Special Report

Impact of Management Practices on Municipal Credit

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■ Summary

Management has always been viewed as a crucial component of credit analysis at all levels of government. However, in conjunction with our analysis of historical municipal bond performance, Fitch IBCA has come to the conclusion that management practices are even more important to predicting favorable credit performance than had been appreciated in the past. In its future rating assignments, Fitch IBCA will place greater and more specific weight on management practices, both good and bad, that are employed by issuers in running their financial operations.

This report discusses those management practices Fitch IBCA believes are conducive to strong creditworthiness and those that are detrimental to financial soundness. In our current review of outstanding general obligation and tax-backed ratings, Fitch IBCA is giving more positive credit rating weight to issuers that employ a number of these best practices, and will result in a significant number of rating upgrades when our review is completed later this spring. Going forward, Fitch IBCA will continue to study ways to specify and quantify the value of "best practices" so that management can be more objectively evaluated in assigning ratings.

■ Background

Rating agencies have always given consideration to financial management practices in assigning bond ratings. Policies that call for contingency operating reserve funds, pay-as you-go capital spending, and multiyear budgeting have been encouraged, although their rating value has been left vague in rating agencies' guidelines. In the same spirit, the achievement of budgeting and financial reporting awards by organizations like the Government Finance Officers Association (GFOA) generally have been lauded by rating agencies but given the same lukewarm response as to their value for ratings. Most rating adjustments for management reasons have occurred on a case-by-case basis, rather than by consistent benchmarks that describe their worth in an issuer's ultimate rating assignment.

In analyzing actual financial crises over the past 25 years, it is clear that management has had a significant impact in salvaging, as well as exacerbating situations. In the 1970s, New York City had more than its share of economic problems with declining population, employment, and property values. The financial crisis, however, was precipitated by cash basis accounting, excessive short-term debt, poor management decisions, lack of internal controls, overspending, and poor record keeping. The default by the Washington Public Power Supply System was as much a result of unrealistic projections as it was of a national shift away from nuclear power generation to conservation as a means of addressing energy shortages. Finally, the inappropriately speculative investment strategy and lack of internal controls in Orange County caused the huge investment losses that led the county to seek bankruptcy protection. On the positive side, fiscal discipline and strong management practices have significantly benefited credits. Baltimore, MD has been faced with long-term economic erosion, and urban flight as much as any center city in the U.S. However, the city's budgets are consistently balanced, and its bond ratings have remained in the upper end of the 'A' category by all three major rating agencies. The cities of Detroit and New York have also employed management practices that have resulted in enhanced credit quality.

So, what does this all mean? It means that management practices and policies can add stability to weak credits, maximizing their credit rating potential. Conversely, it also shows that weak financial management can negatively impact even the strongest economies and local government structures. In the extreme, poor management can cause rating downgrades to below investment grade, and, on rare occasions, bankruptcy or missed debt service payments.

■ Best Practices

Best practices promoting efficiency in government and solvency in public finance have been identified or disseminated by the GFOA; the National Associations for State Auditors, Controllers and Treasurers, and Budget Officers; the National Association of Counties; and the International Association of City Managers. In 1997, the National Advisory Council on State & Local Budgeting (NACSLB) was created by these and numerous other government organizations and business leaders. NACSLB published a report of approximately 60 best practices in budgeting and financial management for state and local government in 1998. Its recommendations form the basis of many of the financial management practices that Fitch IBCA recognizes as superior and considers in the credit rating process.

Not all of NACSLB's best practices deal with financial management, many deal with taxpayer communications or assessing programs and services. Fitch IBCA believes that if taxpayers understand the services governments provide, they may be less likely to propose restrictive initiatives or to force dramatic political or management changes through the electoral process. The list below represents those financial management practices in the government sector that Fitch IBCA believes to have the most value in credit analysis.

Best Practices Having Significant Rating Value for Fitch IBCA

1. Fund balance reserve policy/working capital reserves.
2. Multiyear financial forecasting.
3. Monthly or quarterly financial reporting and monitoring.
4. Contingency planning policies.
5. Policies regarding nonrecurring revenue.
6. Depreciation of general fixed assets.
7. Debt affordability reviews and policies.
8. Pay-as-you-go capital funding policies.
9. Rapid debt retirement policies of more than 65% in 10 years.
10. Five-year capital improvement plan integrating operating costs.
11. Financial reporting award (GFOA, ASBO).
12. Budgeting award (GFOA, ASBO).

GFOA – Government Finance Officers Association.
ASBO – Association for School Budgeting Officers.

