U.S. Local Governments: General Obligation Ratings Methodology and Assumptions – One Year Later

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Agenda

- Introduction
- Overview of Criteria and Analytic Framework
- Summary of Factors
- Ratings Impact
- Regional Results
- Q&A

Overview of Criteria

And Analytic Framework

Introduction

The scope of the criteria

- All U.S. local government issuer credit ratings and issue ratings on General Obligation (GO) bonds issued by municipal governments that are not special purpose districts

This criteria is intended to:

- Provide transparency into our rating process
- Enhance ratings comparability
- Formalize the forward-looking rating component

The one-year implementation period ended on September 12, 2014

Improved Transparency and Comparability

The update provides transparency similar to that contained in the state criteria

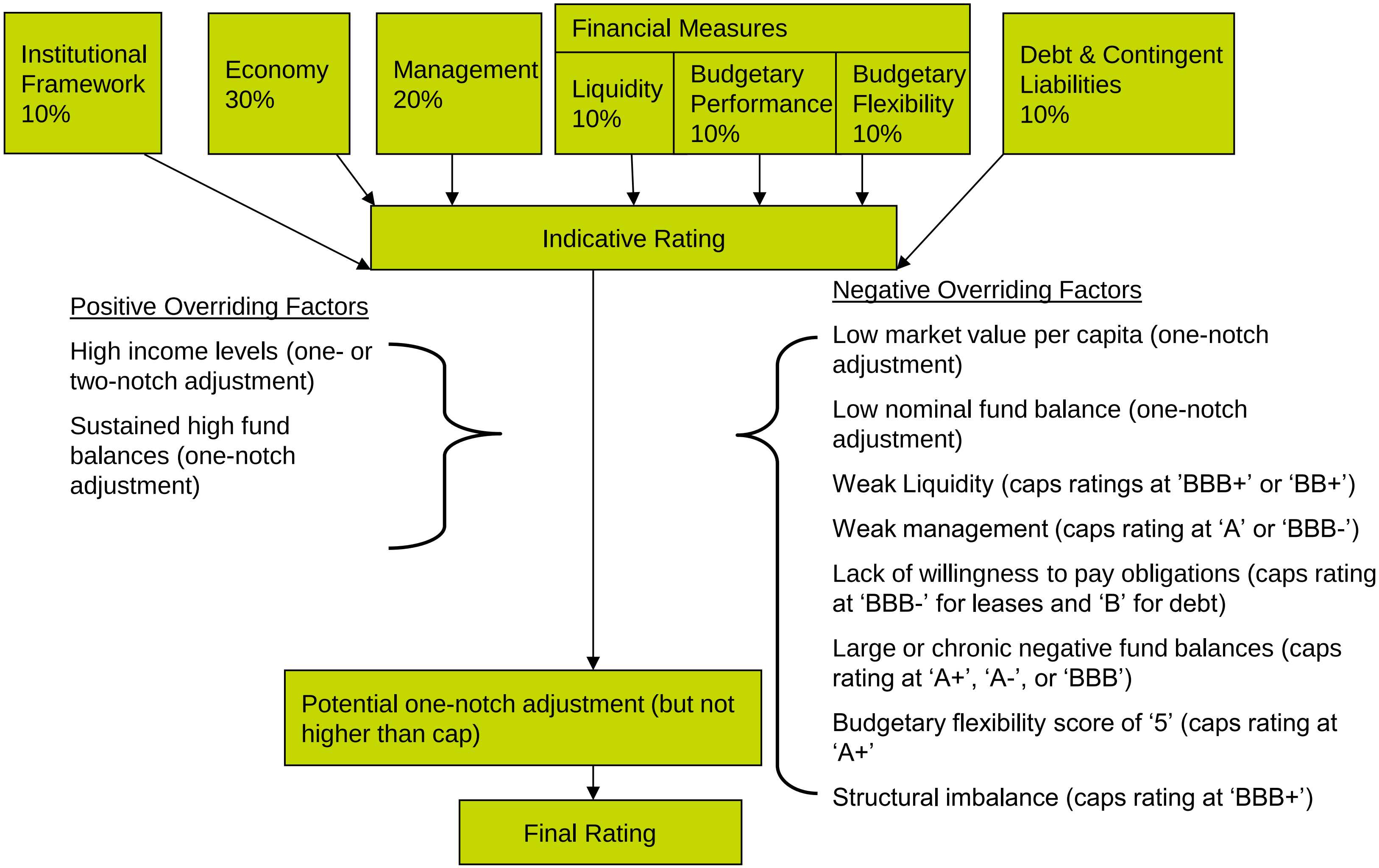
Greater clarity on how to derive Standard & Poor's Ratings Services' U.S. public finance ratings

- Builds on similar underlying principles as we previously used
- Allows for greater understanding of how we arrive at specific ratings
- Aids in understanding how ratings may change given underlying conditions

Criteria resulting in forward-looking and comparable ratings

- Comparability across sectors and regions

Analytical Framework



Source: Standard & Poor’s Ratings Services.

Analytical Framework

- Score Range Descriptors for Each Framework Factor:
  - 1 = “Very Strong”
  - 2 = “Strong”
  - 3 = “Adequate”
  - 4 = “Weak”
  - 5 = “Very Weak”

Summary of the Factors

Local GO Criteria Factors

Institutional Framework (1 of 7 Factors)

Institutional Framework 10%

Assesses the legal and practical environment in which the local government operates

The score is based on the average of four discretely scored areas

- *Predictability*: the extent to which a local government can forecast its revenues and expenditures on an ongoing basis (Table 4)
- *Revenue and expenditure balance*: the extent to which a local governments have the ability to finance the services they provide (Table 5)
- *Transparency and accountability*: the overall institutional framework's role in encouraging the transparency and comparability of relative financial information (Table 6)
- *System support*: the extent to which local governments receive extraordinary support from a state government when the local government is under extreme stress (Table 7)

Institutional Framework (1 of 7 Factors)

Institutional Framework
10%

All governments of the same type within the same state receive the same score

- Cities and counties can differ
  - Municipalities of the same type can differ based on home rule status, population, etc.

The institutional framework scores will be reviewed and maintained on an ongoing basis

Table 3: Institutional Framework Score Outcomes	
Score Range	**Institutional Framework Score**
1 – 1.5	1 (very strong)
1.75 – 2.75	2 (strong)
3.0 – 3.75	3 (adequate)
4 – 4.5	4 (weak)
4.75 – 5	5 (very weak)
The institutional framework score results from the average of the scores for predictability, revenue and expenditure balance, transparency and accountability, and systemic support (see paragraphs 37-40). Each score receives equal weight in the average.	

