

Top 10 Ways To Improve or Maintain A Municipal Credit Rating

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Standard and Poor's has widely disseminated information to investors and issuers outlining how a credit rating is established. We have also developed GO credit benchmarks for the industry-wide ratios utilized to analyze municipal bond issues. These ratios are the foundation of the quantitative measures Standard & Poor's utilizes when establishing a credit rating. Municipal market participants focus on ratio or median comparisons in order to fine-tune credit analysis. For investors, credit benchmarks help to make credit distinctions. For bond issuers, the benchmarks are often used as a framework for comparing credits with the focus often being on improving a credit rating.

Best Practices Make a Difference

In addition to quantitative factors, qualitative information factors heavily into credit analysis. The whole concept of credit ratios/benchmarks excludes management factors, administrative characteristics and other structural issues facing a government entity that can be an overriding factor in a rating. Management can contribute significantly to many of the individual credit benchmarks used by our industry and can positively impact ratings in a number of ways. Conversely, the lack of strong management is usually a significant factor in a weakened credit profile. The economy will determine a rating category to a large extent but management will be one of the deciding factors in fine-tuning the rating. The management or administrative structure of a government will move a rating up or down more significantly and swiftly than any other element of a credit review.

When it assesses management, Standard & Poor's includes analysis of the political framework that governs as well as the day-to-day management staff. The priorities of the two can be different. 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 below of ways to improve or maintain your credit rating 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 fosters a positive working relationship not only with a rating agency but a government constituency as well.

Top 10 List

1. Establish or enhance rainy day/budget stabilization reserves.

regions of the country experienced sustained revenue weakness that required severe budget reduction measures. Many state and local governments were afforded the opportunity during the decade-long economic expansion through 2001 to accumulate reserves. As economic trends have weakened over the past year, the importance of reserves from credit standpoint is again highlighted. It clearly provides a measure of financial flexibility to react to budget shortfalls 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 as follows:

- What the government's cash flow/operating requirements are;
- The historic volatility of revenues and expenditures through economic cycles;
- 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 utilized.

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 utilizing reserves is important in most cases, however, as 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. Establish regular economic and revenue reviews to identify potential budget problems early.

Establishing 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.

3. Prioritize spending plans and establish contingency plans for operating budgets as a fallback financial strategy.

Although budget shortfalls had been a scarce commodity until 2001, they have been widespread recently. Across the country, budget discussion has rapidly shifted from surplus revenue and tax relief to spending reduction in order to end the fiscal year in balance. What is done with surplus funds can be as important as how shortfalls are addressed. If revenue growth is abnormally high and potentially unsustainable, program and service expansion can create significant budget shortfalls as the economy cycles downward.

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

- 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 different economic scenarios.

4. Have 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 on a short- and a long-term basis.

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

5. Establish a debt affordability model to evaluate your 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.

6. Develop a pay-as-you-go financing strategy as part of your operating and capital budget.

Pay-as-you-go financing can be a sound financing policy. Not only does it lower debt service costs but it provides a lot of 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 done. It is important again to note that this is applicable to enterprise operations of a government as well.

7. Consider the affordability of actions or plans before they become part of your budget by analyzing revenue and spending as part of a multi-year financial plan.

It is important to do this on a comprehensive basis. During a sustained economic recovery, program enhancements and tax reductions are natural. Pension funds that performed at record levels provided incentive to expand or enhance benefits. As these program enhancements and tax reduction

A multi-year planning process is a critical exercise. 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, as it is very politically unpopular. Standard & Poor's realizes that the out-years of a multi-year plan are subject to significant change. They provide a model to allow evaluation of how various budget initiatives impact out-year revenues, spending and reserve levels. These plans will often have out-year gaps projected which allow governments to work out, in advance, the optimal way to restore fiscal balance.

8. Long-term planning for all liabilities of a government, including pension obligations and contingent liabilities, would be optimal and would 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 creates unexpected contingent obligations or "off balance sheet" liabilities that could ultimately affect taxing resources. The solid waste area is a recent example of this. While many waste disposal projects were financed with revenue bonds, changes in the industry have dramatically changed the revenue generating capacity of many plants. In many instances, local or state governments have stepped up to support these obligations with general tax resources although they had no legal obligation to do so.

9. Establish and maintain effective management systems.

This was another really positive use of surplus revenues by governments across the country. Investing in systems that improve the efficiency and effectiveness of a government unit and enhance overall service delivery is a positive financial management tool. Governments made significant technology investments in the 1990s. Many financial and budgetary systems were fully overhauled. To the extent that financial systems are improved and the ability to monitor revenues and expenditures are enhanced, a government will be much better positioned for the next "rainy day." Governments have also turned to the Internet to provide or augment services where it is cost effective, which can also have a positive budget impact.

10. Have a well-defined and coordinated economic development strategy.

Economic development programs have expanded rapidly over the last 15 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 generate employment, enhance diversification, and generate solid income growth, they could have a positive impact on a government credit rating over the long term. The revenue base of a government could also benefit from an improved economic profile, which would also positively impact a government's credit rating. Economic development strategies have increasingly become regional in nature and there has been a more coordinated approach between state and local governments. This would likely lead to a more positive and cost effective method of generating economic development.

Governments in general were more cautious during the record economic expansion that ended in March 2001. Many improved their financial structure by observing the positive management actions listed above. This clearly

be sustained and possibly improved for those governments that employ some of "best management practices" identified above.

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