OMAC MuniNews

Volume 14, Issue 2 News & Views About the Ohio Municipal Finance Industry May 2012

This newsletter is available on our website: www.ohiomac.com

The Impact Of Economic And Fiscal Pressures On Credit Quality: Using S&P's Proposed Criteria For Rating U.S. Local Governments To Estimate Rating Distributions

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Standard & Poor's Ratings Services is presenting this analysis in conjunction with the publication of its proposed criteria "Request For Comment: U.S. Local Governments: Methodology And Assumptions" (the RFC), on March 6, 2012.

Introduction

U.S. local governments could face two potential credit risks in the coming year: federal spending cuts and further economic decline. These uncertainties raise the question of how local government credit performance might fare in the future, and what impact potential economic or fiscal pressures may have on credit ratings.

While local governments receive very little direct federal funding, cuts to federal spending could affect them in several indirect ways. We have indentified some of the potential changes state and local governments could face stemming from the current federal budget situation (see the article, "A Look At U.S. State And Local Governments As Joint Committee Deadline Nears", published Nov. 21, 2011). First, cuts in federal aid to states could be passed through to local governments. More than 90% of counties and municipalities rated by Standard & Poor's receive some form of state aid, which represents, on average, 15% of general fund revenues. Second, removing the tax exemptions of mortgage interest or property taxes would decrease the affordability of homes, potentially leading to declining valuations that could pressure property tax revenue. Lastly, a repeal of the federal tax exemption for municipal bond interest income would increase the cost of debt for local governments by raising investors' required rate of interest.

Economic decline would have both direct and indirect impacts on local governments. Direct impacts at the local level include increases in the unemployment rate, declines in market values and assessed values, reduced consumer spending, and associated declines in tax revenues. Indirectly, if macroeconomic declines weaken state finances, states may reduce aid to local governments. In addition, declines in the stock market and other securities markets could reduce the value of assets held by individuals as well as those in pension and other postemployment benefit (OPEB) trust funds. A decline in the value of assets increases both the unfunded liability position of and required annual contributions to such plans. This could result in higher annual costs to local governments, further stressing budgets.

Given future fiscal and economic uncertainties, our analysis seeks to provide clarity on possible sector-wide changes in rating distributions that could result from different levels of economic and fiscal pressures and different levels of government response to those pressures. It uses the framework described in the RFC, which applies to general obligation (GO) debt of U.S. counties and municipalities, to produce estimated rating distributions under each of the scenarios considered.

The primary purpose is to demonstrate that the transparency of the proposed criteria better facilitates this type of analysis -- estimating possible rating distributions under various levels of pressure and management response. The secondary purpose is to illustrate that, as stated in the RFC, our estimation of rating changes under the proposed criteria rests on a number of assumptions and that depending

on how actual conditions vary, the rating results may also vary. In addition, we believe the analysis illustrates that the proposed criteria reflect the resiliency of the U.S. local government sector to significant pressures, but also that ratings may change as economic and fiscal challenges and government responses change.

Limitations

The analysis and its outcomes are subject to a series of limitations. The scenarios we analyze do not represent economic or fiscal forecasts of what we necessarily think will occur in the future. Rather than speculating on the extent to which economic and fiscal threats may occur and precisely how they may combine to affect local government credit quality, the analysis examines a range of effects that might result if such risks were realized. The scenarios vary significantly to reveal the degree of rating responses to pressures. The analysis does not include the benefit of information and projections we would receive from management teams relevant to the circumstances at hand. This lack of information prevents full application of the proposed criteria due to its reliance on qualitative information. As such, the analysis requires simplifying assumptions and, therefore, the results of the scenarios should not be viewed as precise rating outcomes. The results are estimates based on data available as of mid-2011 for over 3,700 U.S. counties and municipalities with GO ratings.

