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Evaluating Credit Risk in the Muni Market

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Vice President
Council of Development Finance Agencies
Columbus, OH

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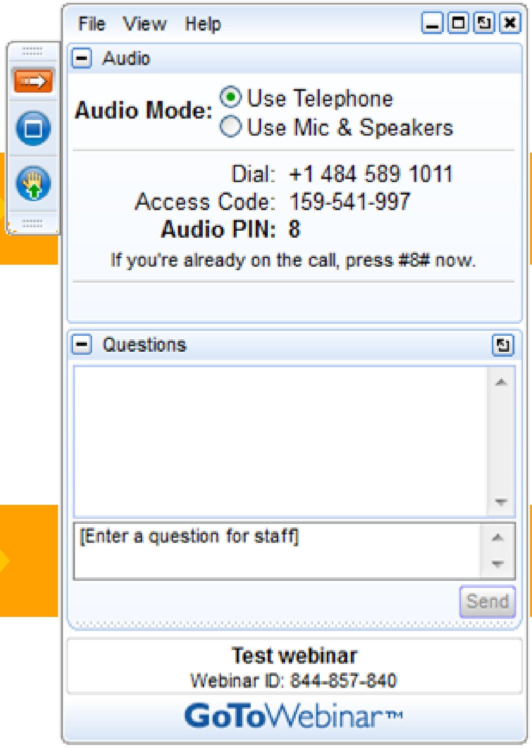

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Panelists

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CDFA Webinar- Fitch's State & Local Credit Update

Richard Raphael
Managing Director & Head, U.S. Public Finance
Fitch Ratings

June 16, 2015

Key State Credit Issues

- Budget challenges continue to be manageable in an environment of continued economic and revenue growth
  - Strength of Economic and Revenue Recovery
  - Ongoing Spending Pressures
  - Tax Relief Demands
- Risks Related to Federal Government Now Longer Term
- Core State Credit Strengths Unchanged
- State Credit Trends Largely Stable

Strength of Economic and Revenue Recovery

- Most current year state budgets realistically assumed continued but below historical trend economic and revenue recovery.

- Revenues to date are generally in line with or exceeding estimates (energy related states an exception) but are still not robust.

- The continued economic and revenue recovery has led to demands on both the spending and taxing side of the equation. There are calls to increase program funding following years of constraint, as well as pressures to lower taxes. Thus far, budget managers have been cautious.

Ongoing Spending Pressures

- Spending growth in some areas, particularly healthcare (Medicaid) and pensions, continues to outpace slower revenue growth in many states.
- Medicaid continues to be the focus of spending control, and possible alternatives to Medicaid expansion through federal waivers continue to be discussed in states that did not expand eligibility under ACA.
- Revenue caution continued during this budget development season, which combined with pent up demands contributed to challenging budget processes for more states than expected at this point in the recovery cycle.
- Pensions under control for most states with some notable exceptions including Ill, NJ, Pa, Ky.
- Pension/Legal Issues-- Recent pension related court decisions are State specific--increasing clarity in such states--Or, RI, Ill, NJ.
- Transportation capital demands remain a funding pressure. Proposals to increase funding to this area have been met with mixed success.

Tax Relief Demands

- Numerous states enacted tax cuts in their fiscal 2015 budgets with the stated goal of spurring economic development.
- Changes were relatively modest in scope.
- Enacted tax cuts in some states do not go into effect until the out years.

Risks Related to Federal Government Now Longer Term

- The threat of federal action that derails economic recovery or materially lowers funding to the states has abated for the time being.
- Although the implementation of federal health care reform has presented challenges, the negative budgetary impact effecting some states has been manageable.
- Longer term, states remain significantly exposed to the possibility of federal funding cuts, although Fitch believes states would have time to adjust to any significant federal actions.
- Any material reduction in federal support for the Medicaid program could be negative for state credit, particularly in the absence of related mandate relief.
- Steep cuts to vulnerable discretionary programs and/or federal tax code changes also could have significant effects on state budgets and economies over time.

State Credit Trends Largely Stable

- Fitch expects most state ratings to remain stable.
- States are continuing to manage budgets closely as the slow economic recovery supports revenue growth.
- Of Fitch's current U.S. state general credit ratings, four carry a negative outlook (Connecticut, Illinois, Mississippi, and New Jersey) and the rest are stable.

Core State Credit Strengths Unchanged

- U.S. states have broad economies and tax bases and substantial control over revenue raising and spending.

- The states' primary role is funding rather than providing services, allowing additional flexibility to control expenditures by downloading fiscal challenges to service providers, including local governments and universities.

- These inherent strengths should continue to support high ratings in the sector.

Key Local Credit Issues

- Moderate revenue recovery provides some budget relief but spending pressures are still present.
- Key credit issues include:
  - Stable Property Tax Tends
  - Other Revenues More Variable
  - Spending Under Control
  - Changing Labor/Management Relationship
  - Addressing Capital Needs
  - Mixed Pension Outlook
  - Bankruptcy Ramifications
  - Core Fundamentals Remain Strong

Stable Property Tax Trends

- Recent Assessed Value and home price trends indicate modest to moderate near-term property tax revenue growth
  - S&P/Case-Shiller's 20-City Composite Home Price Index shows continued, but slower, year-over-year growth

- Fitch's First-Quarter 2015 Sustainable Home Price Report indicates national home prices are at sustainable levels
  - Continued economic growth should place modest upward pressure on prices for the foreseeable future
  - Home sales volumes are recovering, but production levels are low
  - Austin, Houston, Phoenix, Riverside, Miami, and San Antonio highlighted as the most overvalued
  - Analysis differentiates between cities with strong fundamentals but over-exuberant growth (San Francisco Bay are, Texas oil-patch cities) and those with constricted supplies (Miami, Las Vegas, Phoenix)

