Tax-Supported Rating Criteria

Master Criteria

This report updates and replaces the prior criteria report of the same name dated Aug. 15, 2011.

Four Key Rating Factors: Fitch Ratings evaluates four major factors (debt, economy, finances, and management) in determining the credit quality of a tax-supported governmental issuer. The rating process analyzes trends in these areas and seeks to identify actual and potential future obligations and exposures.

Interaction of Rating Factors: The major rating factors are interactive. For instance, while an issuer may have a vibrant and wealthy economy, weak fiscal management or stringent tax rate limits may offset the positive credit factors, resulting in a reduced ability to meet obligations. In turn, a weak economy may be offset by other strengths, such as proactive management or a very low debt burden.

Debt and Other Long-Term Liabilities: In evaluating debt and other long-term liabilities, Fitch seeks to determine the extent and nature of the issuer’s outstanding liabilities and evaluates the outlook for the future, with a focus on affordability and flexibility.

Economy: Fitch’s economic analysis considers the capacity of the issuer’s economic base to support balanced ongoing operations and repayment of debt and provides insight into potential future financial and debt resources or challenges.

Finances: Fitch’s analysis of finances is focused on the issuer’s financial resources and flexibility to support its obligations over the near and long terms.

Management and Administration: Management practices and actions can positively or negatively influence the other major credit factor. Fitch’s analysis of management encompasses both elected officials and appointed staff members.

Institutional Framework: Fitch’s analysis is done in the context of the regulatory framework and requirements of the country in which the rated entity is located.

Rated Securities: For governments within the U.S., Fitch’s analysis focuses on specific security structures, while outside the U.S., ratings are usually an assessment of the subnational credit quality. When a specific security is being rated, the rating will reflect the nature of the security and its relationship to the general credit quality of the issuer.

Related Criteria
Rating U.S. Municipal Short-Term Debt, Dec. 8, 2011

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Public Finance
Tax-Supported Rating Criteria 2
August 14, 2012

Public Finance

Scope and Limitations
This master criteria report identifies rating factors considered by Fitch when assigning ratings to a particular entity or debt instrument within the scope of the master criteria. Not all rating factors in the master criteria may apply to each individual rating or rating action. Each specific rating action commentary or rating report will discuss those factors most relevant to the individual rating action.

Fitch’s tax-supported ratings consider an obligation’s relative vulnerability to default and do not incorporate any measure of recovery given default.

Rated Security
Rated security analysis applies when Fitch is rating a specific debt issuance, in addition to the issuer’s general credit quality.

Legal Pledge
A security’s rating takes into account the strength of the legal pledge. For example, in the U.S., a general obligation (GO) full faith and credit pledge is a very broad security, and the rating on this type of obligation reflects the general credit quality of the issuer. In cases where a bond payment requires annual legislative appropriation, this lesser long-term commitment to repayment is reflected in a lower rating than the GO rating. The rating for a special tax security, where payment is derived from a specific tax revenue source, while still informed by the analysis of the issuer’s general credit, also reflects structural factors, such as lien status, indenture requirements, and debt service coverage.

Lien Status
In tax-supported ratings, the lien status is generally only a rating consideration for special tax bonds, which normally provide a first lien on the pledged revenue. Rating distinctions between senior and subordinate lien debt generally are based on notably weaker legal protections for subordinate bonds provided by the indenture. Fitch only makes such distinctions in cases where there are no cross-default provisions between the liens and, when made, the distinctions are generally small (one to two notches).

Indenture Requirements and Relevant Statutes
Similar to lien status, indenture requirements are most relevant to special tax bonds. Important indenture provisions include: the issuer’s covenants, including the rate covenant (where applicable); the flow of funds; any requirements that enhance or hinder the bondholders’ ability to be repaid; and recourse available to bondholders that could prevent a default. For example, in the U.S., the additional bonds test (ABT) is key to special tax bond ratings, while legal and statutory provisions that strengthen the issuer’s incentive to appropriate can enhance the rating of appropriation-backed debt. Bondholder protections that are incorporated into statute are particularly strong.