Fund Balance Reserve Policy/Working Capital Reserves

Maintaining an operating reserve or "rainy day fund" is perhaps the most effective practice that can enhance an issuer's credit rating. Financial reserves may be used to address unanticipated revenue shortfalls or unanticipated expenditures. This provides a first defense against deficit spending and helps maintain liquidity when budgeted drawdowns are inevitable. The appropriate size of such a reserve depends on the potential variability of the entity's revenues and expenses, as well as its working cash needs to handle seasonality of revenue or expenditure.

Governments may issue cash flow notes — tax anticipation notes or revenue anticipation notes — where revenue receipts and/or expenditure disbursements are uneven throughout the fiscal year or mismatched with one another. In such cases, short-term borrowings can be an effective tool to even out lumpy or unbalanced cash flows. However, in a number of instances, governments have been forced to borrow sizable amounts due to unanticipated year-end cash and fund balance deficits. For these borrowers, the need for notes in situations of fiscal stress may be an indication of weakened credit quality and a leading cause of downgrades. Issuers that can meet their seasonal cash needs from working cash on hand can avoid all of the potential problems that might be created from issuing notes in finance shortfalls.

Multiyear Financial Forecasting

The concept of forecasting operating revenues and expenditures over several years has generally developed from issuers that have experienced severe fiscal stress and come under the oversight of financial control boards, such as the cases of New York City, Washington, D.C., and Philadelphia. In the cases of New York and Philadelphia however, multiyear financial forecasting has had longer term beneficial effects long after the financial crises had passed. The multiyear plan's value is to anticipate future challenges that may be encountered due to projected revenue and expense imbalances. This allows executives and legislators to "get in front of" potential budget stress, and take corrective action long before budgetary gaps develop into crises. The multiyear plans for New York and Philadelphia serve as good models that can be emulated by local governments, large and small.

Monthly or Quarterly Financial Reporting and Monitoring

Interim financial reporting and monitoring can head off impending fiscal stress if the financial management system is calibrated properly. The best interim reports give details on the major tax and revenue sources of the issuer, with variance analysis that demonstrates the factors that are affecting revenue inflow. Likewise, interim reports that show spending for the current month, year-to-date, comparisons-to-budget, and previous year results to date are also beneficial. For the reports to be most meaningful, the format and basis of reporting of the interim reports should be consistent with either the adopted budget, last year's GAAP results, or both. The quarterly City Manager's Report put out by Philadelphia is an example of excellent interim reporting. In addition to providing updates on service delivery and important management initiatives, the report gives quarterly results on general fund operations, adjusted to GAAP and comparable to the city's annual financial statements.

Contingency Planning Policies

The last thing that municipal credit analysts like to see in a credit are surprises, particularly negative ones. Issuers that demonstrate forward thinking and planning against unforeseen events, including potential revenue shortfalls despite reasonable economic forecasts, are viewed positively. Sometimes, future challenges are not completely unforeseen. Each year, there are a number of voter initiatives in several states where revenue limits or reductions are being contemplated that have the potential to change an issuer's financial flexibility dramatically. Issuers should have meaningful contingency plans against the possibility of voter-ordered tax cuts. Likewise, issuers that are located in zones that are frequently subject to hurricanes should have a reasonable contingency plan for dealing with the financial, economic, and social challenges posed by storm destruction. Early planning and timely communication of contingency planning can go a long way in helping to maintain creditworthiness in the face of unusual events.

Policies Regarding Nonrecurring Revenue

Over-reliance on nonrecurring revenue items (one shots) to pay for ongoing and recurring expenses is a credit concern, since it frequently contributes to budgetary stress and fiscal structural imbalances. One shots might be sales of fixed assets (such as surplus school buildings or properties); budgetary savings from a debt refinancing; court settlements; or tax collection windfalls resulting from changes at the state or federal government.

From a credit perspective, the best use of nonrecurring revenues is for one-time or discretionary spending that will not entail future year spending pressures. Examples include the deposit of excess nonrecurring revenue into the pension fund to address an unfunded liability or the use of this revenue to provide pay-as-you-go capital expenditures, reducing that year's debt issuance by a similar amount. This concept may see greater use in the future as issuers consider the use of tobacco settlements in their tax and spending plans.