- Given the lag between changes in home prices and their impact on property taxes, revenue growth should continue into 2016

Other Revenues More Variable/Economic Sensitive

- Many local governments receive funding from either local option or state-shared sales and income taxes
  - Revenue from these sources is subject to greater volatility than property taxes
- Moderate GDP growth should support revenue increases this year
  - Fitch's Global Economic Outlook forecasts GDP growth of 3.1% in 2015 and 3% 2016
    - Private consumption will remain the key growth driver
    - Lower oil prices, higher household disposable income, and strengthening labor market also support growth
    - Export performance will remain constrained by US dollar appreciation
    - Interest rate increases will start in mid-2015 and continue gradually
- Lower oil prices likely to have a moderate and gradual impact on local revenues
  - The direction and magnitude of the impact depends on composition of the economy, revenue composition, and valuation process
    - Oil-dependent regions expected to see some decline in drilling and exploration activity
    - Refining activity may improve
    - Other regions more likely to see benefit of lower prices
- State funding on a stable to positive trend
- Federal actions that affect states and in turn locals are assumed to be incremental
- Federal healthcare reform creates uncertainty for states, which in turn affects local governments
  - Local entities that are responsible for public hospitals face particular uncertainty
  - "Cadillac Tax" takes effect in 2018

Spending Under Control

- A few local governments are still struggling to reduce spending to compensate for weak revenue performance and pension payment increases
- The more common challenge is addressing spending items that have long been postponed
  - Wage increases
  - Service restoration
  - Infrastructure and facility maintenance needs
- More manageable challenges than the heavy cuts required during the downturn
- Structural budget balance likely to prevail in the coming fiscal year
- Prudent reserve levels generally preserved or restored
- Most entities are regaining some capacity to reduce spending without threatening basic service levels

Changing Labor/Management Relationship

- The downturn appears to have led to a growing focus on the components of the cost of providing services
- Labor costs are the largest component of local government spending and have received a large part of the attention
- Increased focus to strengthen governments' control over labor costs
- We look for a productive relationship among management, labor, and taxpayers whether organized labor is present or not, but have more concern when management's role is legally constrained.
- Recent labor settlements appear more cautious than many that were negotiated prior to the start of the downturn

Addressing Capital Needs

- Debt issuance and pay-go capital spending was reduced or postponed well into the recovery

- As a result many finance officials now report deferred maintenance and capital needs as a concern
  - National League of Cities' 2014 survey of fiscal conditions indicates that finance officers rank infrastructure needs above healthcare benefits and pensions as having a significant negative budgetary impact

- We expect increased local government debt issuance
  - Increased volume in first quarter 2015 largely reflective of refundings

- Some concerns about the level of transparency given rise of direct loans

Mixed Pension Outlook

- State and local pension plan reforms have mainly affected new employees, with minimal impact on unfunded liabilities in the near term.
  - New hybrid plans for Detroit have a meaningful impact on the liability but may not have been feasible without bankruptcy

- We anticipate improvement in funding status this year due to positive investment returns rather than reform efforts

- This highlights the dependence on market returns for pension plan health

- Reporting under new GASB standards has begun for plans; will begin for governments near year-end
  - Fitch generally views the changes positively
  - Will highlight weaknesses in plans with large unfunded liabilities and a high discount rate
  - Disclosure of liabilities for cost-sharing multiemployer plans will be enhanced
    - However, use of market instead of actuarial value of assets may lead to reduced reported liabilities and higher year-to-year volatility

Bankruptcy Ramifications

- Both Stockton, CA and Detroit, MI plans of adjustment judged fair and equitable despite disparate treatment of creditors
- Existing pension plan participants received little (Detroit) or no (Stockton) impairment while debt repayments were reduced
- San Bernardino's recent proposed plan of adjustment provides full repayment of bonds for capital projects but minimal repayment of pension obligation bonds
- Concerning benchmark of issuer/court treatment of bonded debt vs. pensions in bankruptcy
- The impact on financial stability over time of the relief from long-term liabilities is unclear
- We expect municipal bankruptcy to continue to remain rare.

Core Fundamentals Remain Strong

- Sector encompasses a vast array of special tax bonds including those supported by sales, gas, utility, and hotel taxes; tax increment revenues; and special assessments.
- The most common security is the full faith and credit, general obligation (GO) pledge.
- The GO pledge usually includes a requirement to levy ad valorem taxes unlimited as to rate or amount for debt service.
- The average GO rating of 'AA' reflects local governments' inherent strengths:
  - The authority to levy property taxes, nonpayment of which can result in property foreclosures
  - Additional taxing power that can include sales, utility, and income taxes
  - The ability to control spending to at least a moderate degree
  - The essentiality of and lack of competition for services provided by local governments
  - Moderate carrying costs relative to spending

Key Recent Rating Actions

Chicago, IL

- ULTGO, sales tax bond ratings downgraded to ‘BBB+’/Negative Watch from ‘A-’/ Negative Outlook

- Key Rating Drivers
  - Downgrade Due to Heightened Pressures – recent events have amplified the city's numerous fiscal challenges, including high long term liabilities/underfunded pensions, and are likely to further limit the city's investor/lender base.
  - Near-Term Execution Risks – regarding the city’s plans to avoid termination events under GO and sales tax swap agreements and events of default for its short-term borrowing program and bank support agreements for variable rate debt.
  - State Pension Ruling Effect Limited -- the city's legal argument supporting its reform plan for the Municipal and Laborers' pension plans is different than that of the state.
  - Underlying Credit Fundamentals Remain Sound -- the city is as an economic hub for the Midwestern region of the United States; its financial profile has markedly improved in recent years. The city's independent legal authority to raise revenues remains a key credit strength.

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U.S. Public Finance Sector Briefing Roundup 1Q15

U.S. Public Finance: Outlook Trend

- Nearly all sectors stable.
- Economic growth continues to support state and local revenues; spending pressures manageable.
- Only sector with negative outlook is Hospitals; volume and margins pressured from changing operating landscape.

