

Municipal Bond Ratings: Financial Management Assessment in Public Finance

NASACT Annual Conference
August 13, 2007


Ted Chapman
Standard & Poor's
Public Finance Ratings
(214) 871-1401
Theodore_Chapman@standardandpoors.com

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General Obligation (G.O.) Credit Ratings

- Full faith and credit pledge
- Most often, secured by an unlimited ad valorem property tax
- Most ratings, over time, have a general tendency to stay the same or go up
- Very low default ratio

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Rating Transitions After One Year (%) *

Rating Category	AAA	AA	A	BBB	BB
AAA	96.27	2.48	0.16	0.00	0.00
AA	0.48	91.99	1.44	0.04	0.00
A	0.02	2.01	88.77	0.95	0.04
BBB	0.00	0.05	2.86	87.64	0.64
BB	0.00	0.09	0.26	7.88	77.66

*All U.S. Public Finance issuers, 1986 to 2006. Source: Standard & Poor's data, as of July 2006

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G.O. Credit Ratings

Main Rating Criteria

- Economy
 - Tax base
 - Employment base
 - Location in/near major metropolitan area
- Financial condition
 - Historical results, current condition, likely future projections
- Debt
 - Current debt burden
 - Identified capital requirements over the medium- and long-term
- Management

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The Financial Management Assessment

An analytical methodology that evaluates established and ongoing management 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

Currently applicable only to general government tax- and appropriation-backed issues, excluding special districts.


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Why the FMA?

- Better transparency to aspects of the analysis that have existed all along
- Better communication and disclosure of the environment in which financial decisions are made
- Highlights in a consistent manner the most transparent aspects of management that are common to most governments

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What The FMA Is and What The FMA Isn't

IS

- One component of the entire rating process
- An enhancement to the existing process
- An evaluation of the guiding assumptions and policies regarding financial decision-making
- An affirmation of best practices you've probably already heard preached by S&P, GFOA, ICMA, etc.

ISNT

- A separate rating
- An evaluation of the competency or aptitude of individual finance professionals or elected and appointed representatives
- An assessment of actual financial performance

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Revenue and Expenditure Assumptions

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); budgeting performance is either good or conservative.
Standard	Optimistic assumptions exist that, while supportable, add risk; assumptions are based on recent performance, but little evidence of questioning or validating assumptions exists. Budget performance is mixed and sometimes reflects optimistic assumptions.
Vulnerable	Assumptions neglect likely shortfalls, expenditure pressures or other pending issues; assumptions exist which enjoy no prudent validation.

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Budget Amendments & Updates

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.
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.

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Long Term Financial Planning

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.

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Long Term Capital Planning

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.

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Investment Management Policies

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.

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Debt Management Policies

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 ¹) 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.

¹ DDP = Debt Derivative Profile

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Reserve and Liquidity Policies

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.

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Overall Assessment

Strong	A Financial Management Assessment of "strong" indicates that practices are strong, well embedded, and likely sustainable. The government maintains most best practices deemed critical to supporting credit quality and these are well embedded in the government's daily operations and practices. Formal policies support many of these activities, adding to the likelihood that these practices will be continued into the future and transcend changes in the operating environment or personnel.
Good	A Financial Management Assessment of "good" indicates that practices are deemed currently good, but not comprehensive. The government maintains many best practices deemed as critical to supporting credit quality, particularly within the finance department. These practices, however, may not be institutionalized or formalized in policy, may lack detail or long term elements, or may have little recognition by decision makers outside of the finance department.

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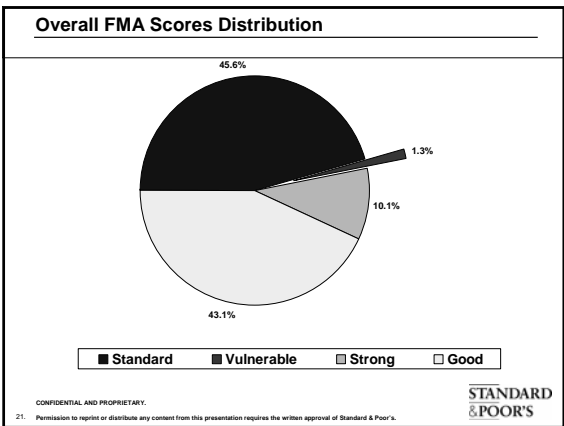
Overall Assessment (continued)

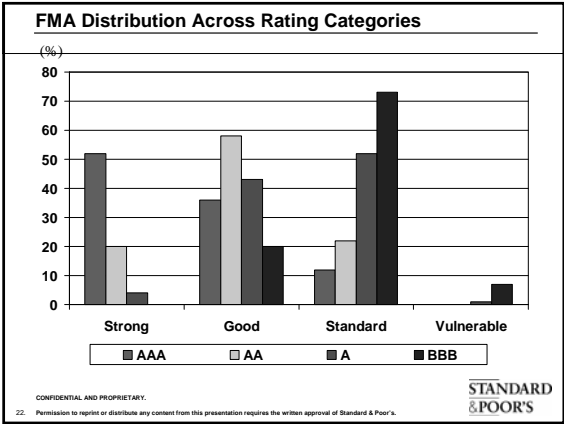
Standard	A Financial Management Assessment of 'standard' indicates that the finance department maintains adequate policies in most but not all key areas. These policies often lack formal detail and institutionalization and may not include best practices. Such policies would be more commonplace in smaller governments with limited finance department resources.
Vulnerable	A Financial Management Assessment of 'vulnerable' indicates that the government lacks policies in many of the areas deemed most critical to supporting credit quality. The 'vulnerable' designation suggests a high degree of uncertainty regarding a government's ability to effectively adapt to changing conditions that could threaten its long-term financial position.

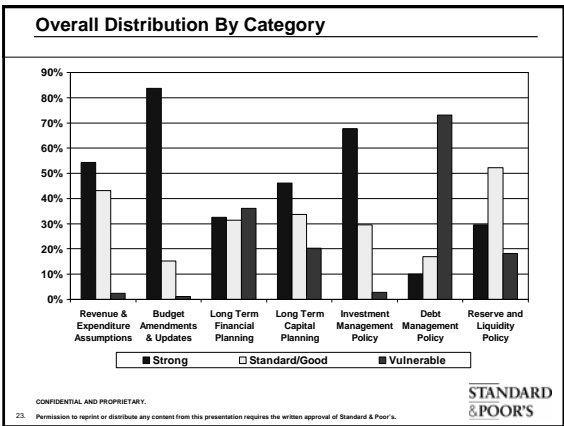
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- So What Have We Seen So Far?**
- About 2,000 assessments completed since June 2006
 - About 90% are either 'standard' or 'good'
 - Strong degree of correlation between the FMA and credit strength
 - Certain areas consistently show strengths
 - Budget amendments and updates
 - Certain areas consistently show opportunities for improvement
 - Debt management policies
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- ### For More Information
- “GO Credit Ratings Are At A Crossroads As Downgrades Increase” (June 15, 2006)
 - “Public Finance Criteria: Financial Management Assessment” (June 27, 2006)
 - “Credit FAQ: Financial Management Assessment In U.S. Public Finance” (June 27, 2006)
 - “U.S. Municipal Rating Transitions and Defaults, 1986-2006” (July 13, 2006)
 - “A Year of FMA Shows Correlation Between Scores and Credit Strength” (June 5, 2007)
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Questions?



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