23rd Annual Delaware Institute for Local Government Leaders

Understanding Municipal Bond Ratings – An Independent Reflection of How Your Local Government Operates

Presented by
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Public Advisory Consultants, Inc.
Do Bond Ratings Matter?

Yes
• Bond ratings matter if you wish to sell bonds.

No
• If you do not wish to sell bonds

Maybe
• If you wish to use rating methodology to evaluate how your jurisdiction is doing.

• Using the bond rating evaluation methodology can contribute to affirming existing management and financial practices and or to form the basis of creating new ones.

• Why? Rating agencies use the same methodology to examine each and every municipal government. Their approach provides insight to what is considered strong to weak governmental operations.

• To continue a municipal government’s progress toward improved fiscal and operational management, one of the goals is to acknowledge and implement management practices that are conducive to strong creditworthiness.

• Bond ratings, credit worthiness means nothing unless an entity wishes to examine its own practices and procedures long before it considers borrowing money from a financial institution, the State, from the public markets or benchmark itself.
Overview

To determine credit quality four primary areas are evaluated:

• Debt
• Financial Performance
• Management/Administration
• Economy and Tax Base
Debt

• Debt structure, amortization, amount, type, (fixed rate, variable rate and other) proportions (amount of fixed and or variable rate) and key debt ratios.

• Analysis of debt burden focuses on overall ratios that include the debt of overlapping and underlying units. While direct debt ratios indicate the burden on the municipality of its own capital costs, overall ratios best measure the debt that must be serviced by the community’s tax base, and are a partial indicator of the total local tax burden that is levied by all the overlapping governments serving the taxpayer.

• Direct debt burden is a crucial part of measuring debt load. Default experience shows mismanagement.
Financial Performance

• Financial performance reflects to some degree, the jurisdictions debt, economic trends, and management quality.

• Analysis of finances focuses on consistency of operating results over time and fund balance levels relative to expenditures or revenues.

• Historical operating results are viewed for matching of recurring expenditures with recurring revenues, the generating of operating surpluses, and the minimal use of one time revenue to fund recurring expenditures.

• Also reviewed are the use of fund balance, such as use of one-time expenditures and emergency situations and its use in any large amount for ongoing operations. Attention is paid to expenditure growth rates and the municipality’s ability to control spending.

• An area of particular concern is how much of the entities annual spending is tied up in fixed charges for debt service and pension funding.

• Financial flexibility can be affected by many factors, including whether expenditures are non-discretionary or within the entity’s control.

• Revenue mix and volatility are considered, as are limitations on the ability to raise taxes and other revenues.

• Balance sheet analysis focuses on liquidity and fund balance levels and their trends.
Management/Administration

• In review of management practices, it is favorable to issuers that have over time, implemented sound fiscal processes and policies for budgetary and financial operations.

• Some of the more noticeable best practices that could lead to stronger creditworthiness are the maintenance of cash reserves; the formal use of multi-year financial forecasting for operating funds; and debt affordability policies that balance capital spending needs with a review of costs to the taxpayer and effect on financial operations.

• Administrative and legal considerations include investment policy, contingent liabilities, and pension funding.

• Governmental structure and the relationship between the county and the citizens. While difficult to assess and subject to change, political factors can affect an entity’s ability to act effectively and efficiently.

• The efficiency by which an elected government can make service and spending decisions is important. The agility of its appointed officials to adjust and react to changing economic and financial conditions plays a key role in the stewardship of the entity.
Economy and Tax Base

- Analysis of the capacity of the community’s economic and tax base to support ongoing operations and repayment of debt should be considered.

- The depth and mix of the employment and tax base are reviewed.

- Historical economic trends and the outlook for ongoing growth.

- Trends in population, tax base valuation, building permits, personal income, and retail sales.

- Although growth is usually considered to be a positive factor, demonstrated stability in the typical demographic factors can also be a positive, particularly for smaller communities that do not have a wide range of service demands and spending pressures.

- The ability to manage growth-generated demands, including the ability to keep up with rising infrastructure needs is also evaluated.