U.S. Public Finance: Key Risks

- Strength of economic recovery.
- Post-employment benefit costs.
- Uncertain status of healthcare reform; reimbursement changes on hospitals.
- Potential environmental regulation changes on utilities over the medium term.
- Affordability and demand pressures for higher education.

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States

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Key Credit Issues

- Budget challenges manageable in environment of continued economic, revenue growth.
- Risks related to federal government now longer term.
- Core state credit strengths unchanged.
- State credit trends are largely stable.

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Related Research

U.S. States Snapshot – A Compilation of Fitch's State Credit Assessments and Rating Histories
New Pension Perspectives – Long-Awaited GASB Pension Changes Begin
U.S. Public Finance Annual Rating Actions 2014
State Gaming Growth Slows – But Favorable Terms Allow Share of Winnings to Climb

Local Governments

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Key Credit Issues

- Stable property tax trends.
- Other revenues more variable.
- Spending under control.
- Changing labor/management relationship.
- Addressing capital needs.
- Mixed pension outlook.
- Bankruptcy ramifications.
- Core fundamentals remain strong.

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Related Research

The Florida Report – Favorable Credit Tailwinds – Fourth-Quarter 2014
New Pension Perspectives – Long-Awaited GASB Pension Changes Begin
U.S. Public Finance Annual Rating Actions 2014
California Governor's Budget Mostly Positive for Local Governments
U.S. Public Finance - Munis Ready for Affordable Care Act Rollout in 2015

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U.S. Public Finance Sector Briefing Roundup 1Q15

Water & Sewer

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Key Credit Issues

- Cost recovery and capital spending key.
- Drinking water supply pressures.
- Gradual tightening of environmental regulations.
- Improved environment for local governments.

Related Research

Texas Water and Sewer 2015 Update
2015 Texas Water and Sewer Retail Peer Study
2015 Outlook: Water and Sewer Sector
2015 Water and Sewer Medians
Risk Radar Global 3Q14
U.S. Public Finance Sector Briefing Roundup 3Q14
U.S. Public Finance Rating Actions Third-Quarter 2014

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Public Power

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Key Credit Issues

- Environmental focus shifts to carbon.
- Rate pressures ease.
- Lower fuel costs and interest rates broadly positive.
- Improved environment for local governments.
- Lower consumption and sales growth anticipated.

Related Research

Prairie State Energy Campus – Post-Completion Update
U.S. Public Power Peer Study Addendum
The Carbon Effect – Assessing the Challenges for Public Power
The Credit Outlook

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Colleges and Universities

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Key Credit Issues

- Increased challenges for segments of the sector.
- Persistent affordability concerns ;potential margin compression
- Continuing shift of student demand/ demographic changes.
- Federal and state funding environment.
- Financial flexibility remains a key focus.

Related Research

Risk Radar Global 1Q15
Event Risk and Overall Credit Resiliency
Online Learning Here to Stay – MOOCs' Role Remains Uncertain

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U.S. Public Finance Sector Briefing Roundup 1Q15

Housing

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Key Credit Issues

- Sound state housing finance agency (SHFA) financial trends.
- Deleveraging of bond programs.
- Increased equity.
- Alternative funding tools for new loan production.
- Shrinking loan portfolios.
- Replacement liquidity concerned muted.
- Changing first-time homebuyer.

Related Research

State Housing Finance Agencies: Past, Present and Future
State Housing Finance Agencies (Statistical Information)
2015 Outlook: State Housing Finance Agencies
State Housing Finance Agencies Interactive Peer Study
What Drives Mortgage Performance?
U.S. Public Finance Sector Briefing Roundup 3Q14

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Nonprofit Acute Care Hospitals and Health Systems

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Key Credit Issues

- Expectation for greater year-over-year volatility in financial performance.
- Margin pressures (move to high deductible health plans, reimbursement under Medicare) occurring more slowly than anticipated.
- Providers in Medicaid expansion states benefit from expanded coverage with sharp reductions in charity care.
- The ACA's increasing political and legal challenges.
- Consolidation within the sector is expected to be strong.

Related Research

Trends in Not-for-Profit Hospital Pension Liabilities
The Affordable Care Act: Early Impacts
Risk Radar Global 1Q15
U.S. Public Finance Annual Rating Actions 2014
The Credit Outlook

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Nonprofit Continuing Care Retirement Communities

Key Credit Issues

- Improving occupancy and core operating performance .
- Improving economy and housing prices.
- Significant improvement in access to capital.
- Key recent rating action.

Related Research

2015 Outlook: Nonprofit Continuing Care Retirement Communities
Nonprofit Continuing Care Retirement Communities Interactive Peer Study
Risk Radar Global 1Q15
The Credit Outlook

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Families of Ratings: Relationships Among US Public Finance Credits

Rachel Cortez, Vice President, US Public Finance

BNY Mellon/CDFA Webcast – June 16, 2015

Moody's "Families of Ratings" Concept

Ratings within the same family of credits influence one another.

Relationships exist throughout the rating scale but generally become most obvious under stress.

Two types of relationships that inform our credit opinions include:

- A common or related **revenue base**
- A common or related **governance or legal structure**

Common or Related Revenue Base

Our methodologies for rating US local governments provide for an analysis of the base from which revenue is generated.

- For general obligation (GO) credits, we evaluate the property tax base and the source of any other income, such as intergovernmental revenue.
- For sales tax credits, we evaluate the sales tax base.
- For utility credits, we evaluate the system's customer base.

Common or Related Revenue Base *continued*

To assess current and future **capacity** to generate income, we consider the revenue base's size, wealth, diversity, and stability.

To assess current and future **demands** on the revenue base, we analyze the aggregate governmental costs supported by the base. We consider expenses of the rated entity as well as those of other governments that access the same revenue base.