Source: Standard & Poor's Ratings Services.

Institutional Framework

Kansas Local Govt Type	IF Score
Counties	2 (strong)
Counties (under $275,000 in annual revs)	2 (strong)
Municipalities	2 (strong)
Municipalities (under $275,000 in annual revs)	2 (strong)
City/county unified govts	2 (strong)

- **Only new factor that is now part of the rating**
  - Formalizes what we were already doing
- **IFs are assigned in advance**
  - Does not need a conversation during the rating call

Economic Score (2 of 7 Factors)

Economy
30%

- **Assess both the health of the asset base relied upon to provide both current and future locally derived revenues as well as the likelihood of additional service demands resulting from economic deterioration**
- **The initial score (1 through 5) is based on market value per capita and projected per capita income as a % of U.S. (Table 8)**
- **Per capita income is based on a 5-year projection**
- **Especially high income will lead to a positive override and especially low market value per capita will lead to a negative override**

	Total Market Value Per Capita				
Projected Per Capita EBI as a % of U.S. Projected Per Capita EBI	>$195,000	$100,000 to $195,000	$80,000 to $100,000	$55,000 to $80,000	≤$55,000
>150	1	1.5	2	2.5	3
110 to150	1.5	2	2.5	3	3.5
85 to110	2	2.5	3	3.5	4
70 to 85	2.5	3	3.5	4	4.5
≤70	3	3.5	4	4.5	5

Source: Standard & Poor's Ratings Services.

Economic Score Adjustments

Economy
30%

Qualitative factors with a positive impact on the initial score	Qualitative factors with a negative impact on the initial score
Participation in a larger broad and diversified economy.	Negative budget impact from demographic profile: population decrease and/or high share of dependent population (>55%) have a material negative impact on future revenue growth and expenditure needs.
A stabilizing institutional influence with a longstanding role as a major employer, such as higher education, health care, military, or large and stable corporate presence.	High county unemployment rate (>10%).
	If employment concentration where an individual sector (excluding education/health, government, and transportation, trade and utilities) represents more than 30% of the nonfarm work base, or tax base concentration where the top 10 taxpayers represent more than 35% of the tax base, the score worsens by one point. If the top 10 taxpayers exceed 45% of the tax base, the score worsens by two points.

Source: Standard & Poor's Ratings Services.

Management Score (3 of 7 Factors)

Management 20%

- **Assess the impact of management conditions on the likelihood of repayment**
- **Financial Management Assessment (FMA) is based upon our current methodology**

Table 9: Assessing the Management Score

Rounded Score	Characteristics
1 (Very strong)	FMA score of “strong” and none of the factors in score ‘4‘ or ‘5’ is present.
2 (Strong)	FMA score of “good” and none of the factors in score ‘4‘ or ‘5’ is present.
3 (Adequate)	FMA score of “standard” and none of the factors in score ‘4‘ or ‘5’ is present.
4 (Weak)	FMA score of “vulnerable” or any of the following is present: there is a financial reporting restatement that has a material negative impact; any of the conditions in score ‘5’ existed in the past three years; the structural imbalance override condition exists or existed within the past three years; or a very high debt, pension and OPEB burden.
5 (Very weak)	Regardless of the FMA score, any of the following is present: a management team that lacks relevant skills resulting in a weak capacity for planning, monitoring, and management; an auditor has delivered a going concern opinion; the government appears unwilling to support a debt or capital lease obligation; or the government is actively considering bankruptcy in the near term

Source: Standard & Poor’s Ratings Services.

Management Score Adjustments

Management
20%

Qualitative factors with a positive impact on the initial score	Qualitative factors with a negative impact on the initial score
Consistent ability to maintain balanced operations.	Frequent management turnover inhibiting a current understanding of the government's financial position and its ability to adjust, or political gridlock, or instability that brings the same results.
Government service levels are limited.	Consistent inability to execute approved structural reforms for two consecutive years.

 Source: Standard & Poor's Ratings Services.

Management

Capped Score of ‘4’:

- Finances have been structurally imbalanced over past 3 years
- Debt, pension, and OPEB burden considered very high and management does not have a credible plan to address the situation
- Any condition that has resulted in a ‘5’ management score has existed in the past three years
- Caps the final rating at ‘A’ or one notch lower than the indicative

Capped Score of ‘5’:

- Management team lacks relevant skills to adequately plan, monitor, and manage the government’s finances
- Going concern opinion
- Unwillingness to support a debt, capital lease obligation, or moral obligation pledge
- Active consideration of bankruptcy filing in the near term

Financial Measures

- **Three components factor into our assessment of a municipality's financial credit characteristics**
- **Budgetary flexibility, budgetary performance, and liquidity**
- **Each factor is weighted 10% — all financial measures together are 30%**

Financial Measures		
Budgetary Flexibility 10%	Budgetary Performance 10%	Liquidity 10%

Financial Measures: Budgetary Flexibility Score (4 of 7 Factors)

Budgetary Flexibility 10%

The budgetary flexibility initial score measures the degree to which the government can create additional financial flexibility in times of stress

- Available fund balance as a % of general fund expenditures: for the most recently reported fiscal year
- When other fund balances outside of the government's general fund are available beyond the current fiscal year, they are included in the calculation
- This measure can cap a rating or it can be a positive override if extremely strong

Table 10: Assessing The Budgetary Flexibility Score

	Available Fund Balance as a percentage of expenditures				
%	>15	8 to15	4 to 8	1 to 4	≤1
Score	1	2	3	4	5

Source: Standard & Poor's Ratings Services.

Budgetary Flexibility Score Adjustments

Budgetary Flexibility 10%

Qualitative factors with a positive impact on the initial score	Qualitative factors with a negative impact on the initial score
If projections for the current year and the following year suggest a better initial score.	If projections for the current year and the following year suggest a worse initial score.
Ability to avoid financial imbalances with demonstrated capacity and willingness to cut operational spending (by more than 2%), resulting from a flexible cost structure, flexible legislation, and/or widespread political support.	High levels of questionable receivables or amounts due from other funds with deficit balances.
Existing state tax caps do not apply to the government, or the government retains substantial flexibility under the caps.	Limited capacity to cut expenditures due to infrastructure or operational needs or political resistance.
Demonstrated ability and willingness to raise taxes when needed (and voter support is usually obtained when such approval is required).	Limited capacity to raise revenues due to consistent and ongoing political resistance which can include self-imposed restrictions through charter or local initiative processes.
Timing of fiscal year and tax billing dates result in high cash with abnormally low fund balance levels.	Where cash accounting is used, the criteria use cash balances instead of fund balances and the score is worsened by one point.
Maintenance of an available fund balance exceeding 30% of general fund expenditures for the most recently reported year, the current year and the next year.	