Nine Scenarios

We created nine scenarios by varying two dimensions: the level of economic and fiscal pressures (level of pressure) and the level of management response to the pressures (level of response). The three levels of pressure are mild, moderate, and severe. The three levels of response are weak, medium, and strong. Each level of pressure assumes a different level of decreasing market value, increasing unemployment, increasing revenue-expenditure imbalance, and increasing cost of debt and employee retirement benefits. We included different levels of government response because local governments retain significant abilities to alter their revenue and expenditure patterns in response to fiscal pressure. Although many local governments have the ability to offset potential revenue losses with tax rate increases, basing management responses solely on expenditure reduction is one of our simplifying assumptions. Table 1 details the starting assumptions for each scenario.

Table 1

Starting Assumptions

Level of pressure	Mild			Moderate			Severe		
Level of response	Weak	Medium	Strong	Weak	Medium	Strong	Weak	Medium	Strong
Scenario	A1	A2	A3	B1	B2	B3	C1	C2	C3
Market value decline	5%	5%	5%	10%	10%	10%	20%	20%	20%
Unemployment rate increase	1%	1%	1%	2%	2%	2%	4%	4%	4%
General fund and total governmental funds revenue decline	5%	5%	5%	10%	10%	10%	20%	20%	20%
General fund and total governmental funds expenditure reduction (% of revenue decline)	0%	50%	100%	0%	50%	100%	0%	50%	100%
Total governmental funds debt service increase	0%	0%	0%	0%	0%	0%	1%	1%	1%

The scenarios names in table 1 (A1, A2, B3, etc) make it easier to follow the impact of varying one dimension while keeping the other constant. For example, scenarios A1, A2, and A3 have a mild level of pressure but vary on level of response, indicating that any difference in results between these scenarios is due to differences in level of response. Likewise, scenarios A3, B3, and C3 all have a strong level of response but vary on level of pressure, indicating that any difference in results between the scenarios is due to differences in level of pressure.

The starting assumptions in table 1 directly and indirectly affect five of the seven factor scores in the RFC. Market value declines affect the economy factor score directly through market value per capita, one of two metrics forming the initial economy score. As the county unemployment rate increases, the economy factor score worsens (increases) by 1 when it exceeds 10%. Revenue declines in conjunction with expenditure reductions determine the net operating results for the general fund and total governmental funds. These operating results determine the initial budgetary performance score as well as increase or decrease both cash and fund balance levels. The available general fund balance determines the initial budgetary flexibility factor score and can also result in an upward adjustment to the score by 1 when it exceeds 30% of general fund expenditures for three consecutive years. Total government cash serves as the numerator for both metrics used to determine the initial liquidity factor score. Total governmental funds debt service as a percentage of expenditures is one of two key metrics determining the initial debt and contingent liability factor score. That initial score can be adjusted negatively by 1 or 2 due to unaddressed exposure to unfunded pension or OPEB obligations. We assumed the impact of this adjustment for all issuers would be 1 when pressure is moderate and 2 when pressure is severe. We did not assume any changes in debt outstanding because deficit bond financing is very rare among U.S. local governments.

Unaffected by the metrics in table 1 are the management and institutional framework scores. While these scores can change, such a change directly in response to the conditions detailed in table 1 is less obvious. In particular, the management factor assesses the impact of management conditions on the likelihood of repayment, not managerial quality. Therefore, the level of management response that the analysis takes into account would not necessarily change the management score, but instead affects the financial results captured in the budget flexibility, budgetary performance, and liquidity factor scores.

In addition to their impact on the factor scores, the assumptions in table 1 also affect several overriding factors. The proposed criteria employ overriding factors that can create greater rating differentiations when more exceptional circumstances exist. The overriding factors either notch the indicative rating up or down or place a specific cap on the final rating. The overriding factors in the analysis triggered for some credits include:

- Market value per capita less than $30,000;
- Liquidity factor score equal to 4 or 5;
- General fund balance greater than 75% of general fund expenditures for three consecutive years;
- General fund balance below negative 10% of general fund expenditures;
- General fund balance below negative 5% of general fund expenditures for two consecutive years; and
- General fund balance below negative 5% of general fund expenditures for three consecutive years. In the analysis, the overriding factors are triggered indirectly by assumptions made on other metrics, not explicit assumptions about the overriding factor. For example, the revenue decline and expenditure reduction assumptions indirectly affect the fund balance overriding factors through their impact on the available general fund balance