Example: Growing costs associated with the debt and unfunded pension liabilities of the City of Chicago and Chicago Public Schools have led to downgrades of the Chicago Park District and Chicago's Water and Sewer Enterprises. These entities share all or part of the same revenue base.

Common or Related Governance or Legal Structure

Different credits may be linked through governance or legal ties:

- Identical composition of executive and legislative bodies
- Executive or legislative body of one entity appoints the executive or legislative body of another entity
- Established movement of monies between two entities through payments in lieu of taxes (PILOTS)
- Potential movement of monies between two entities given a lack of legal separation

Example: Governance and legal connections between the City of Chicago, Chicago Public Schools, the Chicago Park District, and Chicago's Water and Sewer Enterprises have led to downgrades of the Park District and the Water and Sewer Enterprises.

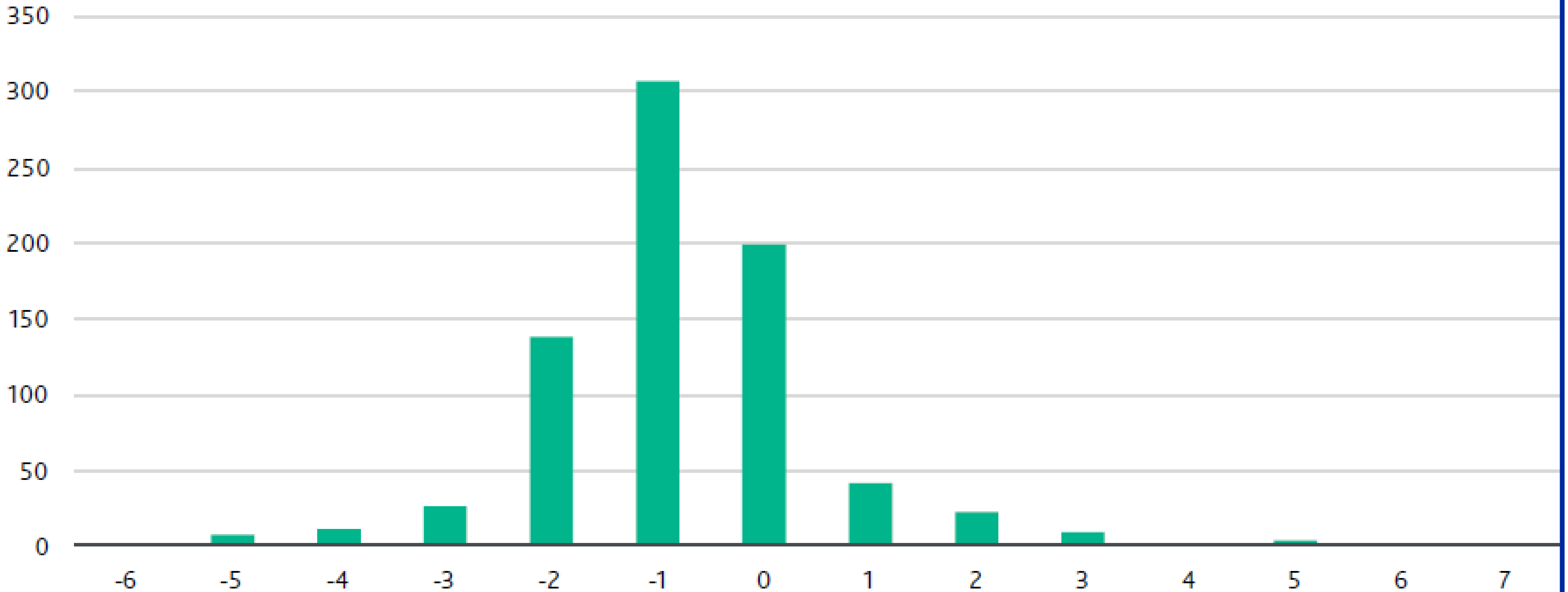
Moody's Special Tax Methodology

A special tax credit may be rated higher than the parent GO credit if the pledged special tax revenues are legally separated from the general government credit.

Example: The Nassau Interim Finance Authority (NIFA), a New York State agency, receives sales tax revenue and pays debt service before remitting remaining sales tax monies to Nassau County.

Moody's Municipal Utility Methodology

(Negative means utility rating is lower than the GO, positive means it is higher; not all rated utilities are associated with rated general governments)



Source: Moody's Investors Service

Other Considerations: State Ratings

States can strengthen local government and higher education credits…

Examples: In New York State, many stressed cities and counties have benefited from state intervention and support.

California has intervened on behalf of distressed school districts and community college districts to stabilize financial operations and strengthen management.

At the higher end of the rating scale, we upgraded Texas Tech to Aa1 stable in March 2015 due in part to consistent operating and capital support from the State of Texas.

Other Considerations: State Ratings *continued*

…and states can weaken higher education and local government credits.

Example: New Jersey lawmakers have proposed pushing certain pension costs down to public school districts and reducing forms of intergovernmental revenue to municipalities. We recently downgraded several public universities that we believe are vulnerable to state budget pressures.