A properly structured debt service reserve fund (DSRF) can provide protection for special tax bondholders by providing a buffer against low tax collection periods. Fitch believes this protection is more important for entities with relatively weak coverage or revenue streams with significant volatility and has little impact on the credit quality of bonds whose coverage and ABTs are already strong. A DSRF is also a rating factor in appropriation-backed debt where
construction risk is a rating factor. The credit given to a DSRF funded with a surety bond will be
determined in accordance with the criteria for enhancement providers, as detailed in Fitch’s

Debt and Other Long-Term Liabilities

In evaluating debt and other long-term liabilities, Fitch seeks to determine the extent and nature
of the issuer’s current liabilities and evaluates the outlook for the future, with a focus on
affordability and flexibility.

Debt Ratios and Trends

Debt analysis includes a review of trends in the amount of debt issued and outstanding. Fitch
analyzes the trend in debt in relation to resources. Sustained increases in debt at a rate in
excess of economic growth may ultimately overburden a tax base and strain budget resources.
Fitch uses various ratios to measure the burden of debt on the issuer’s population and tax base.
Calculations include all long-term, fixed obligations of the issuer, excluding unfunded pension
and other post-employment benefit (OPEB) liabilities, which are considered separately in the
context of an issuer’s overall long-term liabilities. In general, a low debt burden is a positive
credit factor.

For special tax bonds, debt ratio analysis includes the calculation of historical, current, and
projected future coverage of debt service by the pledged revenue source.

Future Capital and Debt Needs

Debt factors are considered within the context of the issuer’s infrastructure needs and capital
plans. Current debt levels may be low; however, future capital projects may significantly
increase debt ratios, weakening the issuer’s debt profile. Fitch evaluates the impact of
expected future debt on the issuer’s debt ratios and views favorably a comprehensive and
realistic approach to capital planning. The issuer’s ability to meet its capital needs where there
are restrictions on debt issuance is also a consideration.

Debt Structure

Fitch reviews the types and proportions of debt utilized (e.g. GO, appropriation-backed, or
special tax) and the rate at which the debt is repaid. Typically, tax-supported debt amortizes
over a period not exceeding 30 years, matching the useful life of the project. Slow amortization
rates limit long-term financial flexibility. The review of outstanding debt also includes an
assessment of the uses of borrowed funds, with uses for noncapital purposes considered a
credit weakness.

Another consideration is the percentage of fixed-rate debt in the issuer’s debt structure. Fitch
views high levels of short-term debt, variable-rate debt, and/or derivatives with concern, as they
expose the issuer to the possibility of unexpected and, in extreme cases, unaffordable future
financial demands. Fitch evaluates whether the issuer has a clear understanding of the benefits
and risks of entering into these types of transactions.

Pension and Other Post-Employment Benefit Funding

Fitch reviews defined benefit pension plan and OPEB funding as part of the analysis of debt
and long-term liabilities. Defined contribution plans are not subject to Fitch’s pension analysis,
as they are a predictable annual commitment and considered as part of the issuer's operating budget.

Pension and OPEB liabilities are not directly included in the calculation of an issuer's debt ratios. Pension benefits represent a more variable commitment to future payments than bonded debt to the extent that they can be significantly influenced by a variety of actuarial, accounting, investment, and other policy decisions of the sponsoring government. OPEB is a legally softer obligation than debt or pensions, perhaps more aptly considered a service obligation and, in most cases, is subject to modification by the government.

The analysis of pension obligations focuses on whether there has been stabilization or progress in the funded ratio over time and a commitment to funding actuarially calculated annual required contributions (ARCs). Key considerations are: the magnitude of the liability; the funded ratio; the size of the resource base from which funding is derived and the liability as a percentage of this base; the amount of the government's budget needed to make pension contributions; and the government's historical commitment (or lack thereof) to system funding, as well as actuarial and other assumptions influencing the burden. For each rated entity, Fitch closely evaluates all significant pension plans in which the government participates.

