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The Updated General Obligation Criteria Reflect The U.S. Local Government Sector's Strength And The Importance Of Qualitative Analysis

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In the past year, Standard & Poor's Ratings Services applied its general obligation (GO) local government criteria to more than 4,000 U.S. local government issuer credit ratings and ratings on GO bonds issued by municipal governments that are not special purpose districts. We included cities, counties, towns, villages, townships, and boroughs. Of those local government ratings, 55% did not change. We raised 41% of our ratings and lowered 4%. Most of the ratings changes (69%) were by one notch (see chart 1), which closely matches our expectations from when we released our criteria on Sept. 12, 2013. However, overall rating actions do differ slightly from our estimates we gave when we released the criteria (60% unchanged, 30% upgraded, and 10% downgraded). We attribute the difference to qualitative analysis and updated information

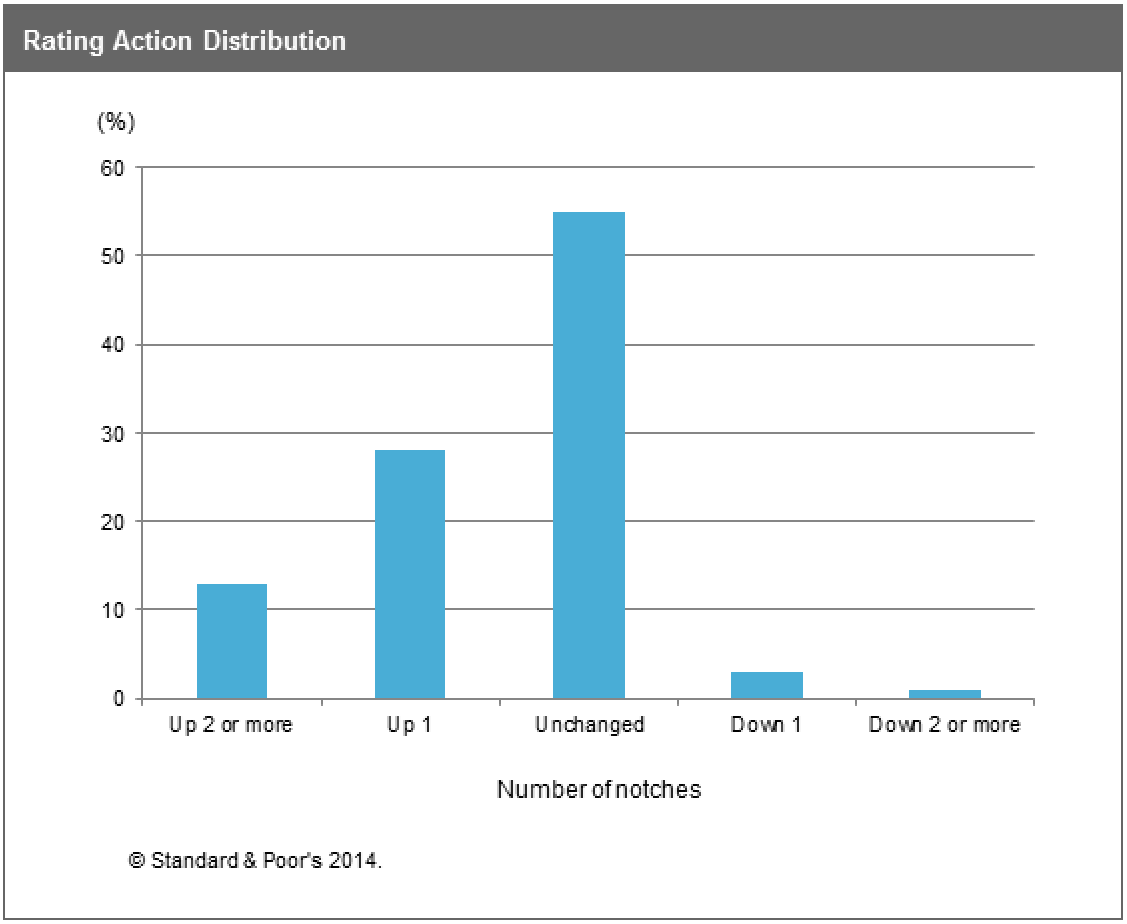
When we first envisioned the criteria update, we had three key goals in mind. First, we wanted to facilitate greater comparability of ratings across geographies and sectors by recognizing and incorporating the overall strength and stability that the local government sector has demonstrated. Second, we sought to enhance the transparency of our ratings methodology, including a clear explanation of qualitative adjustments -- which go beyond the numbers and can have a significant impact on an issuer's creditworthiness. Finally, we wanted to formalize and make explicit the forward-looking components of our analysis.

