

## RESEARCH

# Top 10 Management Characteristics Of Highly Rated Credits In U.S. Public Finance

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Standard & Poor's Ratings Services has widely disseminated information to investors and issuers outlining how a credit rating is established in U.S. Public Finance. We have also developed representative ranges for key ratios that factor into tax-backed credit quality. These ratios are the foundation of the quantitative measures Standard & Poor's uses when establishing a credit rating. Ratios and comparisons are used to fine-tune credit analysis and help to make credit distinctions. For bond issuers, credit ratios are often used as a framework for making comparisons, with the focus often on improving a credit rating.

In addition to quantitative factors, qualitative information factors heavily into credit analysis. Management factors, administrative characteristics and other structural issues facing a government entity can be an overriding factor in a rating outcome. Management can contribute significantly to many of the individual credit ratios and can positively affect ratings in a number of ways. Conversely, the lack of strong management can be a significant factor in a weak credit profile. The economy will play a key role in determining a rating category, but management will be one of the deciding factors in fine-tuning the rating. The management or administrative structure of a government can move a rating up or down more significantly and swiftly than any other element of a credit review.

When assessing management, Standard & Poor's includes analysis of the political framework that governs it, as well as the day-to-day management staff. There could be a strong management team in place, but if there is political instability or lack of political will to make difficult decisions, management will be ineffective in many cases. Standard & Poor's also focuses on the "whole of government." Oversight and management controls covering all of the disparate operations of a government with a focus on accountability at each department or function are critical to strong credit rating.

The "Top 10" list of management characteristics associated with Standard & Poor's highly rated credits is generally applicable to other enterprise operations of government such as water, sewer, or solid waste. The relative importance of these factors may vary from credit to credit. It is important to remember that credibility is an important part of a rating review process and management assessment. Every government has challenges. Identifying problems or issues, and detailing how these will be addressed establishes credibility and greater transparency in the rating process.

## Top 10 List

### 1. An established rainy day/budget stabilization reserve

A formalized financial reserve policy is a consistent feature of most of Standard & Poor's highly rated credits. It has been standard operating procedure for some governments for decades. Others focused attention on this following the recession of the early 1990s, and again in 2001 when many regions of the country experienced sustained revenue weakness that required severe budget reduction measures. Reserves provide financial flexibility to react to budget shortfalls or other unforeseen circumstances in a timely manner. No one level or type of reserve is considered optimal from Standard & Poor's perspective. Many different types of reserves have factored into an improved government credit profile. Some important considerations when establishing a reserve are:

- The government's cash flow/operating requirements;
- The historic volatility of revenues and expenditures through economic cycles;
- Susceptibility to natural disaster events;
- Will the fund be a legal requirement or an informal policy;
- Are formal policies established outlining under what circumstances reserves can be drawn down; and
- Will there be a mechanism to rebuild reserves once they are used.

It is important to keep in mind that use of budget stabilization reserves is not in and of itself a credit weakness. The reserves are clearly in place to be used. A balanced approach to using reserves is important in most cases, however, because full depletion of reserves in one year without any other budget adjustments creates a structural gap in the following year if economic trends continue to be weak.

## **2. Regular economic and revenue reviews to identify shortfalls early**

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 income tax or consumption-based taxes that respond rather quickly to economic fluctuations. Evaluating historical performance of certain revenues is important to this analysis because each government will have different leading or lagging economic indicators that signal potential revenue variance issues based on their economic structure. The earlier revenue weakness is identified in the fiscal year, the more effective the budget balancing response can be. It is important to monitor upside growth as well. A surge in revenues is important to understand as well to determine if the trend is an aberration or something that is likely to sustain and require a mid-year adjustment.

## **3. Prioritized spending plans and established contingency plans for operating budgets**

Contingency planning should be an ongoing exercise for governments. Budgets tend to inflate in good times: governments will expand services, fund generous employee pay packages, and accelerate financing for quality-of-life projects that would never be considered in a slow growth or declining economic environment. It is good public policy to have contingency plans and options to address budget imbalance when it occurs. This would include an analysis of the following:

- What part of the budget is discretionary;
- What spending areas can be legally or practically reduced;
- The time frame necessary to achieve reductions of various programs;
- Where revenue flexibility exists; and
- A course of action on the revenue side under various economic scenarios.

