FINANCIAL MANAGEMENT ASSESSMENT

McGRAW HILL FINANCIAL

Massachusetts Collectors and Treasurers Association

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Standard & Poor's

U.S. Public Finance

Local Government General Obligation Criteria

Institutional Framework 10%

Economy 30%

Management 20%

Financial Measures

- Liquidity 10%
- Budgetary Performance 10%
- Budgetary Flexibility 10%

Debt & Contingent Liabilities 10%

Indicative Rating

Positive Overriding Factors

•High income levels (1 or 2 notch adjustment)

•Sustained high fund balances (1 notch adjustment)

Negative Overriding Factors

•Weak liquidity (caps rating at BBB+ or BB+)

•Weak management (caps rating at A or BBB-)

•Lack of willingness to pay obligations (caps rating at BBB- for leases and B for debt)

•Low market value per capita (1 notch adjustment)

•Large or chronic negative fund balances (caps rating at A+, A-, or BBB)

•Budgetary flexibility score of 5 (cap at A+)

•Low nominal fund balance (1 notch adjustment)

•Structural imbalance (caps rating at BBB+)

Final Rating

1

Financial Management Assessment focuses on seven financial practice areas

- Revenue and Expenditure Assumptions
- Budget Amendments and Updates
- Long-term Financial Planning
- Long-term Capital Planning
- Investment Management Policies
- Debt Management Policies
- Reserve and Liquidity Policies

Revenue and Expenditure Assumptions

– Are the organizations' financial assumptions and projections realistic and well grounded from both long-term and recent perspectives?

Strong	Formal historic trend analysis is performed and updated annually for both revenue and spending; regular effort is made to determine whether revenues or expenditures will deviate from their long-term trends over the next couple of years; evidence of independent revenue forecasting exists(when possible).
Standard	Optimistic assumptions exist that, while supportable, add risk; assumptions are based on recent performance, but little evidence of questioning or validating assumptions exists.
Vulnerable	Assumptions neglect likely shortfalls, expenditure pressures or other pending issues; assumptions exist which enjoy no prudent validation.

Budget Amendments and Updates

– Are there procedures for reviewing and amending the budget based on updated information and actual performance to ensure fiscal targets are met?

Strong	At least quarterly budget surveillance is maintained to identify problem areas and enable timely budget adjustments; management exhibits ability and willingness to address necessary intrA-year revenue and expenditure changes to meet fiscal targets.
Standard	Semiannual budget reviews exist; management identifies variances between budget and actual performance.
Vulnerable	No formal process exists for regular review and timely updating of budget during the year.

Long-term Financial Planning

– Does management have a long-term financial plan that allows them to identify future revenues and expenditures as well as address upcoming issues that might affect these?

Strong	A multi-year financial plan exists where future issues are identified and possible solutions are identified, if not implemented; revenue and expenditure decisions are made primarily from a long-term perspective. Structural balance is a clear goal.
Standard	Multi-year projections are done informally; multi-year projections are done, but without discussion of pending issues, so that issues are not addressed; some one-shot actions exist, but the long-term consequences of these actions are acknowledged and communicated.
Vulnerable	No long-term financial planning exists; operational planning is done on a year-to-year (or budget-to-budget) basis; one-shot budget fixes are used with little attention to long-term consequences.

Long-term Capital Planning

– Has the organization created a long-term capital improvement program?

Strong	A five-year rolling CIP with funding identified for all years exists and is linked to the operating budget and long-term revenue and financing strategies.
Standard	A five-year CIP is done, but is generally limited to projects to be funded from the current budget plus a four-year wish list; some funding for out-year projects is identified, but not all.
Vulnerable	No five-year CIP exists; capital planning is done as needs arise.

Investment Management Policies

– Has the organization established policies pertaining to investments?

Strong	Investment policies exist and are well defined; strong reporting and monitoring mechanisms exist and are functioning.
Standard	Informal or non-published policies exist; policies are widely communicated and followed.
Vulnerable	Absence of informal or non-published policies

Debt Management Policies

– Has the organization established policies on debt issuance; maturity and debt service structure; use of security and pledges, credit enhancement, and derivatives?

Strong	Debt policies exist and are well defined; strong reporting and monitoring mechanisms exist and are functioning. If swaps are allowed, a formal swap management plan that follows S&P's guidelines (see the DDP) has been adopted.
Standard	Basic policies exist; policies are widely communicated and followed. If swaps are allowed there is a swap management plan in place, but it does not follow S&P's guidelines.
Vulnerable	Absence of basic policies or clear evidence that basic policies are followed. Swaps are allowed but there is no swap management plan in place, and/or there is no local (non-FA) knowledge about the swap.