Source: Standard & Poor's Ratings Services.

Budgetary Flexibility

- **Want to know all sources of reserves**
  - Highlight all accounts where 'available' reserves are kept, including those outside the general fund
  - Analysts will ask for current year figures, as well as next year's projections or budget
  - Can be last audited year plus most recent unaudited numbers
- **Other questions**
  - Are any major receivable amounts expected to be uncollectible?
  - Planned expenditure reductions for this year and next?
  - What kind of taxing flexibility do you have, and how much could it generate? Have you increased taxes beyond inflationary levels in recent years?

Financial Measures: Budgetary Performance Score (5 of 7 Factors)

Budgetary Performance 10%

The budgetary performance initial score measures the current fiscal balance of the government

- Total governmental funds net result: the most recent year's net total governmental funds on a budgetary basis as a percent of expenditures
- General fund net result: the most recent year's general fund operational balance as a percent of expenditures

Table 11: Assessing The Budgetary Performance Score					
	Total Governmental Funds Net Result (%)				
General fund net result (%)	> -1	-1 to -5	-5 to -10%	-10 to -15	≤ -15
(> 5)	1	2	3	3	4
(-1 to 5)	2	3	3	4	5
(≤ -1)	3	4	4	5	5

Source: Standard & Poor's Ratings Services.

Budgetary Performance Score Adjustments

Budgetary Performance 10%

Qualitative factors with a positive impact on the initial score	Qualitative factors with a negative impact on the initial score
Expected structural improvement: if projections for the current year and following year suggested a better initial score, the score would improve by one point. The score would improve by two points only if required adjustments to revenues or expenditures to produce the result were already approved.	Expected structural deterioration: if projections for the current year and following year suggested a worse initial score, the score would worsen by one or two points. To worsen by two points, expected performance must fall to the commensurate level within the current year.
	Deferred payments on a cash basis: in cases where good ratios hide significant underspending due to deferred payments, the deferral produces a better score.
	Significant historic volatility in performance because of very cyclical revenues (e.g., oil & gas or sales tax on luxury goods and/or dependence on volatile state transfers) or exposure to event-related risks, the sources of volatility remain.

Source: Standard & Poor's Ratings Services.

Budgetary Performance

- **Projections for current and future years will also be important here**
  - Kansas Budgets
- **Calls/meeting with analysts will likely include:**
  - Discussion of transfers in/out of general fund
    - *Regular transfers to/from enterprise funds*
    - *Regular transfers for debt service payments*
  - Conversations regarding capital expenditures and any one-time revenues or expenditures, including bond proceeds
    - *Both for the general fund and total governmental funds*
  - Existence/changes to deferred payments
  - Structural imbalance: existence of such and plans to remedy

Financial Measures: Liquidity Score (6 of 7 Factors)

Liquidity
10%

The initial score measures the availability of cash and cash equivalents to service both debt and other expenditures

Initial liquidity score: combination of two measures (table 12)

- Total government cash as % of total governmental funds debt service
- Total cash % of total governmental funds expenditures

Table 12: Assessing The Liquidity Score

	Total Government Available Cash As % Of Total Governmental Funds Debt Service				
Total Government Available Cash As % Of Total Governmental Funds Expenditures	>120	100 to120	80 to100	40 to 80	≤40
>15	1	2	3	4	5
8 to15	2	2	3	4	5
4 to 8	3	3	3	4	5
1 to 4	4	4	4	4	5
≤1	5	5	5	5	5

Source: Standard & Poor's Ratings Services.

Liquidity Score Adjustments

Liquidity
10%

Qualitative factors with a positive impact on the initial score	Qualitative factors with a negative impact on the initial score
If projections for the current year (and the following year) suggest a better score, the score improves by one point.	If projections for the current year (and the following year) suggest a worse initial score, the score worsens by one point.
If access to external liquidity is ‘exceptional’ as defined in table 13, the score improves by two points; if ‘strong’, the score improves by one point.	If access to external liquidity is ‘uncertain’ as defined in table 13, the score worsens by two points; if ‘limited’, the score worsens by one point.
Very robust and stable internal cash flow generation capacity compared with peers in this category.	High refinancing risk over the next 24 months.
	Aggressive use of investments.
	Exposure to non-remote contingent liability risk that could come due within 12 months.

Source: Standard & Poor’s Ratings Services.

Liquidity

- **Additional focus on**
  - Unrestricted total government cash balance
    - Most recent audit, plus current and upcoming year
  - Highly liquid investments that are not included as cash?
  - Contingent liabilities due in the next year?
  - Details of existing short term liquidity facilities
  - Direct purchase debt?
  - Frequency of non-GO debt issuance?
  - BANs outstanding that will need to be refinanced?

Liquidity

- *Addition of positive and negative qualitative adjustments:*
  - *Factor Score impact: If projections for the current year and the following year suggest a better/worse initial score, then the score improves/worsens by one point*
- *Liquidity score of 4 caps the rating at 'BBB+'*
- *Liquidity score of 5 caps the rating at 'BB+'*
- *Non-remote contingent liabilities that reach certain levels without a credible plan to finance will trigger these caps*

Debt and Contingent Liability (7 of 7 Factors)

Debt & Contingent Liabilities
10%

Initial debt score: combination of two measures (table 14)

- Total governmental funds debt service as a percentage of expenditures
  - Measures the annual fixed cost burden that debt places on the government
- Net direct debt as a percentage of total governmental funds revenue
  - Measures the total debt burden on the government's revenue position rather than the annual cost of the debt, which can be manipulated by amortization structures

Table 14: Assessing The Debt And Contingent Liabilities Score

	Net Direct Debt As % Of Total Governmental Funds Revenue				
Total Governmental Funds Debt Service As A % of Total Governmental Funds Expenditures	<30	30 to 60	60 to 120	120 to 180	≥180
< 8	1	2	3	4	5
8 to 15	2	3	4	4	5
15 to 25	3	4	5	5	5
25 to 35	4	4	5	5	5
≥35	4	5	5	5	5

 Source: Standard & Poor's Ratings Services.

