

## **Virginia Government Finance Officers' Association (2008 Fall Conference)**

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# How Current Economic Conditions Affect Municipal Bond Ratings

# Topics

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- **Our View of The Current Economic Climate?**
- **Is The Current Economic Climate Impacting Credit Quality?**
- **What Credit Factors Do We Consider The Most Important?**
- **Thoughts on Management**
- **Key Credit Issues For Virginia**

# Economic Condition

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## IHS GLOBAL INSIGHT Reports for Virginia:

- **Job creation has lost momentum, with job growth in 2008 at 0.5%**
- **Commonwealth's unemployment rate continues to rise (estimated at 4.4% in August 2008 versus national rate of 5.9%), but remains one of the lowest of all states in the U.S.**
- **Virginia is experiencing losses in manufacturing, construction and finance sectors**
- **Growth in education and health services sectors somewhat offsetting losses in above sectors**
- **IHS projects Virginia will continue to experience a sharp slowdown in job growth in 2009, but without losses prevalent in so many states, before resuming growth in 2010**

# **Our View of The Current National Economic Climate**

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- **Slowing of construction (new taxable activity down)**
- **Housing values declining**
- **Economically sensitive revenues slowing**
- **Many states project growing deficits**
- **Overtaxed citizens**
- **Housing slump/subprime issues**
- **Rising unemployment**
- **None of these issues unique to Virginia**

# Virginia Specific

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- **After years of strong tax base growth, Virginia now experiencing slow growth/no growth**
- **The State's own budget limitations and projected revenue deficit (\$2.5 billion over the 2008-2010 biennium)**
- **Heightened taxpayer sensitivity**
- **Limited revenue raising options compared to some other states**

# What Does This Mean For Bond Ratings

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- **Our bond ratings take a long-term perspective**
- **Often short term events (positive or negative) do not necessarily result in rating changes**
- **While some aspects of credit may be at times strained, other factors may be sufficiently stable**
- **Management remains key**

# Tax Backed Credit Analysis

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## Our Tax Backed Credit Analysis Focuses On Four Factors:

- **Economy**
- **Debt**
- **Finances**
- **Management**

*Which Factors Do We Consider Most Important and Why?*

# Rating Factors

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- **S&P uses quantitative and qualitative measures in evaluating credit.**
- **Quantitative factors include the use of key ratios on economic, financial and debt.**
- **Qualitative factors focus on Management.**

# Rating Factors

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## Economic Factors:

- Trends in economic activity
- Demographics/wealth levels
- Labor statistics including unemployment and labor force changes
- Largest employers
- Employers and tax base concentration
- Tax base valuation trends

# Rating Factors

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## Finances:

- Reserve trends over multi-year audited periods
- Year end financial position
- Reserve levels (and how they are managed)
- Cash flow/liquidity
- Investments
- Pensions
- Budgeting
- Trends, trends, trends

# Rating Factors

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## Debt:

- Debt burden (past, present, future)
- Debt profile (types of debt outstanding securing the bonds)
- Amortization schedule
- Contingent liabilities
- Capital needs
- Financing options
- Key debt ratios (depending on security)

# Rating Factors

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## Management:

- Governance
- Management focus
- Tenure/staffing
- Operating policies and procedures
- Labor relations
- *Ability to respond to rapidly changing economic and financial conditions*

# **Management Remains Key**

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## **How Does S&P Develop Its Opinion of Management?**

### **Financial Management Assessment (FMA)**

- **Introduced in June 2006**
- **The FMA is an analytic enhancement adopted by S&P to improve the definition of our analysis of management practices and policies, and expand our methods of communicating analytic conclusions about policies and procedures.**

**The FMA encompasses seven areas we believe are most likely to affect credit quality:**

- **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**

# Prioritize Spending Plans/Establish Contingency Plans

- Are contingency plans in place in case budgets need to be adjusted on short notice?
- What part of the budget is discretionary?
- How quickly can spending be changed/slowed?
- Where is the revenue flexibility?

**“Through targeted spending reductions, the county was able to offset a projected \$200,000 revenue shortfall without impacting essential services or dipping into reserves”.**

# Regular Economic and Revenue Review

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- **We believe 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 if a government relies on economically sensitive revenues such as income, consumption based taxes and fees and charges**
- **The earlier revenue weakness is identified in the fiscal year, the more effective the budget balancing response can be.**

**“Proactive, ongoing monitoring of revenue patterns is a key credit strength.”**

# Maintain and Follow a Formalized Capital Improvement Plan

- **Multi-year (5) that prioritizes and identifies funding sources;**
- **Is reviewed and updated annually;**
- **Assesses the impact of capital projects on operating budget; and**
- **Is integrated with a financial plan.**

**“The county’s 5 year capital improvement plan, while quite ambitious, fully identifies revenue funding sources. Most of the CIP that will be debt financed is expected to be self-supporting and therefore will not significantly increase it’s debt burden”.**

# Multi-Year Financial Plan

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- **A comprehensive multi-year financial plan that considers affordability and impact on annual budget.**
  - **Are all potential operating and capital costs identified and projected over a multi-year period?**
  - **Are new programs and additional debt measured against revenue necessary to sustain such items?**
  - **Are alternative scenarios (assumptions about revenues and expenditures) utilized?**
  - **3 to 5 year forecasts are ideal**
- “ The school district’s multi-year financial plan incorporates not only the cost of the new school, but also identifies associated additional operating costs as the building comes on line.”*

# Red Flags

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- **Fund balance comprised mostly of receivables**
- **Declining cash**
- **No cash**
- **Outstanding cash flow operating notes past the end of the fiscal year**
- **Large and growing due to other funds, other governments**
- **Growing accounts payable**
- **Growing amount of transfers**
- **Fund balances dipping into the negative**
- **For one year – questions must be raised – over a few years “a troubling trend”**

# Conclusion

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- **Bond ratings reflect S&P's long-term perspective.**
- **Often short- term events (positive or negative) do not necessarily result in rating or outlook changes.**
- **Management remains key.**

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