Laura Kuffler-Macdonald

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U.S. Higher Education 2015 Outlook

Laura Kuffler-Macdonald
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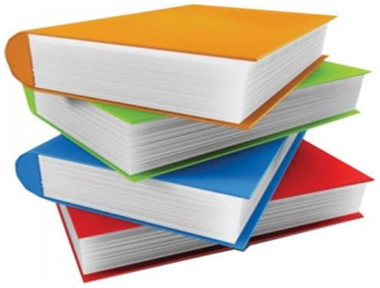
June 16, 2015

U.S. Higher Education: Our Sector Outlook

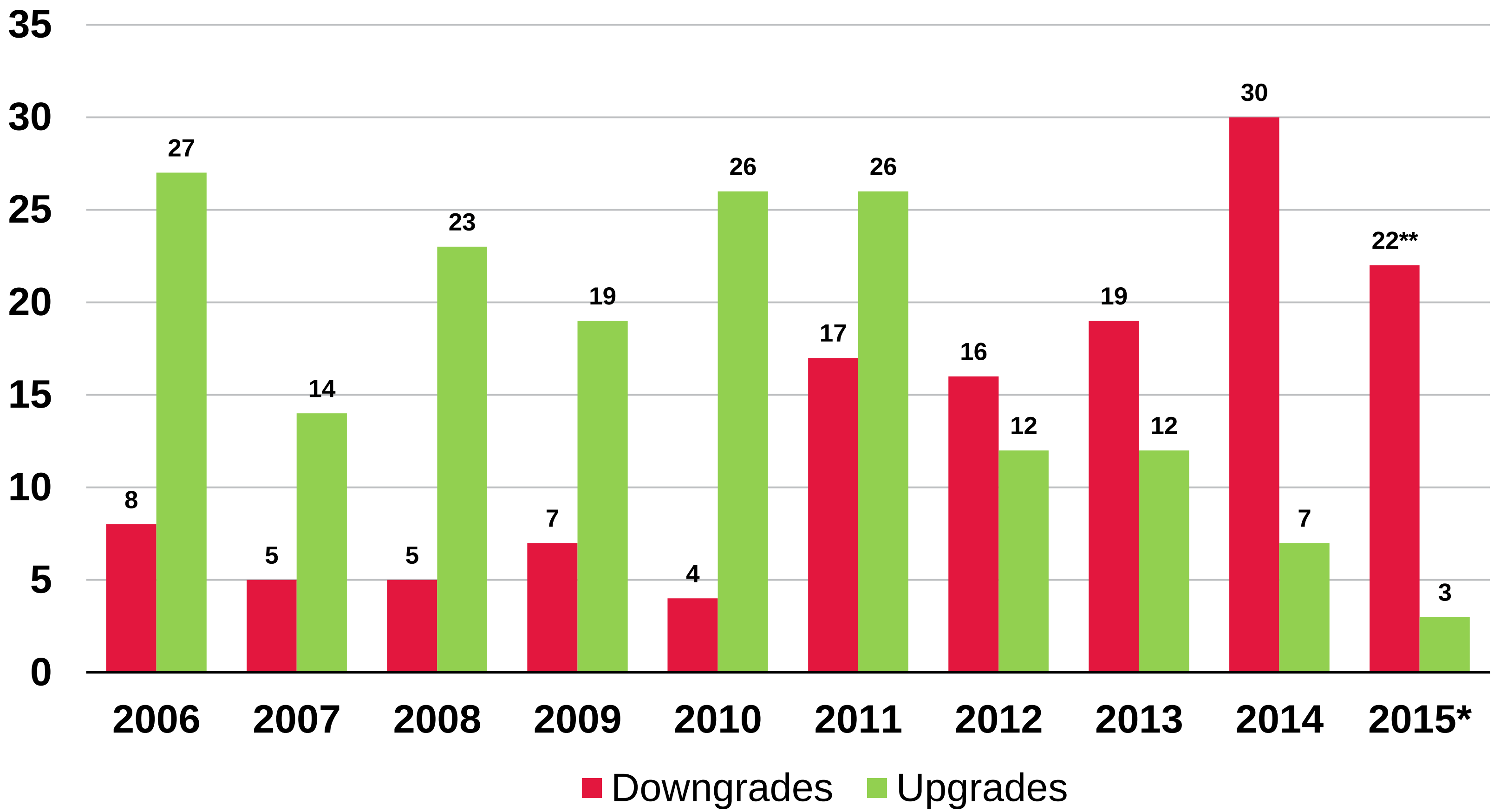
2015 Outlook: Negative

(We expect more negative rating actions than positive in 2015)