Results

Table 2 presents the estimated rating distributions resulting from each scenario. It also includes a baseline scenario, which represents local government credit conditions based on the most recent information available, the application of the proposed criteria as described in the RFC, and additional positive assumptions. The assumptions are:
- That the economy will not slide back into a recession in the coming year although growth will remain subdued;
- That any near-term federal deficit reduction measures will not unduly target local governments;
- That governments will continue to make needed adjustments in response to continuing fiscal imbalances that are less than those of past years; and
- That the slow but observable trend of governments addressing long-term benefit costs will continue at least at its current rate

Table 2

Estimated Rating Results

		Scenarios								
Level of pressure		**Mild**			**Moderate**			**Severe**		
Level of response		**Weak**	**Medium**	**Strong**	**Weak**	**Medium**	**Strong**	**Weak**	**Medium**	**Strong**
Estimated rating	Baseline	A1	A2	A3	B1	B2	B3	C1	C2	C3
AAA	7%	5%	6%	6%	4%	5%	5%	2%	2%	4%
AA+	12%	10%	10%	11%	8%	9%	10%	5%	7%	9%
AA	25%	22%	23%	23%	20%	21%	22%	15%	19%	21%
AA-	24%	22%	23%	24%	21%	22%	23%	19%	22%	23%
A+	22%	21%	21%	20%	21%	23%	23%	17%	21%	24%
A	6%	7%	7%	6%	9%	8%	7%	12%	11%	9%
A-	2%	3%	3%	2%	4%	3%	2%	6%	3%	2%
BBB category and lower	3%	9%	8%	7%	13%	9%	7%	24%	14%	8%
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

The results relied on some additional assumptions to deal with overriding factors that result in capped ratings. The most commonly triggered overriding factor was a final liquidity factor score of 4 (second-weakest liquidity score), which caps a rating at 'A-'. Under the proposed criteria, the rating can be no higher than 'A-', but could be lower depending on the severity of the conditions present. To simulate how this might affect the ratings distribution, we assumed that rating outcomes would fall within three notches of the capped rating level in equal proportions. This assumption should not be viewed as a prediction of rating committee decisions. We believe it is more realistic assumption than leaving all the capped ratings at their capped level. Leaving all ratings only at the level suggested by the cap would likely understate the downward shift

of ratings during the highest-pressure scenarios. Also, under the proposed criteria, assignment of ratings in the 'BBB' category or lower will largely depend on analysts' qualitative assessment and rating committees' ability to assign ratings lower than the capped level when a rating cap is triggered. Since the analysis does not capture such qualitative assessments, we do not break out the 'BBB' category or lower ratings.

Interpretation Of The Results

Relative to the baseline, all scenarios result in fewer 'AAA' and 'AA+' ratings and more ratings at 'A+' or lower. Scenario A3 is most similar to the baseline due to a strong level of response largely offsetting the negative impact of a mild level of pressure. Scenario C1 is most divergent from the baseline due to the combined effects of weak management response and severe pressures. In general, the estimated rating distributions shift downward relative to the baseline and each other as the level of response and level of pressure worsen. Despite these downward shifts, ratings are largely in the 'A' category or better, and the percentage of ratings in the 'BBB' category or lower only exceeds 10% when moderate pressure is paired with a weak response (B1) or severe pressure is paired with a weak or medium response (C1 and C2, respectively).

Table 2 also shows that increasing levels of economic and fiscal pressure, independent of management response, can move the rating distribution downward relative to the baseline. For example, comparing scenarios A1, B1, and C1 shows fewer 'AA' category ratings as economic and fiscal pressures increase from mild to moderate to severe. Likewise, at a given level of pressure, the upward shift of rating distributions across level of response demonstrates the significant impact of level of response on ratings under the proposed criteria. For example, comparing C1, C2, and C3 shows that the percentage of ratings 'AA-' or higher increases as the level of response improves from weak to medium to strong.

