

Standard & Poor's Perspective

US Credits: Strengths and Challenges

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Introduction

- US Public Finance Overview
- S&P's role in Process
- GO Criteria Overview
- Characteristics of Highly Rated Credits
- Challenged Credits in the News: Focus on Detroit

The US Muni Landscape

Municipal Finance in the United States

- Local governments have significant autonomy from federal/central government
- Revenues raised and used locally
- 10th Amendment to the U.S. Constitution
 - Establishes fiscal federalism and state sovereignty

The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people

- Most local government ratings in the US not directly tied to the sovereign rating

State and Local Governments

- ‘States Rights’ is a backbone of the US Constitution
- Relationship with state governments and locals is much closer
- States have sovereign powers and set policy for locals
- 50 Different States = 50 Different Structures
 - Over 150 different Institutional Framework scores

State and Local Governments, con't

- Taxing and revenue scheme differs by state
- States provide support and set the ability/lack thereof to file Chapter 9 (municipal) bankruptcy
- Operations, debt and pension costs are typically determined and funded at the state/local level
 - Federal support generally program-specific
 - Unfunded federal mandates very limited
- Must manage risk and long-term demands independently

Standard & Poor's in the Muni Market

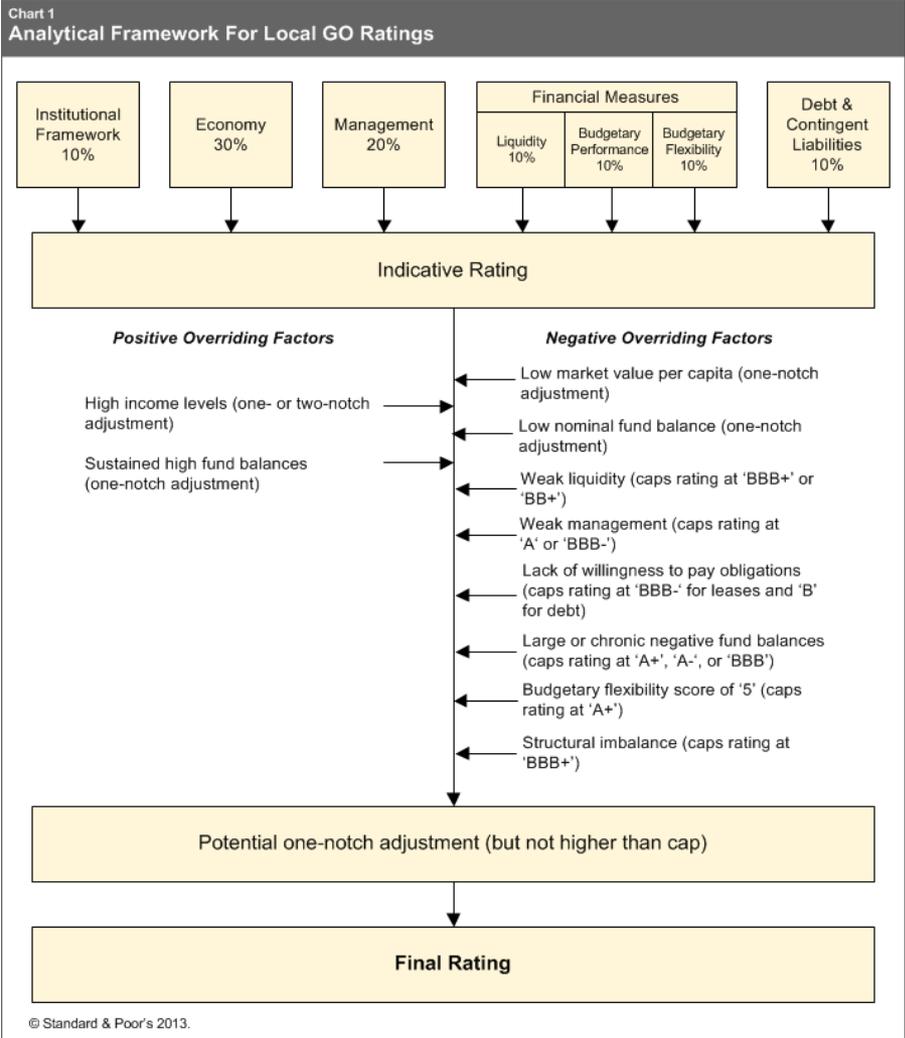
- Independent opinion provided to marketplace
- Provide ratings on issues, not issuers
- Rate only on request
- S&P has more than 14,000 ratings on local units of government
- Ratings based on written criteria
 - One of S&P's goals is to be as transparent, forward looking and comparable as possible