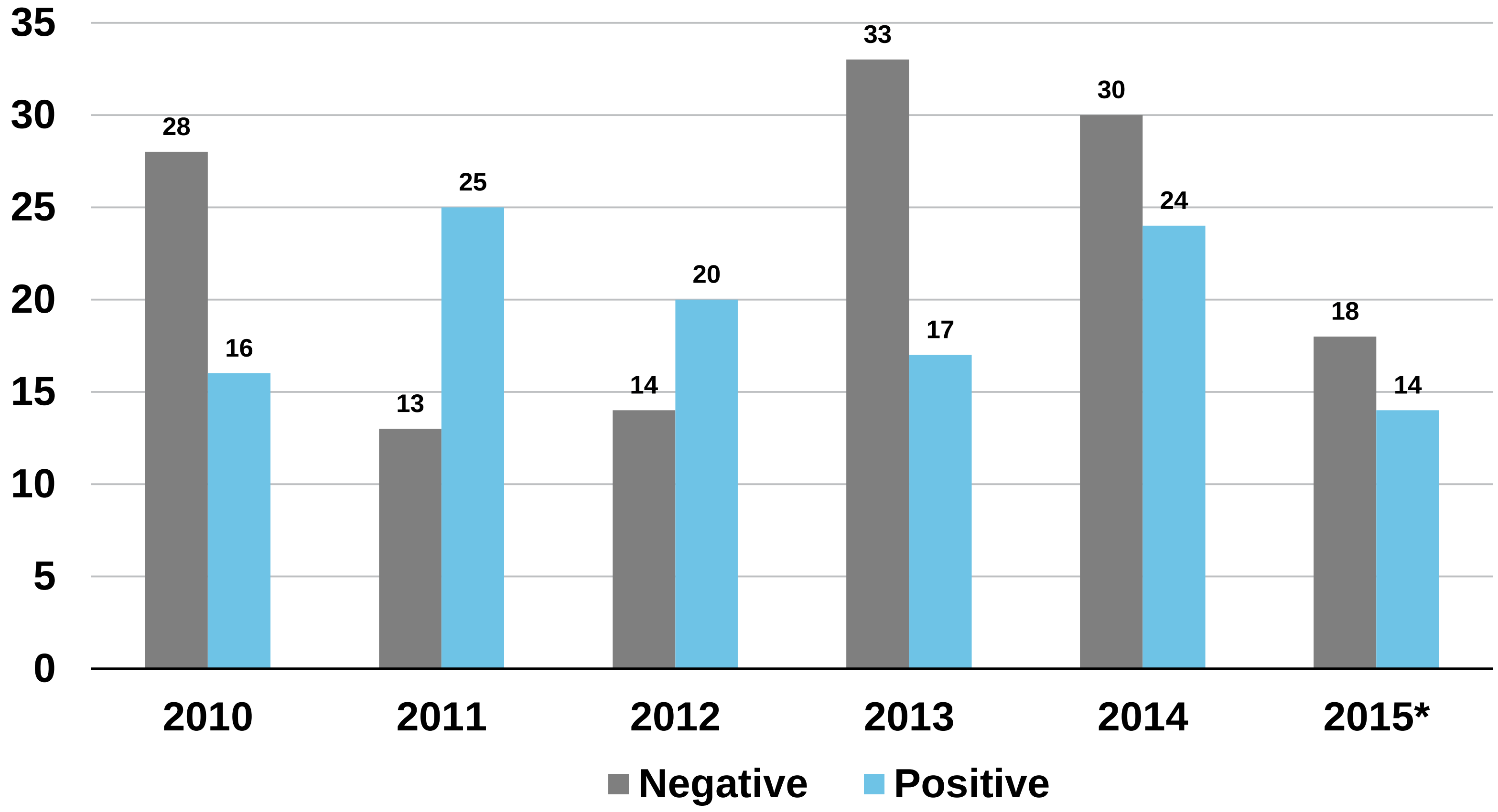
2014 Rating Actions & Distributions Update as of June 8, 2015

U.S. Higher Education Rating Actions in 2015



*As of June 8, 2015. **Includes multiple downgrades for University of Puerto Rico

U.S. Higher Education Outlook Revisions in 2015



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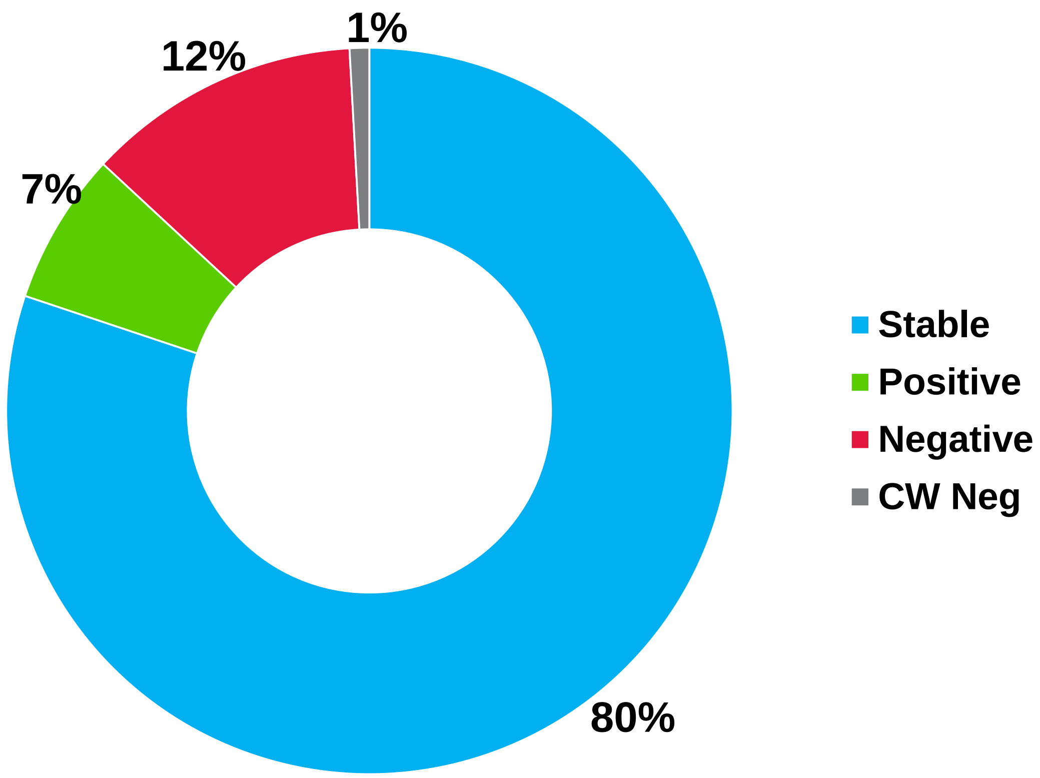
U.S. Higher Education Outlook Distribution