Overview

- In its first year of use, our revised criteria for U.S. general obligation debt have lived up to our goal of greater comparability across sectors, ratings transparency, and an emphasis on forward-looking analysis.
- Our use of qualitative analysis led to slightly more upgrades than we predicted from quantitative factors alone, highlighting the importance of qualitative analysis.
- New data, including improved economic and financial information, also played a role in some upgrades.

We believe the results highlight that the criteria were not a wholesale change to our view of the sector, but built on the previous criteria while enhancing comparability, transparency, and forward-looking analysis. The criteria allow us to appropriately capture not only the sector's overall strength, but also let us analyze pockets of stress we have seen in local governments. Although actual rating results differ slightly from our quantitative estimates, we said when we released the criteria that the qualitative analysis we outline in the criteria would affect actual rating results. In addition, we analyzed ratings one at a time, allowing for multi-notch rating changes where appropriate and a more modest change for the majority of credits (including no change in many cases).

Chart 1

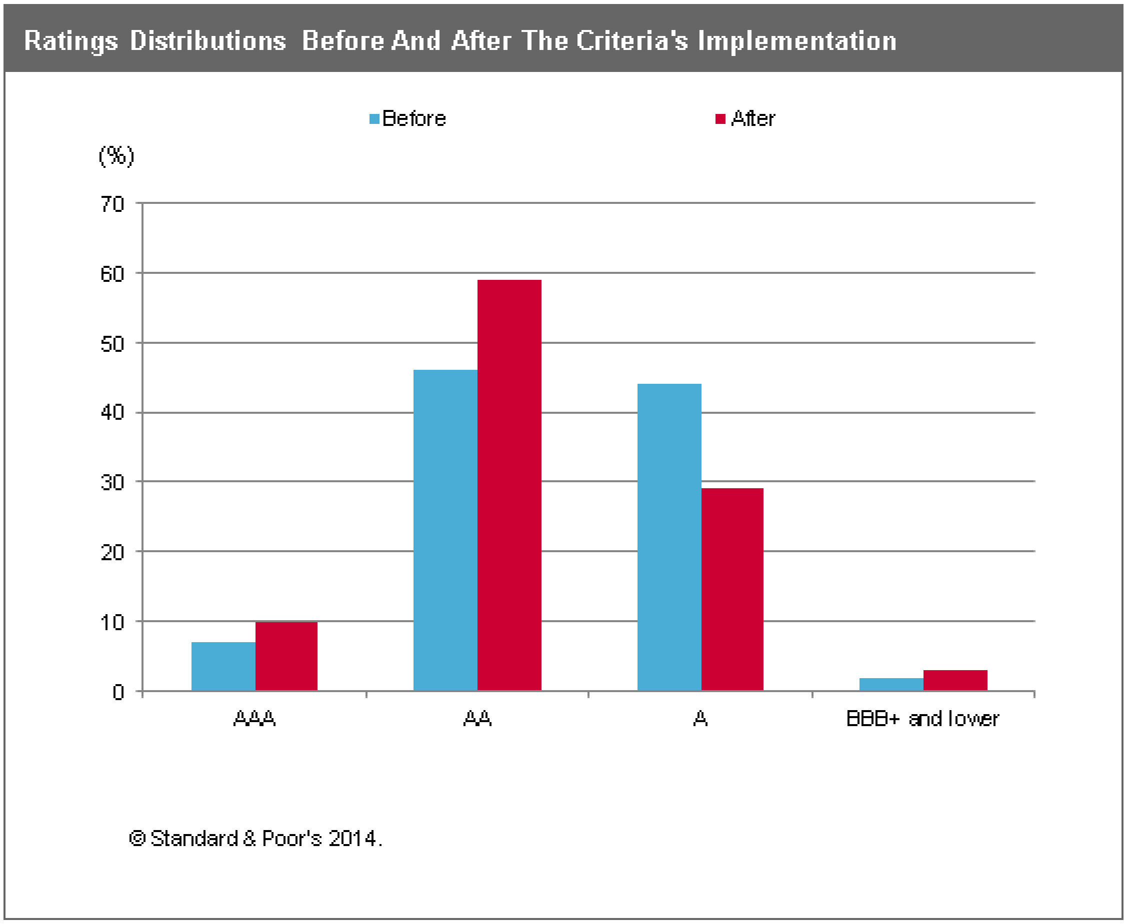


How The Ratings Changed Under The New Criteria

The results following our rating actions show a distribution with relatively few changes at both ends of the rating spectrum and with the majority of ratings that changed having shifted to the 'AA' category from the 'A' category. The average rating in the local government sector moved to 'AA-' from the upper end of the 'A' category (see chart 2).