Debt and Contingent Liability Adjustments

Debt & Contingent Liabilities
10%

Qualitative factors with a positive impact on the initial score:	**Qualitative factors with a negative impact on the initial score:**
Overall net debt as a percentage of market value below 3%.	Overall net debt as a percentage of market value exceeding 10%.
Overall rapid annual debt amortization, with more than 65% coming due in10 years.	Significant medium-term debt plans produce a higher score when included.
	Exposure to interest-rate risk or instrument provisions that could increase annual payment requirements by at least 20%.
	Unaddressed exposure to large unfunded pension or OPEB obligations leading to accelerating payment obligations over the medium term that represent significant budget pressure (see paragraph 82). If there is a plan to address the obligations, the final score worsens by one point; otherwise the score worsens by two points.
	Speculative contingent liabilities or those otherwise likely to be funded on an ongoing basis by the government representing more than 10% of total governmental revenue.

 Source: Standard & Poor's Ratings Services.

Debt and Contingent Liabilities:

- **Debt plans for the next two years**
- **Amortization schedule**
- **Pension or OPEB information not in audit?**
  - Specific list includes contributions and valuation of assets
  - Any plans to make significant adjustments that would affect costs?
  - Expectation of increases to annual pension costs in next 2-3 years?
- **Do you have debt backed by non-GF revenues that you may have to support?**
- **Other contingent liabilities outstanding?**

Putting it all Together

Indicative Rating

Positive Overriding Factors

- High income levels (1 or 2 notch adjustment)
- Sustained high fund balances (1 notch adj)

Negative Overriding Factors

- Low market value per capita (1 notch adjustment)
- Low nominal fund balance (1 notch adjustment)

Rating Caps

- Weak liquidity (BBB+ or BB+)
- Weak management (A or BBB-)
- Lack of willingness to pay obligations (BBB- for leases and B for debt)
- Large or chronic negative fund balances (A+, A-, or BBB)
- Budgetary flexibility score of 5 (A+)
- Structural imbalance (BBB+)

**** * * ONE NOTCH FLEXIBILITY * * ****

FINAL RATING!

 Source: Standard & Poor's Ratings Services.

Ratings Impact

What We Did

Ratings Impact – What We Did

The impact upon application:

- Covers over 4,000 in scope credits
- Rating changes were moderate, averaging one notch
- More upgrades and fewer downgrades than quantitative testing suggested

Application of the criteria led to:

- The majority of ratings remained the same (55%)
  - Rating increases were 41%
  - Rating decreases were 4%

Ratings are a combination of both qualitative and quantitative aspects

- Our analysis confirmed the importance of the qualitative rating aspects

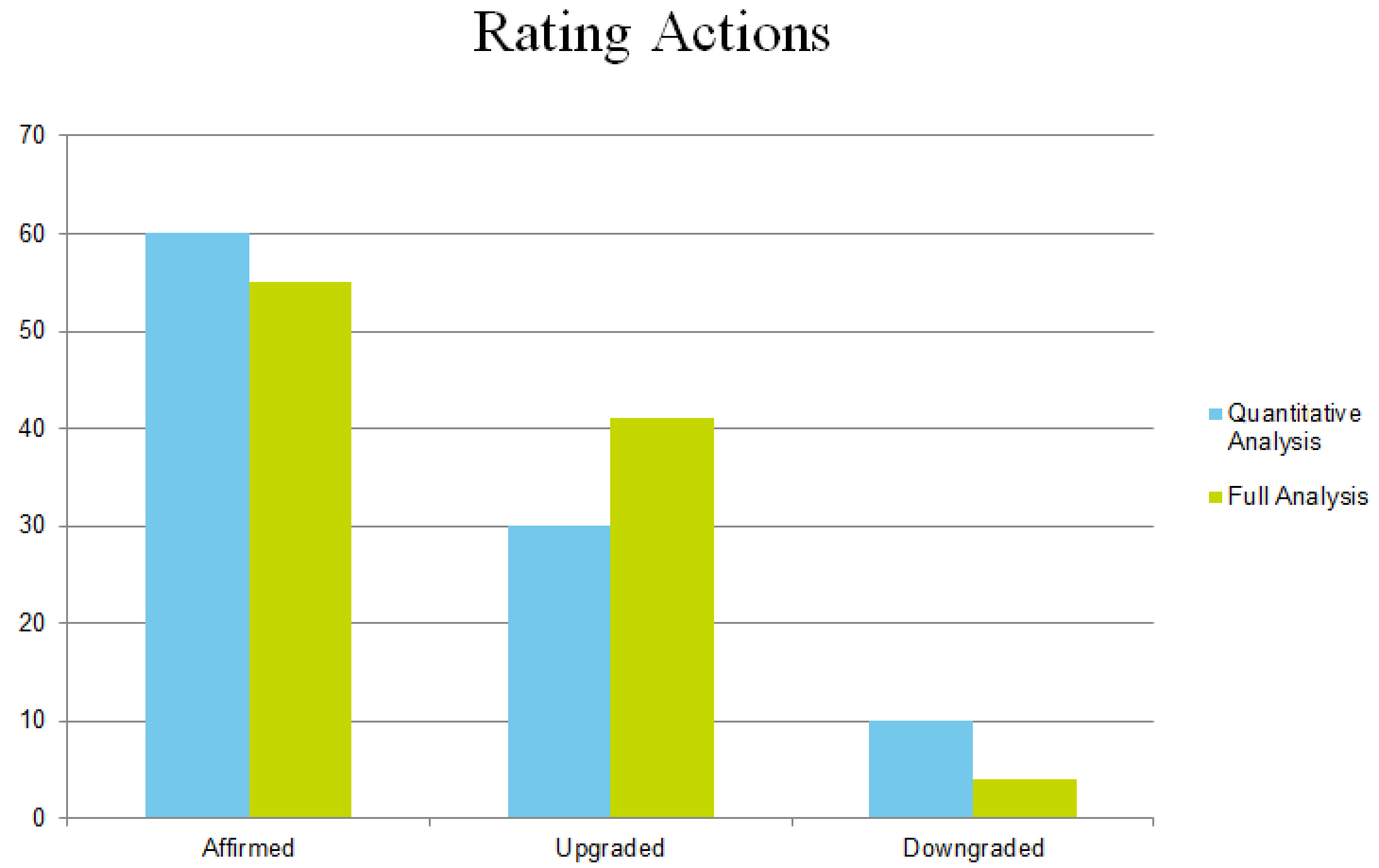
Rating Distribution

Rating Level	Ratings Before New Criteria	Ratings After Initial Implementation of New Criteria*
AAA	7%	10%
AA+	8%	14%
AA	18%	22%
AA-	20%	23%
A+	24%	18%
A	15%	8%
A-	5%	3%
BBB+	1%	1%
BBB	1%	1%
BBB-	<1%	1%
BB+ & Lower	<1%	<1%

*Accounts for the initial rating action for each entity evaluated during the implementation period

Source: Standard & Poor's Ratings Services.