Overview of S&P Local GO Rating Criteria

Local Government GO Criteria

- Four main factors
 - Economy: wealth and income measures
 - Finances: reserves, performance, liquidity
 - Management: policies and practices
 - Debt: all debt and pension obligations
- New Institutional Framework score measures the state environment
- Consistent, transparent, forward looking

Analytical Framework



Putting it all Together

Indicative Rating

Positive Overriding Factors

- High income levels (1 or 2 notch adjustment)
- Sustained high fund balances (1 notch adj)

Negative Overriding Factors

- Low market value per capita (1 notch adjustment)
- Low nominal fund balance (1 notch adjustment)

Rating Caps

- Weak liquidity (BBB+ or BB+)
- Weak management (A or BBB-)
- Lack of willingness to pay obligations (BBB- for leases and B for debt)
 - Large or chronic negative fund balances (A+, A-, or BBB)
 - Budgetary flexibility score of 5 (A+)
 - Structural imbalance (BBB+)

***** ONE NOTCH FLEXIBILITY *****

FINAL RATING

When it all goes right...and Wrong

When it Goes Right

Management Characteristics: Highly Rated Credits

- Create 'Rainy Day' fund
- Regular financial reviews to identify shortfalls early
- Prioritized spending and contingencies for budgets
- Formal capital improvement plan
- Long term planning for long term liabilities (pension, OPEB)
- Multi-year financial planning
- Effective internal controls and systems
- Economic development strategy

When it Goes Wrong

U.S. Bankruptcies are rare but do occur

- High hurdle: demonstrate insolvency and able to file
- Jefferson County, Alabama
 - Plan of adjustment approved 2 years after filing in November 2011
 - Currently under appeal
 - Problems stemmed from variable rate debt and related swaps
- Detroit
 - Largest municipal bankruptcy in US history
 - Filed in July 2013, hope to exit in fall 2014

Detroit: The History

- Economic deterioration over decades
- Shift in population and jobs
- Government did not downsize with city
- Management turmoil and turnover
- Budgets did not keep pace with changing revenue picture

Detroit Bankruptcy: Key Dates

- Defaulted on pension debt in June 2013
- Filed for bankruptcy in July 2013
- Bankruptcy petition approved December 2013
- Emergency manager Kevin Orr appointed by state for 18 months
 - Term is up in September 2014
 - EM hopes to have the process complete by then

Detroit Bankruptcy: What's Next?

- Recent weeks have seen an increase in creditor settlements that become part of plan of adjustment
- Plan of adjustment must be voted on by creditors before the trial begins
 - Provided a plan meets all other confirmation provisions, it may be 'crammed down' if at least one group of impaired creditors approves the plan
 - Must also be found 'fair and equitable'
- Trial dates currently set for July and August
 - Chapter 9 bankruptcy code: "is in the best interests of creditors and is feasible."

Detroit: Long Term Implications?

- Original plan of adjustment called for settlement payments on Unlimited Tax GO Bonds of 20 cents/dollar
 - Unlimited Tax GOs typically considered least risky by market
 - Created market turmoil
 - Recent agreement with bond insurers settled at 74.5 cents/dollar
- With few bankruptcies to go on, market may view Detroit as precedent setting

S&P: What Are We Watching for?

- How other GO bonds are treated (limited tax GO)
- Are water & sewer revenue bonds impaired?
- How pension obligation certificates are treated
 - City has repudiated this debt and there is a lawsuit pending
- Post bankruptcy, how does Detroit fare?
 - Are changes in obligations sufficient to allow the city to operate in structural balance?

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Q&A

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