- 59% of our ratings are in the 'AA' category, up from 46%
- 28% of our ratings are in the 'A' category, down from 44%

Chart 2



What Supports Our View Of A Strong Stable Sector

We believe our ratings distribution accurately reflects the credit risk -- and especially the historically low default risk -- in this strong and stable sector. In addition, it underscores our opinion that U.S. local governments, when compared with other local governments around the globe, have high levels of autonomy, including flexibility in their abilities to raise revenue and control spending.

Strength of the local government sector: Strong history of payment and low default risk

Our criteria enhance comparability by recognizing the strength of the payment track record of local government-issued GO bonds throughout economic cycles. U.S. local government GO bonds have historically had very low default risk. In our most recent annual report analyzing defaults in the sector ("U.S. Public Finance Defaults And Rating Transition Data: 2013 Update," published March 31, 2014, on RatingsDirect), the average default rate since 1986 for all of U.S. public finance (excluding housing) was very low, at 0.02%. For local government bonds with tax secured pledges, two defaults occurred among the more than 4,000 rated entities in 2013. We believe this supports a strong rating distribution and reflects a highly stable sector.

Although there have been some notable exceptions in recent years, which our criteria capture , overall payment trends and barriers to nonpayment continue to support our view that credit quality in this sector is very strong.

Local government autonomy and actions

Management continues to play a key role in our analysis. Local governments within the U.S. enjoy a high degree of autonomy with regard to the level of services they provide and revenues they collect. This autonomy permits local governments to react to changing economic and funding conditions. (For more information on the importance of management's reactions to changing economic conditions, see "The Impact Of Economic And Fiscal Pressures On Credit Quality: Using S&P’s Proposed Criteria For Rating U.S. Local Governments To Estimate Rating Distributions," published March 6, 2012.)

Taking the autonomy they have into account, our criteria view management's role through two lenses: its policies and practices, and its plans to address potential credit concerns. We analyze the latter through multiple qualitative adjustments including plans to address mounting pension and other postemployment benefit (OPEB) costs, budgetary imbalances, liquidity pressures and forward looking financial performance.

We analyze the former through our financial management assessment (FMA) that determines the strength of the overall formal policies a local government has. For the bonds we rate, the majority of our credits have good or strong FMA assessments. As a result, the majority of local governments we rate have overall management assessments of very strong or strong. Also, we believe our rating results show the importance of management's role in credit deterioration. In fact, two-thirds of the ratings we lowered more than two notches included factors associated with a weak or very weak management assessment.