Comparison: Quantitative Estimates vs. Actual Results



Source: Standard & Poor's Ratings Services.

What Drove the Differences: "Quantitatively Unpredicted Upgrades"

- **Qualitative Analysis Done Credit by Credit**
  - Qualitative Adjustments Within Each Factor Score
  - Forward-Looking Assessments
  - Management Capabilities

Qualitative Adjustment	Percent Applied
Expected Available Fund Bal to Stay >75% of Expenditures	14%
Stabilizing Institution	8%

  - Adjustments to Data For a More Sustainable View

Factor Score	Adjustment Improved Initial Factor by 1 or more points
Budgetary Performance	43%
Liquidity	14%

What Drove the Differences: "Quantitatively Unpredicted Upgrades"

- **New Information which was Generally Positive For Credit Quality**
  - Financial
    - 68% had new audited information.
  - Economic
    - 48% had updated market values
    - 80% had updated income indicators.
  - Management

Factor	What was impacted	Percent Improved
Economy		
	Initial Economy Score	18%
Financial Performance		
	Initial Flexibility Score	16%
	Initial Liquidity Score	23%
Management		
	Initial Management Score	13%

Our Sector View

- **The Improving Credit Quality is Reflective of Our View of the Strength and Resilience of the Sector**
- **Credit Conditions for Local Governments Continue to Improve**
- **Our Default and Transition Studies Show Stability**
- **Challenges Remain and Pockets of Stress Will Occur but we Feel our Criteria Can Capture that Stress**

Regional Results

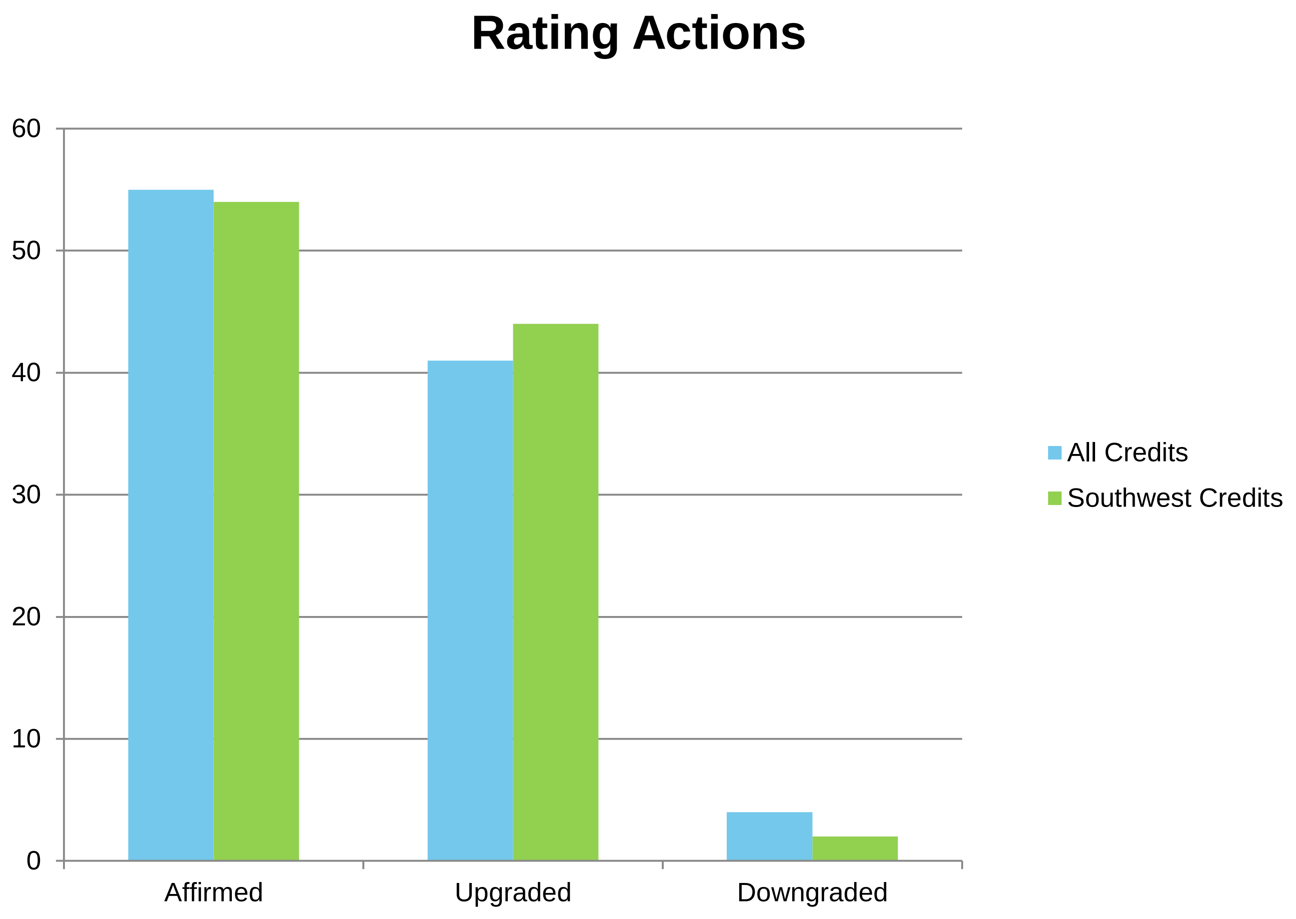
Comparison: National and Regional

Rating Level	Ratings After Initial Implementation of New Criteria* - All Credits	Ratings After Initial Implementation of New Criteria* - Southwest Only
AAA	10%	6%
AA+	14%	10%
AA	22%	21%
AA-	23%	23%
A+	18%	24%
A	8%	11%
A-	3%	4%
BBB+	1%	1%
BBB	1%	1%
BBB-	1%	1%
BB+ & Lower	<1%	<1%

*Accounts for the initial rating action for each entity evaluated during the implementation period

Source: Standard & Poor's Ratings Services.