When varying level of pressure and level of response in opposite directions, the impacts can partially offset. For example, the results in scenarios A1 and C3 are very similar even though they have the most dissimilar underlying assumptions. Scenario A1 represents a situation in which local governments are unable or unwilling to address mild pressures. In that situation, because of heightened exposure to external pressures due to governments' lack of response, the rating distribution shifts downward relative to the baseline scenario. However, in scenario C3, local governments are able and willing to make strong responses to severe pressures, and their actions result in a very similar rating distribution to scenario A1 despite significantly greater economic and fiscal pressures. This comparison illustrates, from a credit rating perspective, the potency of management actions due to U.S. local governments' significant ability to alter their revenue and expenditure patterns in response to fiscal pressure.

Conclusion

We believe the transparency of our proposed criteria better facilitates the analysis of possible rating distributions under various levels of pressure and management response. Our analysis suggests that credit ratings under the proposed criteria reflect the overall resiliency of the U.S. local government sector to significant pressures. That said, the analysis also demonstrates the extent to which rating outcomes may vary according to economic and fiscal challenges and government responses.

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YOUR FEEDBACK IS REQUESTED

Standard & Poor's Rating Service released a Request for Comment for Proposed Changes to its GO criteria that would include cities, counties, villages and townships but would exclude special purpose districts such as school districts, forest preserve districts, etc.

Standard & Poor's recently launched a special internet site that includes the proposed criteria, related reports and videos which you are invited to view. www.standardsandpoors.com/pfcriteria.

To view the Request and provide feedback, you will need to enter the above link to your browser.

ofin Update

It's hard to believe that OMAC's database, *ofin*, is starting its 14th year of availability to Ohio subdivisions. Since, 1999, Ohio Subdivisions have benefitted from this free service to help them prepare financial statements and monitor their debt issuance and debt limitations.

As this is the first electronic version of our newsletter, we would like to invite those who may be unfamiliar with OMAC's *ofin* system to be aware of the information that currently available to them at no charge. If you are already using the *ofin* system, there have been a number of upgrades that you will find beneficial. For example, we have upgraded our direct debt limitations screen to break out energy conservation debt. In addition, we will begin listing the largest taxpayers by subdivisions.

Over the next few issues, our newsletter will be focusing on the types of information currently available on *ofin* as well as a description of each category. If you would like access to the *ofin* system please contact Lorrie Peters at (800) 969-6622 or e-mail your request to Lorrie@ohiomac.com. As previously mentioned, there is no charge to you for *ofin* access. The database is located at www.ohiomac.com under the Member area and then *ofin*. While anyone can access the home page, you will need a password to access the Member area and *ofin*.

For this newsletter we describe the *ofin* options for the assessed values.

Assessed Valuations

By selecting this option you will see a listing of assessed values for a specific subdivision. It contains the total assessed value figure that is further broken down by Real Estate, Public Utility and Personal Tangible. The listing starts with the most recently available year and goes back to 1984-1985 values. You will also find the next reappraisal year and the last reappraisal year.

Real Estate Valuation Breakdown

This screen takes the Real Estate Valuation from the Assessed Value screen and breaks it down into: Residential, Commercial, Industrial, Agricultural, Mineral and Railroad Valuations. It also shows the percentage of the total for each category. These numbers are available from the present back to the 1983/84 taxing year.

In 2005, Ohio House Bill 66 began a phase-out period for the tax on tangible personal property. This was done by reducing the percentage of taxes on the property from 2006-2009. In 2010 a small amount of personal property value is shown for telecommunications companies. After 2010, tangible personal property values are not shown.