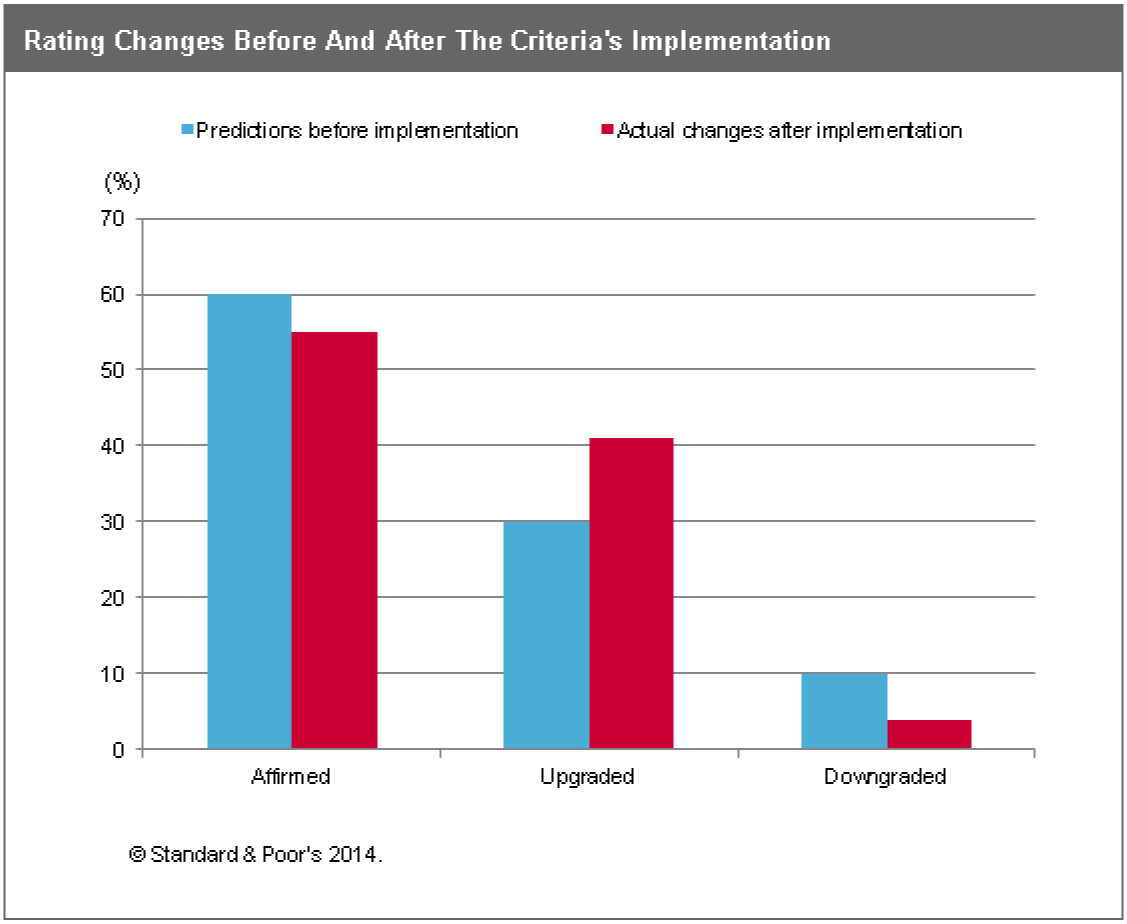
Our criteria also assess credit quality by determining how management uses its autonomy to react to credit pressures. The criteria's qualitative adjustment analysis incorporates this ability.

The Difference Between Quantitative Estimates And Actual Rating Results: Why Qualitative Analysis Matters

Taking into account only the initial rating action for each entity we evaluated during the implementation period, 55% of ratings stayed the same, while 41% rose and 4% fell (see chart 3). As part of the criteria release, Standard & Poor's provided a quantitative estimate of how the ratings might change, using the most recent data available at that time for the quantitative analysis. We stated at that time that assuming that governments maintained their current credit characteristics, quantitative testing results showed that approximately 60% of the ratings would not change under the criteria, about 30% would increase, and about 10% would decrease. At the time, we noted that the quantitative approach provided only estimates and the end results would likely be different.

Indeed, the differences between the estimates from a year ago and actual rating actions highlight our qualitative analysis. With the increased transparency of our criteria we can further explain the difference between the quantitative estimates from a year ago and actual rating actions. The differences incorporate our view of management's decisions; an understanding of the data from a long-term view; and the impact of new information. (We refer to upgrades that were not initially estimated based on quantitatively analysis alone as quantitatively unpredicted upgrades.) We go beyond the issuer's financial statements and take into account, when appropriate, management's actions and any circumstances that could cause financial data to be skewed.

Chart 3



Looking Beyond The Numbers: Some Examples Of How Analysts Apply Adjustments And Overrides

Our qualitative approach has two aspects. The first is using adjustments within the criteria under each factor score, such as forward-looking projections that would suggest a better or worse factor score. The second is by adjusting the actual data that is the basis for our factor score ratios. When we released the criteria, we noted that Standard & Poor's analysts would apply analytical adjustments to data to determine a clearer view of both the short and long-term performance of an issuer (for more information, see "S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency," published Sept 12, 2013). We applied both of these qualitative methods in our analysis.

Qualitative (nondata) adjustments

The local government criteria have more than 30 qualitative adjustments and overrides that can affect factor scores. For example, a stabilizing institution such as a university or military base could positively affect the economy factor score (see table 1), while a significant declining population could negatively affect it. Our analytical adjustments reflect our understanding of how management and its decisions can affect our assessment of financial and debt factor scores.

The financial factor scores all have at least two qualitative adjustments that address expected financial performance. Furthermore, many adjustments and caps require an understanding of what management's intent is. For example, we assess a management team's intention to maintain extremely high reserves, or the plan management has to address rising pension costs.