Comparison: National and Regional



Source: Standard & Poor's Ratings Services.

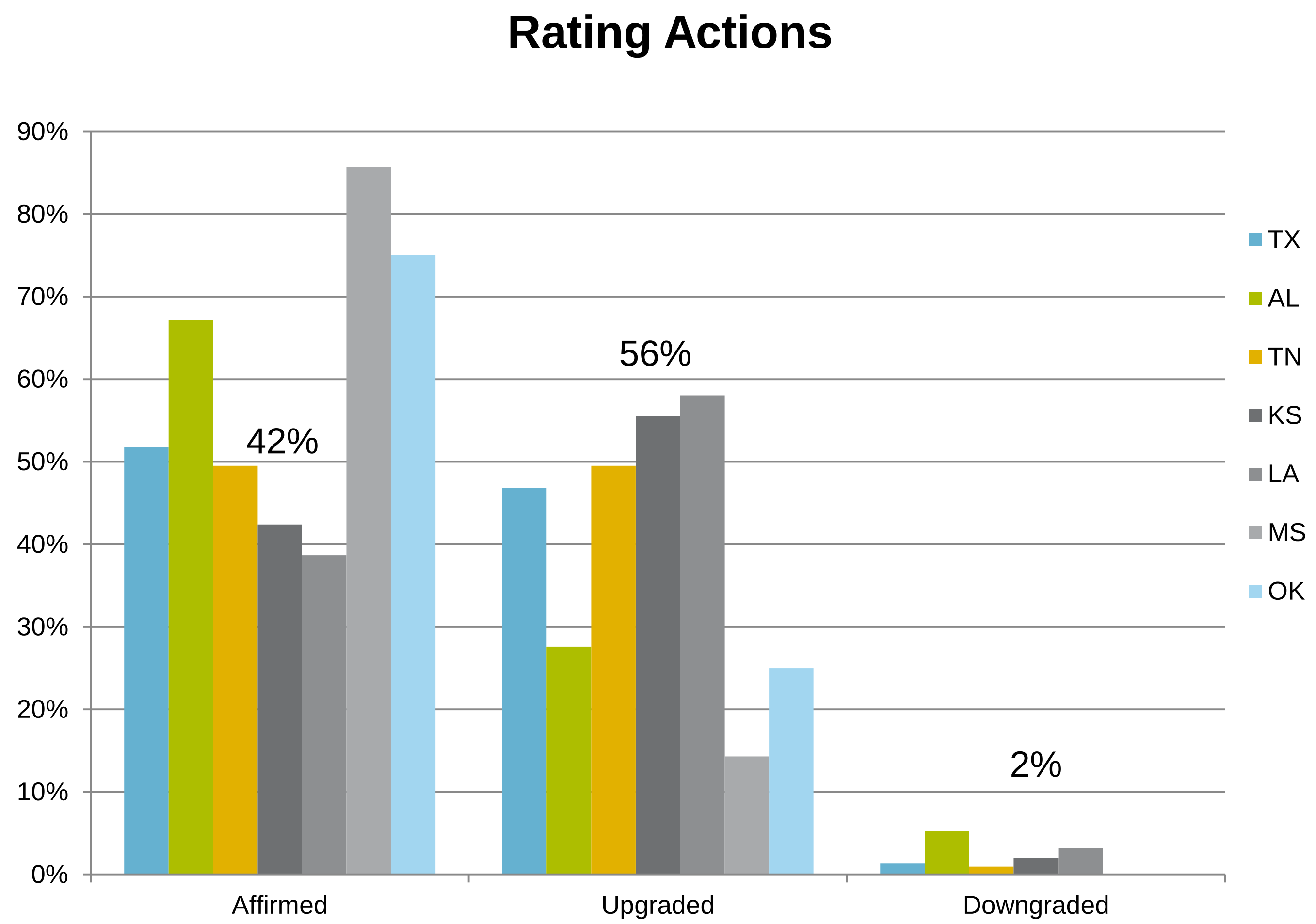
Comparison: Ratings After Initial Implementation of New Criteria*

Rating Level	TX	AL	TN	KS	LA	MS	OK
AAA	8%	1%	6%	**4%**	3%	0%	6%
AA+	11%	10%	10%	**3%**	6%	0%	19%
AA	25%	12%	21%	**7%**	32%	19%	19%
AA-	24%	18%	17%	**24%**	32%	29%	38%
A+	17%	24%	33%	**42%**	13%	38%	13%
A	9%	20%	10%	**16%**	3%	5%	6%
A-	4%	9%	1%	**2%**	0%	5%	0%
BBB+	0%	1%	1%	**1%**	6%	0%	0%
BBB	1%	2%	0%	**0%**	0%	5%	0%
BBB-	0%	1%	0%	**0%**	3%	0%	0%
BB+ & Lower	0%	1%	0%	**0%**	0%	0%	0%

*Accounts for the initial rating action for each entity evaluated during the implementation period

Source: Standard & Poor's Ratings Services.

Comparison: Southwest Region States



Source: Standard & Poor's Ratings Services.