Fitch views favorably entities that have well-funded pension plans and consistently fund the ARC. In cases where the unfunded liability is sizable, Fitch views positively actions or plans to reduce it over time. Concerns arise if the liability level is high or increasing or if the actual contribution is consistently below the ARC.

Indirect Risks and Contingent Liabilities

In looking at an issuer's debt obligations, Fitch examines not only liabilities directly incurred and payable by the issuer but also outstanding debt for which the issuer may in the future have an obligation. Examples include moral obligations, where the issuer may support — but is not legally obligated to support — the debt upon failure of the primary security, and needs of related governmental entities that may require financial resources of the rated issuer. Such obligations are monitored but typically excluded from direct debt calculations unless the issuer's resources have been relied on to cover the obligation during the past three years.

Economy

Fitch's economic analysis considers the capacity of the issuer's economic base to support balanced ongoing operations and repayment of debt and provides insight into potential future financial and debt resources or challenges.

Major Economic Drivers

The evaluation of the economy begins with a determination of the types of economic activity that dominate the area. For example, some issuers are heavily reliant on an industry like automobile manufacturing or natural resource mining, while others have a more diverse base. A broad, diverse, and stable economy is a credit strength, and undue concentration in one or a small group of industry sectors or taxpayers or a high level of cyclicalality may be cause for concern. For issuers dependent on property taxes for a sizable portion of their revenue, Fitch pays particular attention to the level of and trends in the valuation of the total tax base and the largest taxpayers.
Employment

Fitch reviews trends in employment and seeks to understand why a given employer or employment sector has expanded or contracted. Trends in unemployment are reviewed in the context of labor force changes and other factors that might have an impact, such as cyclicalality.

Income and Wealth

Income levels are evaluated on both an absolute and a relative basis to regional and national averages. Reviewing trends in the issuer’s income and wealth, compared with those of the region and nation, provides an indication of the rate of economic value being created, which has implications for future revenue performance.

Other Demographic Factors

Fitch reviews key demographic metrics, particularly population trends. Although population growth is usually considered a positive factor, population stability can also be a positive rating consideration, particularly for smaller communities that do not have a wide range of service demands and spending pressures. Conversely, high-growth areas can pose risks, as capital needs are often great, and providing the appropriate level of infrastructure and services to match, but not exceed, growth needs can be difficult. Fitch considers the reasons a particular area attracts or loses population. Demographic structure and projections are also important for assessing future expenditure pressures, particularly in healthcare and education.

Tax Burden

Comparing the level of taxation, regionally and nationally, can provide an indication of competitiveness, financial flexibility, and/or tax relief pressures. The level of taxation can either encourage or hinder economic development. If the tax burden is already high, an increase may be difficult to implement and have ill effects. Fitch reviews tax rates in comparison to those of similar entities nationally and other entities in the region.

Finances

The analysis of an issuer’s finances is focused on evaluating the issuer’s financial resources and flexibility to support its obligations over the near and long terms.

Revenue Analysis

Fitch reviews revenue sources for volatility and diversity. In general, a diverse revenue system with a foundation of broad-based taxes is more stable and better able to capture the issuer’s economic wealth, resulting in a stronger financial profile. Reliance on economically sensitive revenues, such as real estate transaction taxes, may expose the issuer to financial volatility and lead to a credit concern. An issuer’s ability to control its own revenue sources, including the power to adjust tax rates, is an important credit positive. For entities that rely heavily on funding from another unit of government, Fitch evaluates the consistency of the funding and how potential adjustments would affect the rated issuer.

For special tax bonds, the revenue analysis considers the historical performance of the pledged revenue stream, including its average rate of growth and year-to-year volatility.
Expenditure Analysis

Fitch reviews trends in expenditures, the issuer’s flexibility to make adjustments in spending (both as part of the annual budget process and during the course of the fiscal year), and the expected stability in each major spending item. The analysis also considers potential funding pressures, including outstanding litigation. The centralized ability, or mandate, to implement timely spending cuts to maintain balance is a credit strength.