Accounting for Depreciation of General Governmental Fixed Assets

Governmental Accounting Standards Board (GASB) Statement No. 34 calls for issuers to account for and report use and depreciation of capital assets not reported in utility enterprise funds. Initially, it appears that local governments that have not funded depreciation of such assets on a pay-as-you-go basis are likely to report annual operating deficits in the new government-wide financial statements under the new accounting model, even if all other normal expenses are funded or exceeded by normally recurring revenue. Because of the newness of GASB 34, Fitch IBCA does not expect to downgrade issuers in the near term due to deficits resulting solely from new depreciation expenses for general infrastructure, provided that normal revenue/expenditure balance in the general operating fund continues and the liquidity and financial position of the general fund is not compromised. However, as depreciation accounting becomes more standardized and accepted, Fitch IBCA and other municipal credit analysts will look to governments to account for infrastructure maintenance in compliance with GASB requirements and take actions to keep their infrastructure in good repair. Issuers that are already meeting and funding the depreciation identified by GASB 34 will be recognized in our rating process.

Debt Affordability Reviews

Strong debt management practices are evidenced by comprehensive debt policy statements that discuss the types and methods of financing employed by issuers. These include an issuer's policies regarding off balance sheet financings like certificates of participation or lease debt, as well as bond anticipation notes, tax and revenue anticipation notes, and variable-rate demand notes). Conduit debt need not be included, unless this debt draws on taxes and/or fees levied and collected by the issuer as part of traditional government operations. Policy statements should also set forth any self-imposed debt limitations, such as those based on personal income, property market value, or annual recurring revenue or spending. Debt affordability policies like those employed by the State of Maryland and many of its counties are viewed as having the most value in Fitch IBCA's debt management analysis.

Pay-As-You-Go Capital Funding Policies

The analytical benefits of pay-as-you-go capital funding are several and profound. First, significant funding of capital costs from annual budget appropriations help keep an issuer's debt low, which is always a positive credit factor. Second, pay-as-you-go capital appropriations improve an issuer's financial flexibility in the event of sudden revenue shortfalls or emergency spending. A temporary shift away from pay-as-you-go funding for recurring expenditure needs is not automatically viewed as a negative, particularly if the issuer has demonstrated a historical propensity to return to pay-as-you-go funding when possible. In future years, some issuers may choose to increase their pay-as-you-go appropriations in response to GASB 34 (depreciation of general assets). Such a move would have positive implications for local government credit.

Finally, the contribution of capital pay-as-you-go appropriations for projects that are financed with certificates of participation provide insight on the essentiality of the leased project to the issuer. Providing a substantial downpayment from annual resources demonstrates the government's commitment to such projects and creates another incentive for the issuer to keep annual rent payments current, so as not to lose the contributed capital of the pay-as-you-go appropriation if a certificate of participation defaults and the project is taken over by a receiver or trustee.

Rapid Debt Retirement Policies

A basic tenet in credit analysis is that the life of the debt should not exceed the useful life of the asset or project being financed. Useful life, however, should not be the only benchmark considered when structuring the maturity of an issuer's debt. An issuer that frequently sells 30-year debt or continually extends the existing maturities of debt through refinancing and restructuring may still meet the minimum litmus test of matching debt to useful life. From a credit perspective, however, an issuer that pays its debt off rapidly (65% or more of principal in a 10-year period) will be analyzed more favorably than a similar issuer that retires only 50% of its debt during a 10-year span. Tax-backed debt retirement that falls below 40% in 10 years is considered a weak fiscal practice.

One of the positive analytical features that usually results from rapid debt retirement is a declining debt service schedule, thereby providing additional financial flexibility and debt capacity in future years. Issuers that stretch their debt out, through ascending debt service maturities or through the heavy use of capital appreciation bonds, reduce their financial flexibility. Back-ended debt can raise concerns, particularly if repayment is expected to come from future revenue growth that may not be realized.

Five-Year CIPs That Integrate Operating Costs of New Facilities

The existence of a multiyear capital improvement plans (CIPs) is a practice that has reached such widescale acceptance that its absence is noticeable. The more sophisticated and forward-looking government managers not only project future debt issuance, but also build in the incremental operating costs from newly built facilities. Generally, five years is a good planning time frame, although for some communities a longer range plan may be appropriate. Integrating future operating costs from capital construction assumes that the issuer is also doing multiyear forecasting of its operating funds. Implementing both of these practices is viewed as cutting edge, contributing to more favorable rating consideration.

Award for Excellence in Financial Reporting and Distinguished Budget Presentation Award

Awards for excellence in financial reporting and budgeting are granted by the GFOA and the Association for School Budgeting Officers (ASBO). Receipt of these awards does not infer financial strength; in fact, the City of Philadelphia continued to receive such an award in the early 1990s when it was close to bankruptcy. However, the achievement of these awards do give investors and credit analysts increased confidence that information disclosed in the issuer's financial reports and budgets is comprehensive and accurate.