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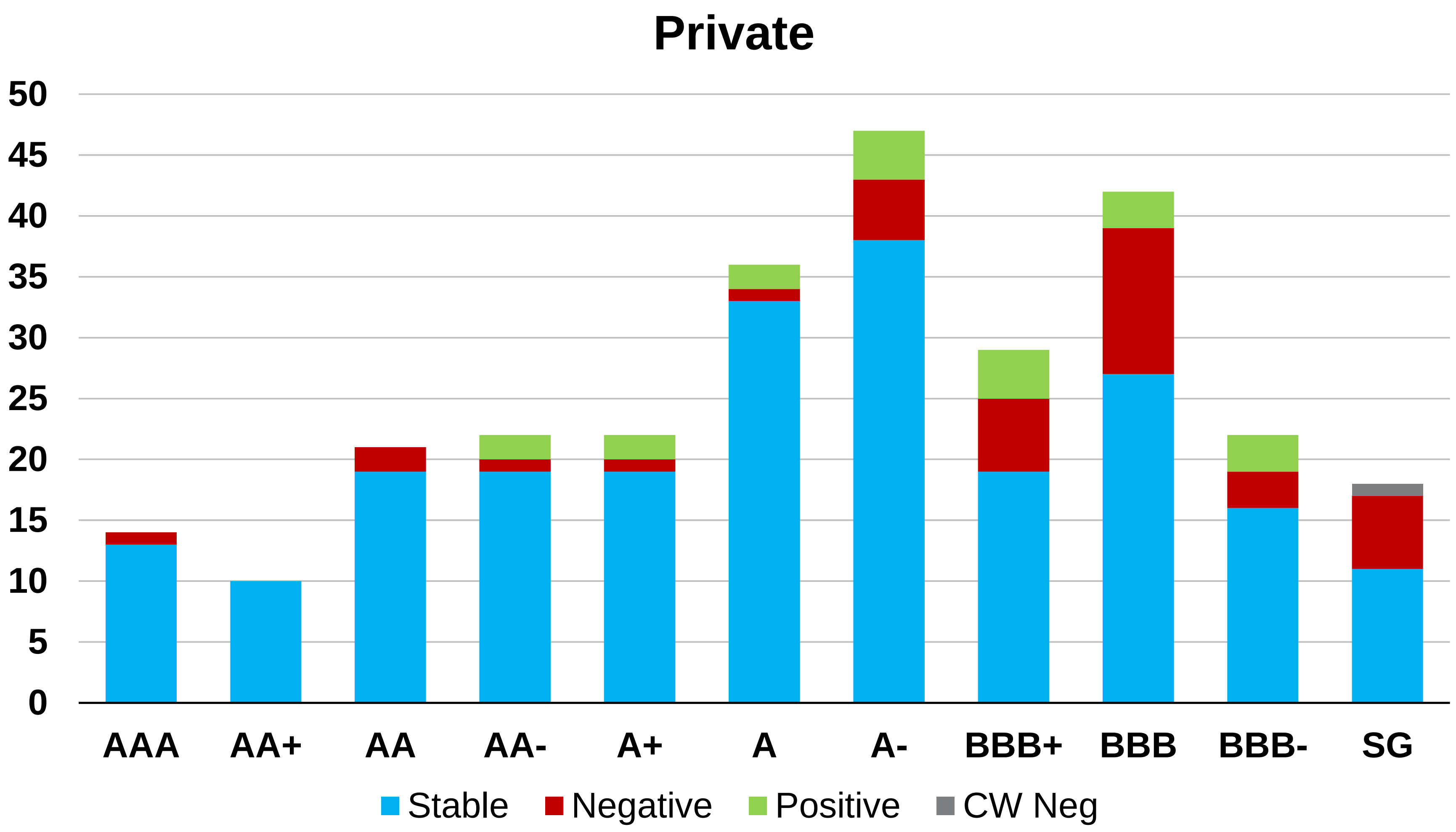

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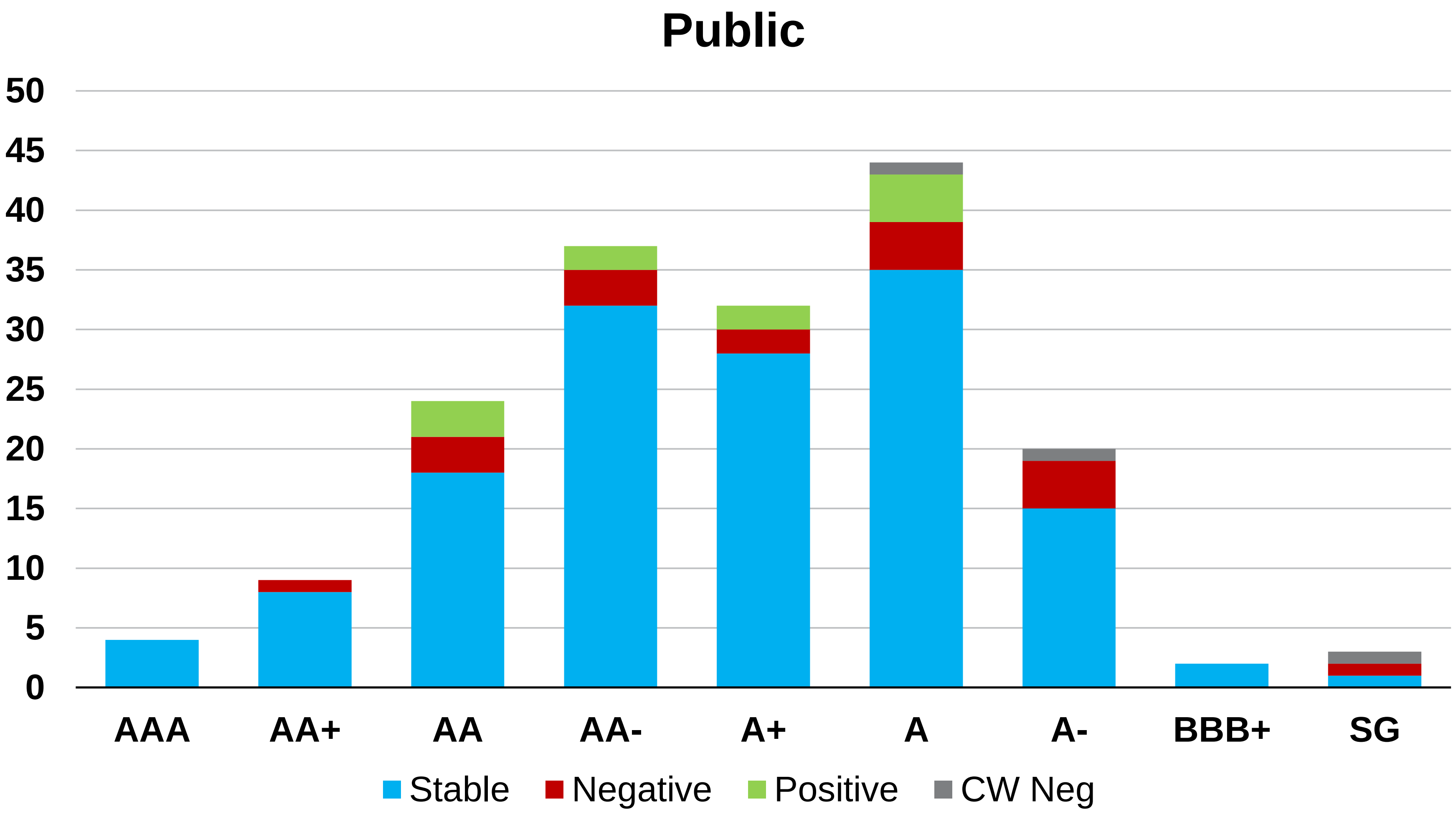