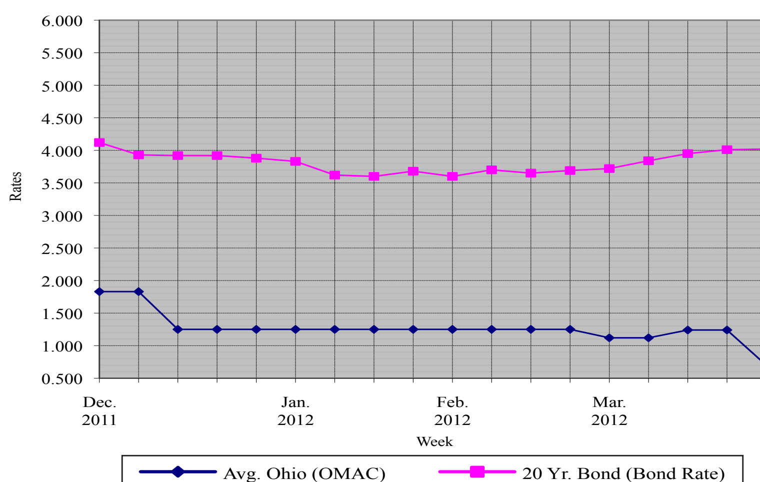
Look for our next newsletter where we will describe menu options dealing Debt Statements, the Indirect 10 mill limitation and Property Tax Rates.

MARKET UPDATE

GENERAL OBLIGATION

Note and Bond Interest Rates
for December thru March

The following graph compares Ohio short-term note rates with the Bond Buyer's 20 year bond index. The short-term rates represent actual rates reported to OMAC by Ohio purchasers and reported on OMAC's weekly calendar.



ANNOUNCEMENTS

Brandon Gavin Book

Was born on March 27, 2012 to OMAC Programmer Russell Book and his wife Diana. This is the first child for Diana and Rusty.

CALENDAR

Calendar of Issuer Conferences & Outings for 2012

NAME	EVENT	DATE	LOCATION
CAAO	Summer Conference	June 6 - 8	The Grand Plaza (T)– Toledo, Ohio
	Winter Conference	Nov. 27 - 29	The Columbus – A Renaissance Hotel - Columbus, Ohio
CTAO	Spring Meeting	May 15 - 17	Columbus Marriott NW at Tuttle Crossing – Dublin, Ohio
	Fall Meeting	November 13 - 15	Columbus Marriott NW at Tuttle Crossing – Dublin, Ohio
GFOA	National Conference	June 10 - 13	McCormick Place West – Chicago, Ill.
	Annual Golf Outing	July 16	Worthington Hills Country Club-Columbus, Ohio
	Annual Fall Conference	September 12 -14	Crown Plaza – Cincinnati, Ohio
MFOA	Annual Conference	November 1 - 2	Renaissance Hotel – Columbus, Ohio
(OML)	Northeast Ohio Golf Outing	July 18	Ridgewood Golf Course, Parma, Ohio
	North-Central Ohio Golf Outing	TBD	Woussickett Golf Course – Sandusky, Ohio (T)
NACO	National Conference	July 13 – 17	David L. Lawrence Convention Ctr – Pittsburgh, PA
OAPT	Annual Conference	October 3 – 5	Dayton Marriott - Dayton, Ohio
	National Conference	August 12 - 15	Williamsburg Lodge – Williamsburg, VA
OASBO	Annual Workshop	April 17 - 20	Hyatt Regency Hotel – Columbus Convention Center
OMCA	Spring Conference	April 18 - 19	Deer Creek State Park – Mt. Sterling, Ohio
OPFOTP	Ohio Public Finance		
	Officers Training Program	June 11 - 15	Kalahari Resort - Sandusky, Ohio
	CMFA Maintenance Program	June 14 - 15	Kalahari Resort - Sandusky, Ohio
OSBA	Capital Conference	November 11 – 14	Columbus Convention Center – Columbus, Ohio

(T) – means date is tentative.

CAAO – County Auditor's Association of Ohio – (614) 228-2226
CTAO – County Treasures Association of Ohio – (614) 233-6818
GFOA – Government Finance Officers Association – (614) 221-1900
MFOA – Municipal Finance Officers Association of Ohio – (614) 221-4349
NACO – National Association of Counties – (614) 221-5627
OAPT – Ohio Association of Public Treasurers – (216) 443-7814
OASBO – Ohio Association of School Business Officials – (614) 431-9116
OMCA – Ohio Municipal Clerks Association – (614) 221-4349
OPFOTP – Ohio Public Finance Officers Training Program – (330) 972-7618
OSBA – Ohio School Boards Association – (614) 540-4000

If you would like your event highlighted, contact Chris Scott at 1-800-969-6622, or by email at Chris@ohiomac.com