Table 1

Quantitatively Unpredicted Upgrades Receiving Qualitative Adjustments

Qualitative adjustment	% of qualitatively unpredicted upgrade
Expected available fund balance to stay above 30% of expenditure	45
Expected available fund balance to stay greater than 75% of expenditure	14
Stabilizing institution	8

To apply the first two adjustments in table 1, analysts need to understand management's intent in maintaining its reserves and what policies or practices might support those reserves. Other aspects that could affect our use of this adjustment include a possible need to support funds outside of the general fund or expected general fund operating deficits. After talking with management and assessing plans for the available fund balance, 45% of issuers received the greater-than-30% adjustment, which positively affects the budgetary flexibility score by one point and can offset other negative adjustments, such as cash accounting. For the greater-than-75% fund balance adjustment, after discussions with management, we applied the override to 14% of the quantitatively unpredicted upgrades. This override affects the ending indicative rating positively by one notch.

To apply the third adjustment, analysts need to determine whether there has been a longstanding institutional presence for the underlying economy and also whether the institution's presence is suppressing incomes or market value. The adjustment positively affects the economy assessment. The economy factor score is worth 30% of the overall indicative rating. For quantitatively unpredicted upgrades, 8% received this adjustment.

As noted earlier, management can play both a positive and a negative role in our rating assessment. For ratings we lowered, there were some common qualitative adjustments (see table 2).

Table 2

Qualitative Factors For Downgrades

Qualitative adjustment	% of downgrades receiving the adjustment
High pension and OPEB burden	36
Lack of credible pension or OPEB plan	15
Projected weaker budgetary performance	17

OPEB--Other postemployment benefits.

To apply the first two adjustments in table 2, analysts take into account the overall cost pressure of the pension annual retirement contribution and pay-as-you-go OPEB costs and the likelihood of the pressure growing in the medium term (for more information, see "Evaluating Pension/OPEB Obligations Under Standard & Poor’s U.S. Local Government GO Criteria, published Dec, 19, 2013). We saw what we consider to be a high usage of analytical adjustments for high pension and OPEB stresses (36%). Another important aspect of this analysis is whether management has a credible plan to address these costs. The prevalence of the adjustment that captures management's inability or inaction to address high pension or OPEB costs was higher amongst our downgraded issuers, at 15%, compared with 5% for our affirmed ratings. Discussions with management can provide insight into whether the cost of pension and OPEB obligations is likely to negatively affect financial operations. As well, if management has no plan to curb the growth of these costs, pensions and OPEB obligations are likely to have a greater impact in the medium term. Discussions with management play a key role in determining the application of these adjustments. This affects the debt factor score, which represents 10% of the overall rating. If we view the liabilities as very high and growing, the management score can be lowered and we can cap the rating at 'A'.

To apply the third adjustment, analysts determine whether budgetary performance will worsen in the next two years. Projected numbers from budgets and forecasts help determine these adjustments, as well as analysts' experience with management's ability to meet their projections. Analysts take into account not only issuer-provided information, but also assess whether management's projections are likely to materialize. For ratings we lowered, we expected 17% to have weaker budgetary performance the next two years. This affects the budgetary performance factor score, which represents 10% of the overall rating.

Data adjustments

The second type of analytical adjustment occurs before we analyze ratios. Analysts need to determine whether the data represent an accurate view of the obligor's performance. Under the new criteria, Standard & Poor's analysts adjust data to improve the analysis of the short- and long-term operational performance (see table 3). Some adjustments are fairly standard and apply to many of our issuers, such as the smoothing of one-time major capital projects that distort a particular year's operating result. Once the data is adjusted, we use it to calculate the factor ratios. In many cases, this led to improved factor scores.

Table 3

Improvement In Factor Scores For Quantitatively Unpredicted Upgrades From Data Adjustments (%)

Factor assessment	Adjustment improved initial factor 1 point or more	Adjustment improved initial factor by more than 2 points
Budgetary Flexibility	7	1
Budgetary Performance	43	13
Liquidity	14	10

To adjust data for available reserves (a component of budgetary flexibility), analysts look at additional reserves outside our basic definition of available reserves (assigned and unassigned reserves) and assess whether other reserves are available for operations. One common example of this would be those under the designation of committed, when that commitment is for emergencies or budgetary contingencies. After further research and discussions with management, we consider whether to include those additional reserves as available. The data adjustment affects the overall budgetary flexibility score and improved 7% of the scores for our quantitatively unpredicted upgrades. Budgetary flexibility represents 10% of the overall score, but can also cap a rating at 'A' if reserves are below 1% of expenditures and can lead to a one-notch negative override if reserves are below $500,000.