Frequently, reporting requirements beyond the GFOA and ASBO standards are helpful in fully describing an entity's financial operations. Additional items include details of the major transfers in and out of operating funds and a breakout of revenues categorized as

Relative Values of Best Practices in Ratings by Fitch IBCA

Best Practice	Value
Fund balance reserve policy/working capital reserves.	Very Significant
Multiyear financial forecasting.	Significant
Quarterly financial reporting and monitoring.	Significant
Contingency planning policies.	Influential
Policies regarding nonrecurring revenue.	Influential
Depreciation of general fixed assets.	Influential
Debt affordability reviews and policies.	Very Significant
Pay-as-you-go capital funding policies.	Significant
Rapid debt retirement policies of more than 65% in 10 years.	Significant
Five-year capital improvement plan integrating operating costs.	Influential
Financial reporting award (GFOA, ASBO).	Influential
Budgeting award (GFOA, ASBO).	Influential

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"taxes" into specific components. In addition, issuers that regularly disclose their management and internal controls assessments from their auditors are recognized as making the best efforts for full and complete disclosure to rating agencies and other industry credit analysts.

Best Practices, and Their Impact on Debt Ratings

Historically, analysts have given only limited weight to best practices in assessing a government's credit. The concern has always been that when economic conditions turn tough, government financial managers may loosen their standards and policies, reverting to acts of fiscal or political expediency to maintain or increase services without raising taxes. However, after reviewing the historical performance data, it is clear that most issuers that have been able to garner executive and legislative support for best practices did not scuttle their policies when revenues fell short of budget. Furthermore, disciplines that were adopted as part of long-range financial management improvements helped those issuers during the tough times. Policies that have been legislated into local law are viewed favorably. However, recognizing that policies and statutes can be altered, best practices that have been tested during challenging times are viewed most favorably. Pay-as-you-go financing has been curtailed temporarily, but has generally resumed when revenue collection improved. And self-imposed debt affordability restraints have not generally been abandoned during recession. Rather, they have provided the "steady course" to see an issuer through troubled economic times, shored up investor confidence, and assured continued access to the debt markets. As such, Fitch IBCA believes it is appropriate to explicitly give greater weight to such standards in the credit rating process.

Assessing management can be very subjective. One analyst's view of what constitutes strong management may be substantially different from another's assessment. It seems clear, however, that the management practices cited above are all tangible evidence of good management practices that, in one form or another, have been viewed positively by credit analysts in the public finance sector.

The table above is an attempt to try to weigh the value of the best practices cited as beneficial to an issuer's creditworthiness. Those practices viewed as most valuable are labeled very significant, on down to significant and influential, in that order. Fitch IBCA's rating process will weigh an issuer's achievement of these best practices, and higher ratings will reflect the scope and magnitude of an issuer's adoption of these sound financial management

Worst Practices Having Significant Rating Concern for Fitch IBCA

1. Cash basis accounting.
2. Qualified audit opinion for material weakness.
3. Deficit financing for two of last five years.
4. Slow debt retirement (less than 35% in 10 years).
5. Unfunded accrued pension liability (funding ratio less than 60%).
6. TRANS/RANS growing significantly faster than annual spending.
7. Debt restructuring that defers less than 35% of current debt service.
8. Over-reliance on nonrecurring revenue of less than 15%.
9. Aggressive investment policy for operating funds.
10. Pension contribution deferral in the current budget year.
11. Budgetary impasse beyond legal completion date.
12. Lack of capital improvement plan.
13. Excess interfund borrowing, with no capacity to repay in near future.

TRANs – Tax and revenue anticipation notes. RANs – Revenue anticipation notes.

practices. Finally, many of these practices are indicative of the management for issuers that have received 'AAA' rating assignments from Fitch IBCA in the past. Going forward, they will be important criteria for new 'AAA' assignments.

Practices that Create Concerns for Fitch IBCA

The table at the bottom of page 5 lists some practices that raise an analyst's concern about an issuer's fiscal future. In a future report, Fitch IBCA will examine these practices and other negative developments that have had, and will continue to present, negative concern and lower debt ratings.

Management is Key to Ratings in the 21st Century

Management analysis, as well as new viewpoints in the analysis of local economies and special tax pledges, form the cornerstones to Fitch IBCA's revised rating guidelines for tax-backed debt, which will be published shortly. Fitch IBCA feels that its approach will serve as a standard for tax-backed credit analysis in the age of the internet and rapidly expanding technology. As always, Fitch IBCA welcomes comments and debate from issuers, analysts, investors, or academia, among others.

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