Operating Margin Trends

Fitch evaluates recurring revenues, compared with recurring expenditures. Concerns arise when operating expenditures consistently exceed operating revenues, as the use of nonrecurring revenue is unsustainable and usually leads to depletion of reserves and deeper financial imbalances.

Fund Balance and Reserve Levels

Fitch views a satisfactory fund balance as an important cushion against potential revenue and expenditure volatility. The amount Fitch considers satisfactory varies based on such factors as economic or tax base concentration, revenue and/or expenditure volatility, and flexibility to adjust revenues and spending. Established reserves that benefit from automatic funding mechanisms and clear restrictions on use are the strongest credit features, but fund balances that have been maintained consistently over time also are beneficial. Similarly, segregated funds that are available, or could be made available, for general expenditures can contribute to financial flexibility.

Liquidity

Fitch analyzes an issuer’s liquidity position, including tax collection schedules, the timing of disbursements, and the quality and timing of receivables and payables. Those in the strongest position do not depend on external cash flow borrowing. The liquidity analysis is particularly important in financially strained situations.

Management and Administration

Management practices and actions can positively or negatively influence the other major credit factors, affording strong ratings to entities with limited economic or financial resources or weaker ratings to more diverse or affluent entities.

Institutionalized Policies

Fitch views positively implementation of and consistent adherence to sound processes and policies for budgeting, debt, and financial operations. Notable policies include established rainy day reserve funds (particularly those with automatic funding sources and limits on use), multiyear revenue and expenditure forecasts, restricting use of nonrecurring revenue to nonrecurring expenses, sound capital planning, and debt affordability guidelines.

Budgeting Practices

Fitch reviews an issuer’s budgeting practices, particularly revenue and expenditure estimations, and compares the key assumptions included in an issuer’s budgets to actual revenues and expenditures over time. Fitch views conservative estimates favorably and is concerned if an
The issuer does not appear to be incorporating fully current economic, political, or financial conditions. Regular intrayear budget reviews, which can allow an issuer to identify underperforming revenues or overspending in time to make necessary adjustments to eliminate or lessen budget gaps, are also a positive credit factor.

**Financial Reporting and Accounting**

Where established accounting practices exist, Fitch expects the issuer will be in compliance. Additional financial reporting, such as interim revenue reporting throughout the year, is viewed positively. For governments in the U.S., Fitch expects compliance with GAAP and relevant Government Accounting Standards Board (GASB) policies.

**Political, Taxpayer, and Labor Environment**

Fitch expresses no preference for one form of government over another and does not view any type as better for credit quality. Rather, the key credit element is the efficiency with which an elected government can make service and spending decisions and its ability to adjust and react to changing economic and financial conditions.

Evidence of taxpayer dissatisfaction, with the level of either taxation or service provision, is a credit concern, as it may reduce an issuer’s flexibility to address budget shortfalls. A negative taxpayer environment could include voter or legislative attempts to contain the government’s legal ability to raise revenues or build reserves. This concern increases in environments with easy access to the voter-initiative process. Similarly, a difficult labor environment can limit budgetary options.

**Revenue and Spending Limitations**

Establishing and adhering to policy guidelines is considered a credit positive. However, onerous statutory or constitutional operating limitations are potential credit risks. Additionally, Fitch recognizes that, in some instances, practical limitations are just as restrictive. An inability to generate sufficient revenue to fund needed services due to political or other practical concerns can have long-term implications for an issuer’s financial and economic health.

**Note on Sources**

Fitch’s analysis and rating decisions are based on relevant information available to its analysts. The sources of this information include the issuer and/or the obligor, the public domain, and, in the case of U.S. Public Finance, the financial advisor if a financial advisor has been engaged. Sources also include relevant publicly available information on the issuer, such as financial statements and regulatory filings. The rating process may also incorporate information provided by other third-party sources. If this other third-party information is material to the rating, the specific rating action will disclose the relevant source.
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