To adjust data for general fund and total governmental funds (which affects budgetary performance), analysts consider an issuer's long-term performance and adjust general fund and total governmental fund data for one-time expenditures and revenues. Accounting for these, the assessment reflects what we consider to be a more sustainable view of ongoing operating performance. Data adjustments to these metrics had a positive ratings impact for close to half of our quantitatively unpredicted upgrades through improved budgetary performance scores, which represents 10% of the overall rating.

To adjust cash and cash equivalents (which affects the liquidity score), analysts may view highly liquid investments maturing in less than a year as liquid for the purpose of the score. In analyzing this, 14% of quantitatively unpredicted upgrades received data adjustments to include what we consider to be highly liquid investments. Without these data adjustments, we would have capped many of these credits at the 'BBB+' or 'BB+' rating level with weak or very weak liquidity scores. This is a very vivid example of the impact of doing credit-by-credit analysis. Without the cap, the liquidity score represents 10% of the overall rating.

New information: Improving economy and financial indicators also affected our results

With the release of the criteria in Sept 2013, Standard & Poor's noted that upward trends in our ratings would likely continue and reflected not only the changes in our criteria, but also what we believed was an improving underlying economy. Despite some pockets of stress, Standard & Poor's has noted that, since April 2012, the credit conditions for local governments were improving and stabilizing after a period of decline. We continued to note local governments are experiencing improving credit conditions and shoring up their finances during this period, which we believe is a partial reason for some of our quantitatively unpredicted upgrades (for more information, see "U.S. State And Local Government Credit Conditions Forecast: Waiting … And Waiting To Exhale," published April 7, 2014). The improvement in the economy affected our ratings in two ways. First, an improving economy can lead to better financial indicators. For the quantitatively unpredicted upgrades, 68% had new audited information. Second, the improving economy's rating impact came through other data, such as market values and incomes. Of the quantitatively unpredicted upgrades, 48% had updated market values and 80% had updated income indicators. We also gathered new information during our individual reviews, including on new management policies.

Table 4

Quantitatively Unpredicted Upgrades With Improved Initial Scores Due To New Data

Factor	Impact	% improved
Economy	Initial economy score	18
Budgetary flexibility	Initial budgetary flexibility score	16
Liquidity	Initial liquidity score	23
Management	Initial management score	13

We looked at several factors in this respect:

- Economic improvement: The metrics that drive this factor score are market value and projected per capita income. New economic indicators for 18% of unpredicted upgrades improved the economy metrics enough to have a positive impact on the initial economy factor score (see table 4). For our affirmations, this was 12%. The economy score affects 30% of the overall rating.
- Budgetary flexibility: This is a measure of available reserves as a percent of expenditures. Separate from the use of data adjustments, the budgetary flexibility metric improved for 16% of our quantitatively unpredicted upgrades from new data alone, compared with only 7% of our affirmations. In addition, the improvement in available reserves above our original predictions decreased our use of the low nominal balance one-notch down override. Budgetary flexibility represents 10% of the overall score, but can also cap a rating at 'A' if reserves are below 1% of

expenditures and can lead to a one-notch negative override if reserves are below $500,000.

- Liquidity: This measures year-end cash as a percent of total governmental expenditures and debt service. New data improved this factor score for 23% of the quantitatively unpredicted upgrades compared with 9% for our affirmations. When there is no ratings cap, the liquidity score represents 10% of the overall rating.
- Management: New data improved our view of management in 16% of our quantitatively unpredicted upgrades, compared with 5% for our affirmations. In our reviews, we received new information regarding the implementation of new polices, or the formalization of existing practices. For our downgrades, 30% had new information about management decisions that worsened our view of management. Management represents 20% of the overall rating unless it is viewed as weak or very weak, which leads to a rating cap.

Qualitative Analysis Will Continue To Be Important In Our Analysis

Our local government ratings are consistent with Standard & Poor's view of a strong and stable sector with a rating distribution that reflects the sector's payment history, low default rate, and strong management autonomy. The final rating changes are close to our original quantitative estimates. The majority of our ratings did not change; for those that did, the majority changed by one notch. The difference between our quantitative predictions and our results were due to a combination of qualitative analysis and new information.

We believe the benefits of the U.S. local government GO criteria are long-lasting. Beyond the rating comparability, and formalized forward-looking analysis, we expect the increased transparency will enable greater understanding of our analytical decisions and concerns. We expect this will result in greater market insight into our rating decisions.

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