- Historically, the economy has been considered the least controllable of the major credit factors. However, in many instances, local economic development efforts have been effective in promoting new development or redevelopment, increasing economic diversity and adding to area stability.

- Undue concentration by either employer or industry sector may be cause for concern. Over dependence on one taxpayer or one industry also poses obvious risks.
Self-Evaluation: An Implementation Plan

Presented in the following pages is a two phased plan for your consideration.

• Phase I focuses on twelve primary items that tend to have a more significant impact than the items in Phase II.

• Phase II will focus on the remaining recommendations.
## Phase I: Best Practices

**Best Practices with Relative Values**

<table>
<thead>
<tr>
<th>Practice</th>
<th>Relative Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund Balance reserve policy/working capital reserves</td>
<td>Very Significant</td>
</tr>
<tr>
<td>Debt affordability reviews and policies</td>
<td>Very Significant</td>
</tr>
<tr>
<td>Multi-year financial forecasting</td>
<td>Significant</td>
</tr>
<tr>
<td>Quarterly financial reporting and monitoring</td>
<td>Significant</td>
</tr>
<tr>
<td>Pay-as-you-go capital funding policies</td>
<td>Significant</td>
</tr>
<tr>
<td>Rapid debt retirement policies of more than 65% in 10 years</td>
<td>Significant</td>
</tr>
<tr>
<td>Contingency planning policies</td>
<td>Influential</td>
</tr>
<tr>
<td>Policies regarding nonrecurring revenue</td>
<td>Influential</td>
</tr>
<tr>
<td>Depreciation of fixed assets</td>
<td>Influential</td>
</tr>
<tr>
<td>Five-year capital improvement plan integrating operating costs</td>
<td>Influential</td>
</tr>
<tr>
<td>Financial reporting award (GFOA)</td>
<td>Influential</td>
</tr>
<tr>
<td>Budgeting award (GFOA)</td>
<td>Influential</td>
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</table>
Phase I: Worst Practices

Worst Practices having Rating Concern

- Cash basis accounting
- Qualified audit opinion for material weakness
- Deficit financing for two of the last five years
- Slow debt retirement (less than 35% in 10 years)
- Unfunded accrued pension liability (funding ratio less than 60%)
- Debt restructuring that defers less than 35% of current debt service
- Over reliance on nonrecurring revenue of less than 15%
- Aggressive investment policy for operating funds
- Pension contribution deferral in the current budget year
- Budgetary impasse beyond legal completion date
- Lack of capital improvement plan
- Excess interfund borrowing and no capacity to repay in near future
## Phase I – Implementation Goals

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<tr>
<th>Management Practice</th>
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<tr>
<td>Fund Balance reserve</td>
<td>Financial reserves may be used to address unanticipated revenue shortfalls or unanticipated expenditures. The appropriate size of such a reserve depends on the potential variability of the entity’s revenue and expense, as well as its working cash needs to handle seasonality of revenue and expense.</td>
<td>Very Significant</td>
</tr>
<tr>
<td>Debt Affordability reviews and policies</td>
<td>Strong debt management practices are evidenced by comprehensive debt policy statements that discuss the types and methods of financing employed by issuers. Policy statements should also set forth any self-imposed debt limitations, such as those based on personal income and property market value.</td>
<td>Very Significant</td>
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## Phase I – Implementation Goals