As of June 8, 2015

2015 Outlook

U.S. Higher Education: Essential or Optional?

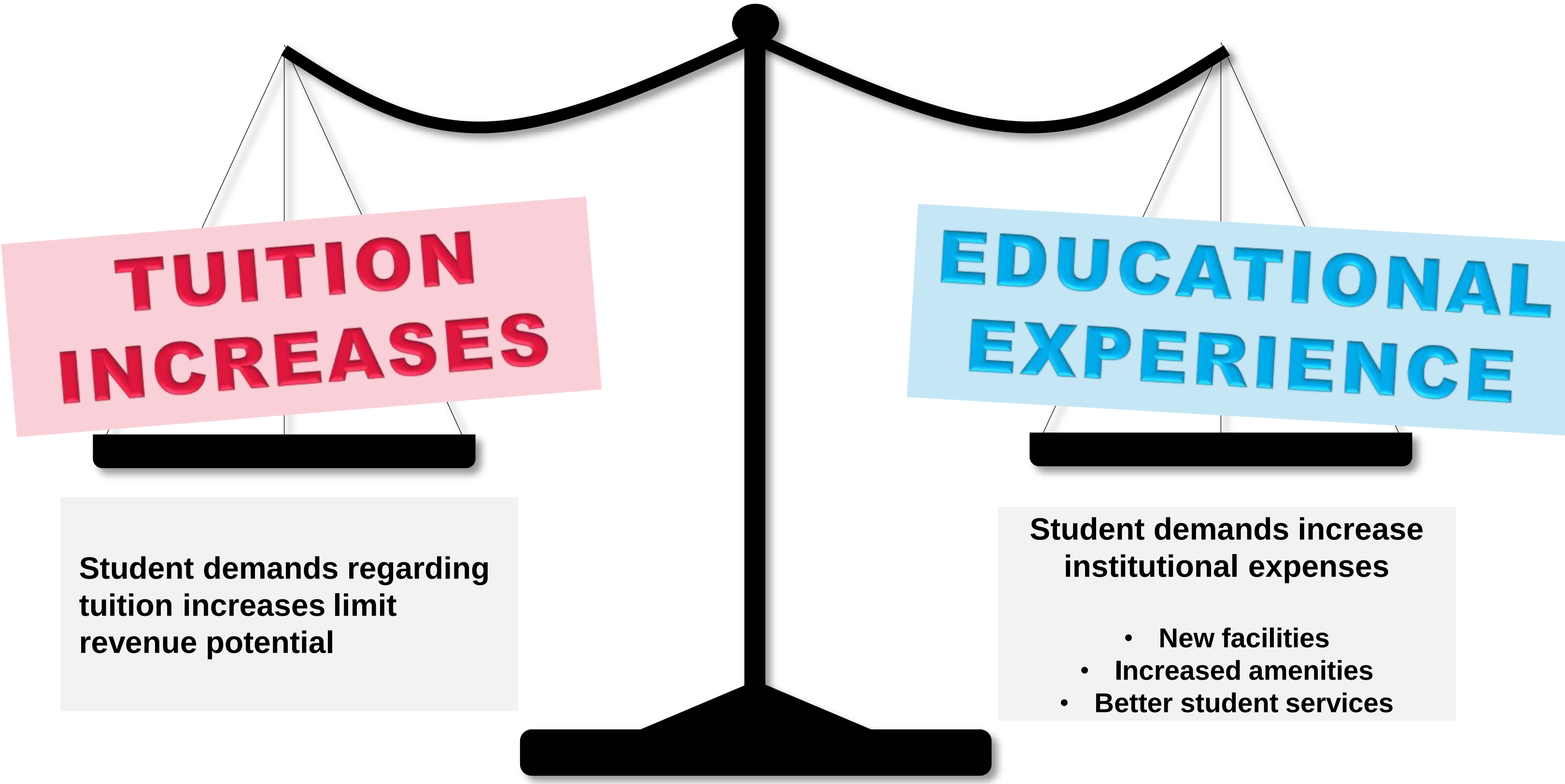
TRANSPORTATION



HIGHER EDUCATION

Technical College	Ivy League University	Public University
Private Liberal Arts College	Community College	Online College

U.S. Higher Education: A Buyer's Market with Mounting Expenses



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Questions

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Thank You

2015 Higher Education Outlook
Upping The Ante: Costs Of Luring Top Students Keep The Outlook Negative On U.S. Not-For-Profit Higher Education Sector - January 15, 2015

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  - CDFA New York/New Jersey Webcast: Financing the World Trade Center
    Wednesday, June 24 @ 11:00 am EDT
  - CDFA Kentucky Webcast: Understanding the EB-5 Model in Kentucky
    Wednesday, August 19@ 11:00 am EDT

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