Reserve and Liquidity Policies

- Has the organization established a formalized operating reserve policy, which takes into account the governments cash flow/operating requirements and the historic volatility of revenues and expenditures through economic cycles?

Strong	A formal operating reserve policy is well defined. Reserve levels are clearly linked to the government's cash flow needs and the historic volatility of revenues and expenditures throughout economic cycles. Management has historically adhered to it.
Standard	A less defined policy exists, which has no actual basis but has been historically adhered to it.
Vulnerable	Absence of basic policies or, if they exist, are not followed.

Evaluating additional Management Risks

- Event Risk, how ably can management react to natural disasters
- Political Instability, Turnover or Gridlock
- Inability to execute approved structural reforms
- Management team lacks relevant management skills
- Timeliness of financial disclosure could alert to material negative financial restatements and/or Auditor’s ongoing concern
- Is Management actively considering bankruptcy, or are they unwilling to support capital lease or appropriation debt.

- Management and administrative characteristics, along with other structural issued it faces, can move a rating up or down more significantly and swiftly than any other element of a credit review.
- S&P published a list of some distinct commonalities in the management practices of highly rated U.S. public finance issuers over the years.

1. Focus on structural balance

- Most views balanced budget:
  - current revenue + available reserves = balanced budget
- S&P's view:
  - recurrent revenue = recurring expenditures
- Highly rated credits:
  - Maintain or quickly return to structural balance during a period of economic weakness.
  - No reliance on one-time measures.

2. Strong liquidity management

- Ability to manage cash flow and identify potential issues.
- Sufficient money to meet debt obligations.
- Access to pooled cash or interfund loan is not enough, accountability of where cash comes from and how to pay back is important.
- Liquidity risk often tie to variable rate demand obligations or other debt instruments.

3. Regular economic and revenue updates to identify shortfalls early

- Regular intervals is a key feature of stable financial performance.
- Evaluate historical performance of key revenues is important because each government has different leading or lagging economic indicators that signal potential revenue variance issues based on its economic structure.
- It’s also important to identify a surge in revenues to determine if the trend is short term or sustainable.

4. An established rainy day/budget stabilization reserve

- Formalized financial reserve policy is a consistent feature of most S&P's highly rate credits.

- Factors to establish the level:
  - Cash flow/operating requirement
  - Volatility of revenue/expneditures
  - Susceptibility to natural disaster
  - … and more

5. Prioritized spending plans and established contingency plans for operating budget

- What ifs… and what could be done:
  - What part of the budget is discretionary?
  - What spending could be legally or practically reduced?
  - Scenario building and analysis of revenue results.

6. Strong long-term and contingent liability management

- Growing pension and OPEB pay-as-you-go and unfunded liabilities.
- Management of non-essential government operations such as stadiums, convention centers, golf course.

7. Multiyear financial plan that considers the affordability of actions

- Is the plan comprehensive and based on realistic assumptions?
  - Putting a general inflator across all expenditures and revenues might not work for all line items.
- Plan often has out-year gaps projected, which would allow governments to work out, in advance, the optimal method of restoring fiscal balance.

8. A formal debt management policy to evaluate future debt profile

- Many highly rated governments have developed debt affordability guidelines or models, such as:
  - Debt as a percentage of market value;
  - Debt as a percentage of operating expenditures;
  - Variable rate debt does not exceed X% of total debt;
  - Amortization of debt to be no longer than Y years, etc.

9. A pay-as-you-go financing strategy as part of the operating and capital budget

- Advantage is to lower debt service costs but also provides operating budget flexibility when the economy or revenue growth slows.
- A long term capital improvement plan that identify sources and uses of fund.

10. A well-defined and coordinated economic development strategy

- How significant a resource commitment should be dedicated to running economic development programs and offering incentives?
- Synergies of activities to create employment, enhance diversification, and generate solid income growth.
- Coordinated effort between state and local governments.

Top 10 Management Characteristics of Highly Rated U.S. Public Finance Issuers

FMA Category	Example from Article
Revenue and expenditure assumptions	1
Budget amendments and updates	2, 3, 5
Long term financial planning	7
Long term capital planning	9
Investment management policies	2
Debt management policies	6, 8
Reserve and liquidity policies	2, 4

Proactive budget and liability planning, strong liquidity management, and the establishment of reserves are among the factors the strongest issuer share

Questions

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