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<td>Multiyear financial forecasting</td>
<td>This anticipates future challenges that may be encountered due to projected imbalances. This allows the entity to “get in front” of potential budget stress and take corrective action long before a crisis develops.</td>
<td>Significant</td>
</tr>
<tr>
<td>Quarterly financial reporting and monitoring</td>
<td>Interim financial reporting and monitoring can head off impending fiscal stress. This report should give details on major revenue sources and spending activity.</td>
<td>Significant</td>
</tr>
<tr>
<td>Pay-as-you-go capital funding policies</td>
<td>Significant appropriations help keep an issuer’s debt low and improve the county’s financial flexibility in the event of sudden revenue shortfalls or emergency spending.</td>
<td>Significant</td>
</tr>
<tr>
<td>Rapid debt retirement policies</td>
<td>One of the positive features of rapid debt retirement is a declining debt service schedule, thereby providing additional financial flexibility and debt capacity in future years.</td>
<td>Significant</td>
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<td>Contingency planning policies</td>
<td>Entity’s that demonstrate forward thinking and planning against unforeseen events, including potential revenue shortfalls despite reasonable economic forecasts can help to maintain creditworthiness in the face of unusual events.</td>
<td>Influential</td>
</tr>
<tr>
<td>Policies regarding nonrecurring revenue</td>
<td>Over-reliance on nonrecurring revenue items to pay for ongoing and recurring expenses are of concern, since it frequently contributes to budgetary stress and fiscal structural imbalances.</td>
<td>Influential</td>
</tr>
<tr>
<td>Depreciation of fixed assets</td>
<td>GASB 34 calls for depreciation of fixed assets in governmental funds. Depreciation that has not been funded in the past will probably create operating deficits in the government wide statements.</td>
<td>Influential</td>
</tr>
<tr>
<td>Five year capital improvement plan</td>
<td>This allows the entity to forward think and project future debt issuance, which also builds in incremental operating costs.</td>
<td>Influential</td>
</tr>
<tr>
<td>Financial reporting award Budgeting award</td>
<td>The achievements of this award do give investors and the public confidence that information disclosed in the county’s financial reports and budgets is comprehensive and accurate. Reporting requirements beyond the standards are helpful in fully describing the jurisdictions financial operations.</td>
<td>Influential</td>
</tr>
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</table>
Phase II – Good Budget Policies

Phase II focuses on various other practices and budgetary policies.

Several essential features characterize a good budget process and include:

• Incorporates a long-term perspective
• Establishes linkages to broad organizational goals
• Focuses budget decisions on results and outcomes
• Involves and promotes effective communication with stakeholders
• Provide incentives to government management and employees
Phase II – Establish Broad Goals

• Assess community needs, priorities, challenges and opportunities:
  – Identify stakeholder concerns, needs, and priorities
  – Evaluate community condition, external factors, opportunities and challenges

• Identify opportunities and challenges for government services capital assets, and management:
  – Assess services and programs, and identify issues, opportunities, and challenges
  – Assess capital assets, and identify issues, opportunities, and challenges
  – Assess governmental management systems, identify issues, and opportunities
Phase II – Develop Approaches

• Adopt financial policies:
  – Develop policy on stabilization funds
  – Develop policy on fees and charges
  – Develop policy on debt issuance and management
  – Develop policy on debt level and capacity
  – Develop policy on the use of one-time revenue
  – Evaluate the use of unpredictable revenue
  – Develop policy on balancing the operating budget
  – Develop policy on revenue diversification
  – Develop policy on contingency planning

• Develop programmatic, operating, and capital policies and plans:
  – Prepare policies and plans to guide the design of programs and services
  – Prepare policies and plans for capital asset acquisition, maintenance, replacement, and retirement
Phase II – Develop Approaches

• Develop programs and services that are consistent with policies and plans:
  – Develop programs and evaluate delivery mechanisms
  – Develop options for meeting capital needs and evaluate acquisition alternatives
  – Identify functions, programs, and/or activities of organizational units
  – Develop performance measures
  – Develop performance benchmarks

• Develop management strategies:
  – Develop strategies to facilitate attainment of program and financial goals
  – Develop mechanisms for budgetary compliance
  – Develop the type, presentation, and time period of the budget
Phase II – Develop Budget

• Develop and evaluate financial options:
  – Conduct long-range financial planning
  – Prepare revenue projections
  – Analyze major revenues
  – Evaluate the effect of changes to revenue source rates and bases
  – Analyze tax and fee exemptions
  – Achieve consensus on a revenue forecast
  – Document revenue sources in a revenue manual
  – Prepare expenditure projections
  – Evaluate revenue and expenditure options
  – Develop a capital improvement plan