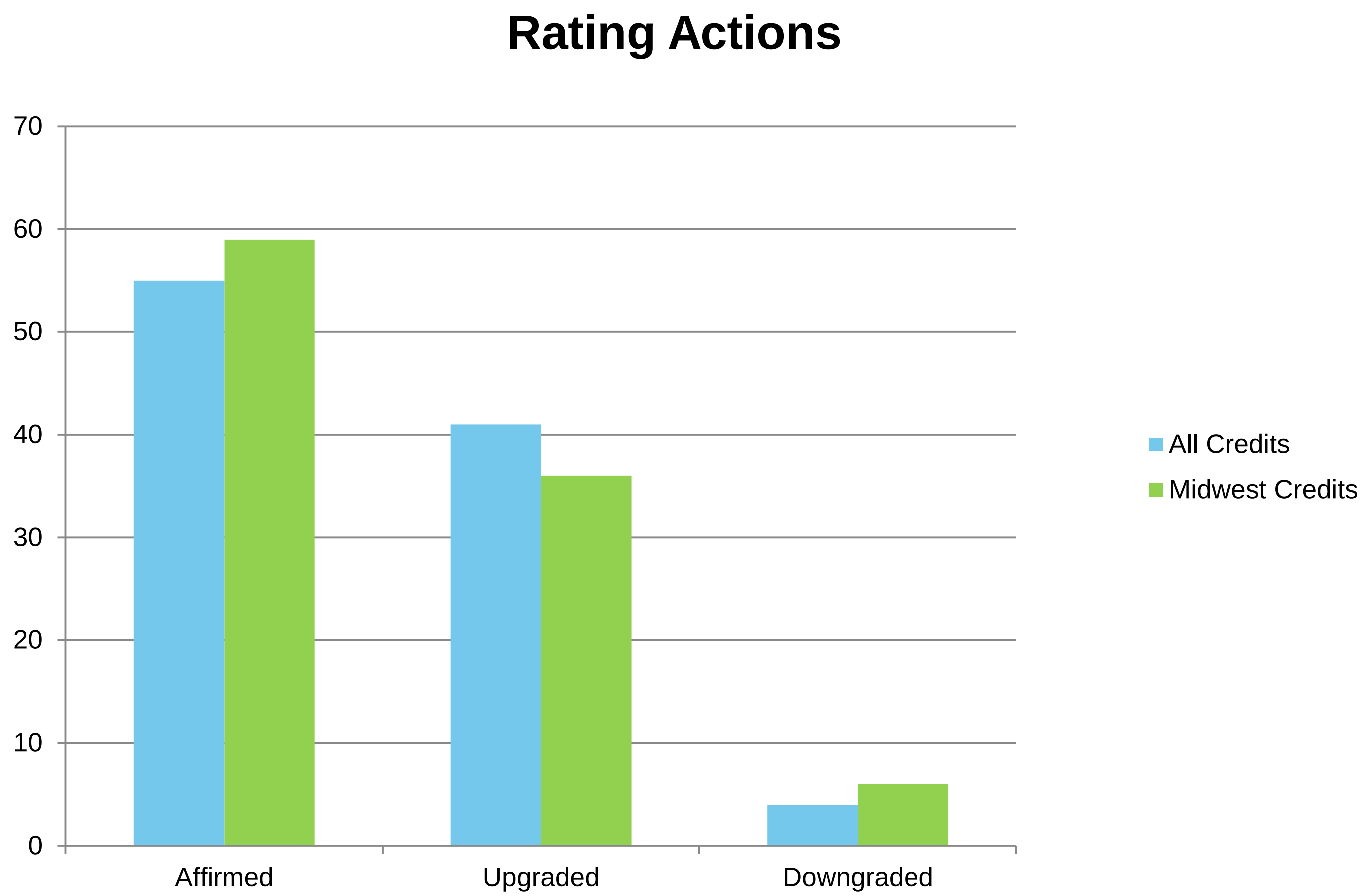
Comparison: National and Regional

Rating Level	Ratings After Initial Implementation of New Criteria* - All Credits	Ratings After Initial Implementation of New Criteria* - Midwest Only
AAA	10%	6%
AA+	14%	11%
AA	22%	20%
AA-	23%	26%
A+	18%	20%
A	8%	10%
A-	3%	3%
BBB+	1%	1%
BBB	1%	1%
BBB-	1%	<1%
BB+ & Lower	<1%	1%

*Accounts for the initial rating action for each entity evaluated during the implementation period

Source: Standard & Poor's Ratings Services.

Comparison: National and Regional



Source: Standard & Poor's Ratings Services.