## **4. A formalized capital improvement plan in order to assess future infrastructure requirements**

Highly rated credits will have a long-term capital improvement program that comprehensively assesses the infrastructure requirements of the government and a plan to fund these requirements over a five-year (or longer) time frame. Having a realistic plan that is comprehensively developed and updated annually is a requirement of all highly rated local governments. Developing these programs for state government is difficult because the scale of projects and the scope of responsibilities are so broad. Many have accomplished this task despite these obstacles, which is a positive credit factor. It is also important to incorporate the impact of capital projects on the operating budget for the short- and long-term.

Governments have been moving into non-traditional projects, whether they are economic development (contributing infrastructure to a developer or industry) or quality of life (stadiums). These projects come with an upfront budget cost, but can have multiyear budget impacts. Projects can be sold as self-supporting, but may potentially be a drain on taxing resources.

## **5. Long-term planning for all liabilities of a government, including pension obligations, other post employment benefits and other contingent obligations would be optimal and allow for comprehensive assessment of future budgetary risks**

This area of analysis should be comprehensive and include the "whole of government" approach. The nature of government services can create unexpected contingent obligations, or "off balance sheet" liabilities that could ultimately affect taxing resources. Unfunded pension liabilities have been disclosed in detail for years and this disclosure has enhanced the transparency of funding obligations in both the current year, and future years. Disclosure of this liability has also focused attention and planning on ways

to improve funding levels. The new GASB Statement 45 requiring disclosure of liabilities associated with other post employment benefits (OPEB) will highlight some significant future liabilities for many governments. Given the rate of growth in health insurance costs and current demographic trends, greater transparency in this area will allow for advance development of funding and management solutions. Other areas of government operations and services have also resulted in budget pressure that may fall out of the traditional general fund focus. Hospital and nursing home operations, as well as various other enterprise operations have caused funding challenges at the local level, even when there is no clear legal responsibility for the government to provide funding. At the state level, local government fiscal difficulties can increase and become a funding challenge for the state.

#### **6. A debt affordability model in place to evaluate future debt profile**

Recently, state and local governments have developed debt affordability models. The impact of these models on a long-term credit rating will be dependent on how the model is established and used by the government, and the track record in adhering to the affordability parameters established in the model. There is no question that the process enhances the capital budgeting and related policy decisions regarding debt issuance and amortization.

#### **7. A pay-as-you-go financing strategy as part of the operating and capital budget.**

Pay-as-you-go financing can be a sound financing policy. Not only does it lower debt service costs, but also it provides operating budget flexibility when the economy or revenue growth slows. This is a more significant financing option when tax revenue growth in many areas can be considered extraordinary. A better match can be achieved between non-recurring revenues and non-recurring expenditures if this type of financing is used.

#### **8. A multiyear financial plan in place that considers the affordability of actions or plans before they are part of the annual budget.**

It is important that this plan is comprehensive. During a sustained economic recovery, program enhancements and tax reductions are natural. Pension funds that performed at record levels can provide incentive to expand or enhance benefits. As these program enhancements and tax reduction programs are incorporated on a long-term basis, it is important that management and elected officials understand the implications of any funding change. Elected officials will be ultimately responsible for the decisions necessary to restore out-year budget balance. Multiyear planning can be an important part of this process. The reality of government finance today is that even when there is legal authority to raise taxes, there may not be a practical ability to do so because it is politically unpopular. Standard & Poor's realizes that the out-years of a multiyear plan are subject to significant change. They provide a model to evaluate how various budget initiatives affect out-year revenues, spending and reserve levels. These plans will often have out-year gaps projected, which allows governments to work out, in advance, the optimal method of restoring fiscal balance.

#### **9. Effective management and information systems**

Investing in systems that improve the efficiency and effectiveness of a government unit and enhance overall service delivery is a positive financial management tool. Investment in financial management and information technology infrastructure has been significant during the past decade. To the extent that these changes improve financial reporting and monitoring capabilities, they enhance transparency and are viewed as a positive credit factor.

#### **10. A well-defined and coordinated economic development strategy**

Economic development programs have expanded rapidly over the last 20 years. The question for state and local governments now is not whether there should be a formal economic development program, but rather how significant a resource commitment should be dedicated to running these programs and offering incentives. These are clearly government policy decisions involving cost benefit analysis that are generally outside the credit rating process. However, if these economic development programs and strategies create employment, enhance diversification, and generate solid income growth, they could have a positive effect on a government credit rating over the long-term. To the extent that there is a net revenue benefit to a government, it could also be a positive credit factor. Economic development strategies have increasingly become regional in nature and there has been a more coordinated approach between state and local governments.

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