

TESTIMONY OF PETER NISSEN TO CITY COUNCIL OF PHILADELPHIA

Committee on Fiscal Stability and Intergovernmental Cooperation

Wednesday, September 7, 2016

Good Afternoon, Council President and Members of City Council. My name is Peter Nissen and I am a Managing Director with the firm of Acacia Financial Group. We serve as one of the “financial advisors” (also known as a *municipal advisor* under terminology of the Securities and Exchange Commission) to the City of Philadelphia with respect to its general obligation credit. I have practiced financial advisory services for the last 22 years having had the pleasure of serving the City for more than the last 8 years. In addition to serving the City of Philadelphia, I and my firm represent many other significant cities and states including, among others, the Cities of New York, Chicago and Washington D.C. and the States of New Jersey, New York, Connecticut, Illinois, Ohio and Alaska.

It is my pleasure to appear before you today to be a part of a forum and to further a discussion on the importance of the City’s credit rating and the factors that contribute to (or hinder) the City’s goal of achieving and maintaining strong credit ratings. In particular among these factors is the City’s fund balance.

The City funds needed capital improvements, in large part, through the issuance of bonds, secured either by the general obligation of the City or by a “service agreement” when issued through one of the City’s authorities. Other things being equal, the City (like all other issuers) would like to borrow at lower rather than higher interest rates. One of the significant factors that determines at what rate the City can borrow relative to other municipal issuers is the underlying credit rating of the City as assigned by the rating agencies.

The three rating agencies who rate the City’s general obligation credit are Moody’s Investors Service (Moody’s), Standard & Poor’s Ratings Group (S&P) and Fitchratings (Fitch). Each of these rating agencies uses a similar rating system that includes letters. The highest possible rating is “AAA” (or “triple A”). Next below “AAA” is “AA”, then “A”, then “BBB”, etc. Each of the letter ratings further carries three sub-gradations (indicated with a “+” or a “-” or numbers 1, 2 or 3), except for “AAA” for which there is no sub-gradation. For example, an issuer in the “A” category could be a high single A, a mid single A or a low single A.

The City is rated “A+” by S&P (high single A), “A2” by Moody’s (mid single A) and “A-” by Fitch (low single A). For comparison purposes, the only major cities in the nation rated below Philadelphia are Detroit and Chicago. Most major cities carry ratings in the double A category with a few in the triple A category (e.g. Anchorage, Boston, San Antonio) and a few partially in the single A category (e.g. Miami, Pittsburgh). One of the reasons for the City’s lower rating compared to its peers, and a criterion that is within control of the City, is the relatively low fund balance of the City.

The process by which the rating agencies determine a credit rating is mostly quantitative, based upon objective criteria, but also includes a qualitative component. Moody’s and S&P utilize a “scorecard” methodology, assigning different mathematical weightings to different objective criteria, while Fitch uses a more holistic approach.

Regardless of approach, each of the rating agencies places significant importance in fund balance. Moody's places 30% of the objective criteria in fund balance and cash balance metrics. S&P places 10% of its objective criteria in liquidity (fund balance) with "low" fund balance resulting in a one notch reduction from an otherwise determined rating. S&P places another 20% in budgetary performance and budgetary flexibility, both of which are fund balance related. Fitch includes one of its four key rating factors as operating performance including "financial resilience through economic downturns" to which fund balance is key protection.

The Government Finance Officers Associate (GFOA) recommends, "at a minimum, that general-purpose governments, regardless of size, maintain unrestricted budgetary fund balance in their general fund of no less than two months (e.g. 16%) FY of regular general fund operating revenues or regular general fund operating expenditures." Moody's places fund balances in the range of 15%-30% of revenues in the double A category. S&P places fund balances in the 8%-15% range of revenues in the double A category.

At an FY16 closing estimate of \$105mm (QCMR), the City's fund balance will be only 2.6% of revenues. Under the FY17-FY21 Five Year Financial Plan, the fund balance is projected to decline to nearly 1% at the end of FY18. This percentage is in the lower triple B category for both Moody's and S&P. This level of fund balance will place downward pressure on the City's rating.

Fund balance is important not just from a statistical comparison perspective. It represents a margin of protection against downturns in economic conditions, especially for the City with multiple of its primary tax revenue sources being economically driven (e.g. wage tax, sales tax and BIRT). It also is a broader indicator of an entity's financial position because it is a product of other factors including prudent budgeting, conservative revenue projection, expenditure control and strong management. To an extent, it is a "bottom line" indicator of financial health. It is also a representation of the priority with which the City places the repayment of its lenders, running to the qualitative considerations of the rating agencies.

Among the various ratings concerns expressed by the rating agencies and recognized by the investing community including above-average poverty, financial difficulty at the School District, the underfunded municipal pension, increasing the fund balance is one that can be controlled by the City and where marginal additional dollars provide the greatest "ratings" impact.