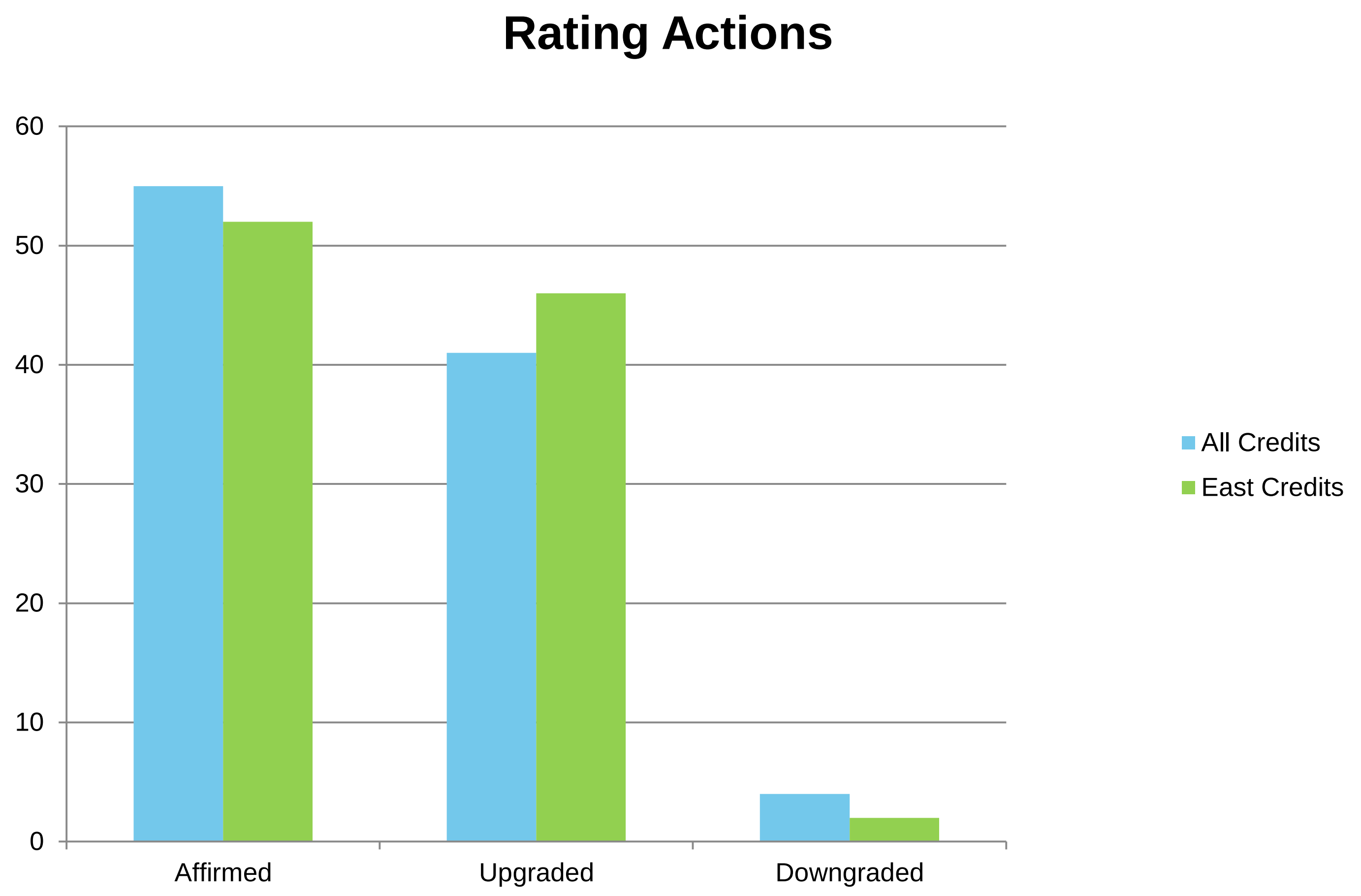
Comparison: National and Regional

Rating Level	Ratings After Initial Implementation of New Criteria* - All Credits	Ratings After Initial Implementation of New Criteria* - East Only
AAA	10%	14%
AA+	14%	19%
AA	22%	24%
AA-	23%	18%
A+	18%	15%
A	8%	5%
A-	3%	2%
BBB+	1%	1%
BBB	1%	1%
BBB-	1%	1%
BB+ & Lower	<1%	<1%

*Accounts for the initial rating action for each entity evaluated during the implementation period

Source: Standard & Poor's Ratings Services.

Comparison: National and Regional



Source: Standard & Poor's Ratings Services.

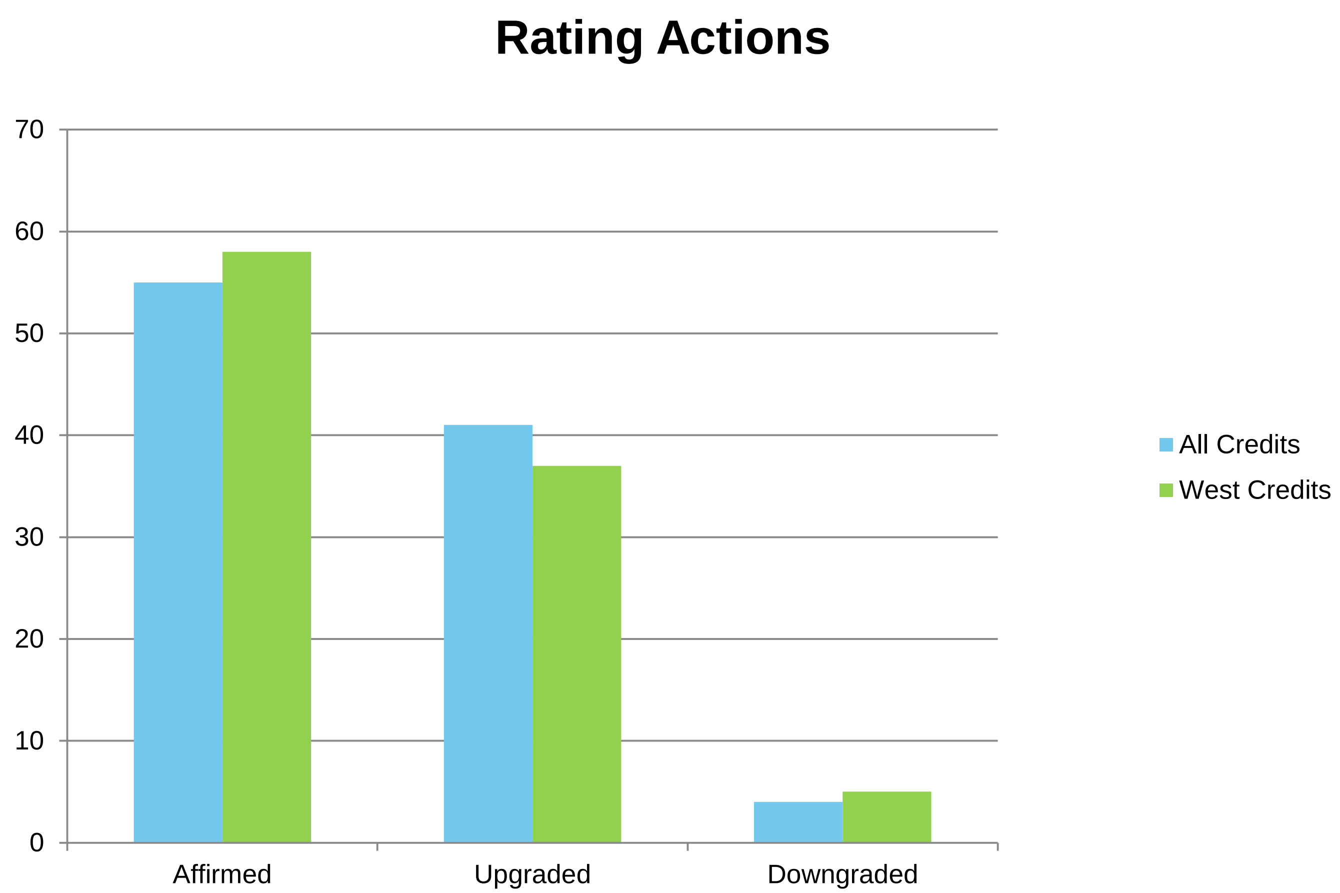
Comparison: National and Regional

Rating Level	Ratings After Initial Implementation of New Criteria* - All Credits	Ratings After Initial Implementation of New Criteria* - West Only
AAA	10%	16%
AA+	14%	18%
AA	22%	21%
AA-	23%	26%
A+	18%	11%
A	8%	4%
A-	3%	2%
BBB+	1%	1%
BBB	1%	1%
BBB-	1%	1%
BB+ & Lower	<1%	1%

*Accounts for the initial rating action for each entity evaluated during the implementation period

Source: Standard & Poor's Ratings Services.

Comparison: National and Regional



Source: Standard & Poor's Ratings Services.

Q&A

Thank You

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STANDARD & POOR'S RATINGS SERVICES

McGRAW HILL FINANCIAL