

From: Council President's Office – Finance and Budget Team

Date: 9/7/2016

RE: UPDATED: Philadelphia Credit Report Summaries - General Obligation Bond Ratings

Summary

The City of Philadelphia last received a credit upgrade in December of 2013, when Standard and Poor's (S&P) moved the City's rating from A- to A+. However, **as of September 6, 2016, the City was moved from a Stable outlook to a Negative outlook by Moody's Investors Service (though Moody's has affirmed their A2 credit rating)**. Moody's cites the following the reasons for the Negative outlook¹:

- City's inability to achieve structural balance, resulting in continued weakened reserve levels
- Expenditures continuing to outpace revenues (leading to operating deficits through FY18)
- Projected General fund balance levels barely above 1%, well below its peers

Moody's most recent report also cites factors that could lead to a credit upgrade or downgrade. Factors that could lead to an upgrade include a tax base expansion, the ability to achieve and maintain a structurally balanced budget, growth in reserve levels and a substantial decrease in unfunded pension liabilities. Tax base declines, continually declining reserve levels, and failure to reasonably fund current pension plans, along with the factors bulleted above, could lead to a credit downgrade. One of the biggest challenges, the large amount of unfunded pension liability (which in turn leads to high debt burden), is an area that rating agencies are taking a closer look at. Recently, Dallas, a city that is facing their own pension woes, was downgraded by both Moody's and S&P mainly because of their large, growing unfunded pension liabilities (Dallas's pension funding ratio is approximately 46%; Philadelphia's pension funding ratio is about 45%).

The City's credit rating is important because it gives Philadelphia access to the capital market, and dictates the rate at which the City may borrow. The lower the credit rating, the higher the interest rate; thus the higher amount of money the taxpayers of the City must pay to borrow. Higher credit ratings can lead to millions of dollars saved in borrowing costs, which translates to either additional dollars for other services, or a lesser tax burden. For example, if the spread between an "A" rating and an "Aa" rating is 30 basis points, this could save the City approximately 11% on interest payments alone. With that said, below summarizes the consistent pros and cons from each of the City's most recent Credit Rating reports (Moody's, S&P, and Fitch) below. It is important to recognize both the pros and cons of the City's Credit Rating, as both are valuable for fiscal policy (and all policy) considerations moving forward.

Consistent *pros* listed in all three credit reports include:

- City's budgeting practice is flexible and highly liquid.
- City has the ability and willingness to reduce spending when revenues decline, as shown during the Recession.
- City is starting to see reversal of long-term employment and population decline (good economic indicators).

Consistent *cons* listed in all three credit reports include:

- City continues to hold high debt levels and fixed costs (Pension costs).
- City continues to maintain a high poverty rate.

¹ https://www.moodys.com/research/Moodys-affirms-A2-on-Philadelphia-PAs-GO-Bonds-Outlook-Revised--PR_903577297

- City continues to hold low fund balance/reserve levels.

When looking at comparable cities, one pro that stood out for the City is its ability to control spending, which is critical for a City this large. Through the use of *target budgeting*, the City can adjust departmental spending mid-year, without the direct approval of Council or other oversight agencies. Due to this flexibility, the City can react quickly to revenue decline to ensure that the City's budget remains balanced.

The next section pulls the most significant pros and cons from each of the City's most recent individual credit rating reports. The actual reports can be found here: http://www.phila.gov/investor/Bond_Ratings.html

Most Recent Individual Credit Report Summaries

Below are individual, high-level summaries pulled from each of the City's most recent credit reports; a short description of the pros and cons from each report is also included.

Moody's Investor Services

Rating: A2
Date: 4/17/2015
Amount: \$174,325,000
Description: General Obligation

Pros: Moody's lists several positive factors in the City's financial standing, referencing Philadelphia's large tax base, as well as its position as a regional economic hub for large institutions, as positives. An increasing population, coupled with comprehensive financial planning and growing revenues are also noted as positives.

Cons: Moody's references several structural issues impacting Philadelphia's credit rating. These include the high poverty rate and overall low incomes of residents, which make it difficult to raise additional tax dollars. Additionally, the City's high debt-levels, high fixed costs, economically sensitive revenues, and weak financial position (low fund balance) prevent a higher rating.

Standard and Poor's Rating Services

Rating: A+
Amount: \$174,325,000
Description: General Obligation

Pro: S&P lists several strengths in the City's A+ bond rating. S&P lists very strong management conditions, budget liquidity, the presence of the oversight board PICA, and the role of Philadelphia as an economic hub as positives in their credit rating.

Cons: S&P's rating focuses on Philadelphia's positive outlooks, but lists the City's debt and liabilities (specifically the pension and post-employment benefits) as tempering the otherwise positive credit position.

Fitch Ratings

Rating: A-
Amount: \$174,325,000
Description: General Obligation

Pros: Fitch mentions accuracy of the City's Five Year plan, especially in the accurate projections of future labor contracts, as well as solid budgetary controls as positive factors.

Cons: Although A- is still considered an Upper Medium Grade rating, Fitch's rating mentions the City's high pension obligation and high debt levels as factors that prevent a higher rating.

Conclusion

The City currently maintains an Upper Medium Grade credit rating given the positive factors that each Credit Rating agency referred to, including its budgeting practices (flexibility and liquidity) and its recent reversal of population decline. However, the City's large unfunded pension liabilities coupled with the City's low fund balances and high poverty rate could hinder the City's ability to improve upon its credit rating. **Given Moody's most recent action in moving the City from a Stable outlook to a Negative outlook only affirms that the City must continue to pay close attention to the listed negative credit pressures.** A proactive, collaborative approach between both the legislative and executive branch of government should continue to be made when addressing these concerns.