate and potentially severe credit deterioration, particularly for those with significant budget misalignments or contingent liquidity exposure, in our view. Ultimately, the possibility of having insufficient resources to meet debt obligations is at the heart of our credit analysis. In the few instances where state or local governments may encounter genuine credit distress, it is likely accompanied and possibly exacerbated by problems with liquidity. Access to additional sources of internal or external liquidity and a plan on how, when, and in what amounts to access these, are a credit positive.

In addition, some obligors' debt profiles include liquidity risk exposure tied to variable-rate demand obligations, alternative financing products (such as direct purchase loans and bank loans), derivative instruments, and other debt instruments. Under some of these structures, the potential for accelerated repayment causing sudden and significant demands on an issuer's liquidity could have credit implications (see "Contingent Liquidity Risks In U.S. Public Finance Instruments: Methodology And Assumptions," March 5, 2012). We have found that management teams of highly rated credits fully understand the risks assumed in these structures and are able to limit, mitigate, or develop a careful plan to manage the potential exposure to these liquidity demands.

3. 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 its economic structure. The earlier revenue

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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, it is also important to understand a surge in revenues to determine if the trend is an aberration or something that is likely to be sustained.

4. An established rainy day/budget stabilization reserve

A formalized financial reserve policy is a consistent feature of most of S&P Global Rating's highly rated credits. 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 S&P Global Ratings' 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 historical volatility of revenues and expenditures through economic cycles;
- Susceptibility to contingent liquidity provisions in alternative financing documents;
- 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 budget gap in the following year if economic trends continue to be weak.

5. 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. Prioritized spending and contingency plans have always been important risk management tools. In our analysis, we consider whether a government has contingency plans and options to address changing economic conditions, intergovernmental fund shifts, budget imbalance when it occurs, as well as other emerging risks that may require resource allocation. These other emerging risks include cyber security, natural disaster risk, sustainability, infrastructure deficiencies and deferred maintenance. We note that risks facing governments may be different and evolve over time and those that regularly monitor, plan and manage them are better positioned to respond swiftly. As it relates to environmental events or cyber attacks, there are various recognized "best practices" to mitigate the risks. In general they can be summarized as identifying vulnerabilities, storm harden structures and cyber harden systems ensuring reliable backups, train and have written policies, and test policies and systems for weaknesses.

6. Strong long-term and contingent liability management

In our view, recognition and management of long-term and contingent liabilities are characteristics of highly rated credits. We continue to incorporate governmental liability management into our rating analysis, as we have for decades, with an emphasis on how liabilities are managed over time. In particular, we view pension and other postemployment benefit obligations as long-term liabilities that will require funding over time and we regularly publish on these issues as it relates to state and local governments. While the funding schedule for pension and OPEB can be more flexible than that for a fixed-debt repayment, it can also be more volatile and may cause fiscal stress if not managed, in our opinion. The size of the unfunded liabilities, the annual costs associated with funding them relative to

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the budget, and the credibility of assumptions, are important credit factors in our review of state and local governments. Currently, pension systems are undergoing the most significant reform in decades--which we view as a credit positive--highlighting the importance of managing these liabilities. We will continue to differentiate credits where these long-term liabilities are large and growing, contributions are less than required, and there has been limited action on reform initiatives.

Other areas of government operations and services that may fall out of the traditional general fund focus could also result in contingent liabilities and create budget pressures if not properly managed. Stadiums, convention centers, and health care entities, as well as various other enterprise operations, could cause funding challenges for governments, even when there is no clear guarantee or 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 and policy challenge for the state.

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

As we mentioned above, a balanced budget is a characteristic of highly rated governments, but maintaining such balance over time is often a challenge. Government officials are responsible for the decisions necessary to restore out-year budget balance. In our view, even when there is legal authority to raise taxes, there may not be a practical ability to do so because it can be politically unpopular. Having detailed information on costs associated with various policy decisions can provide greater transparency to the budget process, in our view. We consider comprehensive multiyear planning to be an important part of this process. We realize that the out-years of a multiyear plan are subject to significant change. They provide a model to evaluate how various budget initiatives affect 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.

8. A formal debt management policy in place to evaluate future debt profile

The use of debt affordability guidelines or models has expanded, which we regard as a positive development. This affordability analysis generally includes a systematic review of existing and proposed debt, and how they will affect a government's future financial profile. In many cases, these policies address exposure to variable-rate debt, swaps, and other contingent liabilities. They can also include criteria for when refunding bonds are allowed, amortization periods, and what types of projects can be funded through debt issuance. The affordability measures are typically tied to a government's revenues or expenditures, debt per capita, and debt per capita as a percent of either gross state product (states) or market value (local governments). The impact of these policies on a long-term credit rating will depend on our view of how the government establishes and uses the policies, and the track record in adhering to the affordability parameters established in the policies, especially during economic downturns. We believe the process enhances the capital budgeting and related policy decisions regarding debt issuance and amortization. In our view, these policies have moderated leverage at the state and local level.

9. A capital planning process

A government with a comprehensive assessment of capital and infrastructure requirements, including deferred maintenance, will be better positioned to manage these requirements over time in the most cost effective way. Neglecting critical capital needs may contribute to higher future costs and also impede economic growth and endanger

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future revenue generation. A capital improvement plan indicating both funding needs and anticipated funding sources is a useful planning tool for determining future borrowing needs.

10. A well-defined and coordinated economic development strategy

In addition to historical economic trends, we consider each government's economic development initiatives and future growth prospects as they are likely to affect future revenue-generating capacity. Effective economic development programs typically take a long time to implement and may involve some resource commitment. A plan that includes a cost benefit analysis and tracks outcomes can provide meaningful information for a government when evaluating the level of resource allocation. If these economic development programs and strategies create employment and income growth and diversification and there is a net revenue benefit to a government, we could view that favorably.

Related Criteria And Research

Related Criteria

- USPF Criteria: State Ratings Methodology, Oct. 17, 2016
- USPF Criteria: Local Government GO Ratings Methodology And Assumptions, Sept. 12, 2013
- USPF Criteria: Financial Management Assessment, June 27, 2006

Related Research

- Pension Pressures Will Weigh On 15 Largest U.S. Cities' Budgets, March 8, 2017
- State Pensions: Weak Market Returns Will Contribute To Rise In Expense, Sept. 12, 2016
- Rising U.S. State Post-Employment Benefit Liabilities Signal An Unsustainable Trend, Sept. 6, 2016
- Incorporating GASB 67 And 68: Evaluating Pension/OPEB Obligations Under Standard & Poor's U.S. Local Government GO Criteria, Sept. 2, 2015

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