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CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Scott P. Johnson

SUBJECT: THE CITY'S CREDIT RATINGS AND THE RATING AGENCIES RATINGS RECALIBRATION PROCESS

DATE: May 17, 2010

Approved

Date 5/19/10

INFORMATION

BACKGROUND

The City's Finance Department was recently notified that two of the three national credit rating agencies (Moody's and Fitch) have recalibrated the City's general fund credit rating to AAA (the City also maintains a AAA rating from Standard and Poor's, which was confirmed in June 2009). The result of this recalibration has put the City of San Jose in an envied position of Aaa/AAA/AAA - "pure AAA" by all three national rating agencies (Moody's, Standard & Poor's, and Fitch Ratings.) These ratings translate to lower costs to the San Jose community since the higher the credit rating, the lower the borrowing costs to the City on the interest rate we pay for debt issued for projects and other purposes.

In March staff notified Council that Moody's Investor Service had announced that it will be recalibrating its ratings of U.S. Municipal Bond issues and issuers from its municipal-specific rating scale to its global rating scale. In addition, staff was recently notified that Fitch Ratings was also going through a similar recalibration process of its municipal bond ratings for local government entities. The purpose of the recalibrations was to "ensure a greater degree of comparability across global portfolio of credit ratings."

In conjunction with the recalibration process, Moody's Investors Service has recalibrated the City's general fund credit rating upward one "notch" from "Aa1" to "Aaa", the highest possible rating. The City's other credit ratings from Moody's were also recalibrated upward one "notch" from their existing municipal scale rating. Moody's rating recalibrations for public infrastructure, including airports, is scheduled to take place in mid May 2010. In addition, the City's general fund credit rating from Fitch Ratings has been recalibrated upward one "notch" from "AA+" to "AAA", the highest possible rating. The City's other credit ratings from Fitch were also recalibrated upward one "notch" from their existing ratings.

The rating agencies caution that it is important to note that the recalibration of the ratings is a translation from one rating scale to another and "does not represent a change in the rating agencies opinion of the credit quality of the affected issuers" and "should not be interpreted as an improvement in the credit quality of those securities. Rather, they are adjustments to denote a comparable level of credit risk as ratings in other sectors."

These include fiscal factors, economic factors, debt factors, and administrative/management factors. Further information on each of these factors is included as an attachment to this memorandum.

CREDIT ANALYSIS PROCESS and the CITY'S STRONG CREDIT RATINGS

Municipal bond ratings provide investors with a simple way to compare the relative investment quality of different bonds. Bond ratings express the opinions of the rating agencies as to the issuer's ability and willingness to pay debt service when it is due. In general, the credit rating analysis includes the evaluation of the relative strengths and weaknesses of the following four factors as they affect an issuer's ability to pay debt service; fiscal, economic, debt s and administrative/management factors. Attachment A provides a description of each of these rating factors.

While it may appear to be counter intuitive that reducing City services is a positive rating factor, it is through these difficult decisions the City demonstrates to the rating agencies and the larger credit community its ability to make the tough choices in order to bring the budget into balance. The rating agencies have consistently commented on the City's ability to carefully manage its expenditures to close budget gaps (even though Council has had to make difficult choices in closing the budget gaps); maintains satisfactory levels of reserves for unforeseen situations, contingencies, and planned future disbursements; maintains strong fiscal controls and sound fiscal policies; and the City's management staff has strong capabilities.

Several quotes from the City's last general obligation rating reports are provided below. They clearly demonstrate the City's commitment to strong financial management, commitment to continue to make necessary budgetary adjustments, and focus on resolving the City's structural budget gap.

Excerpts from the June 5, 2009 Moody's Investor Service Rating Report

> *"San Jose has typically maintained **sound general fund operations** (emphasis added). The capacity of the city to continue to produce these results will be driven by its ability to effectively manage its expenditures amid softening revenues. While this is a challenging proposition, Moody's believes that the **city's management will be able to continue to make necessary adjustments** (emphasis added) to produce sound operations and a satisfactory reserve position."*

*"The rating assignment and affirmations are **based upon the city's exceptionally large tax base** (emphasis added) that should remain well above average for the rating level despite the current economic downturn. The ratings also consider the city's fiscal position, which is going through a period of expenditure reductions amid softening revenues."*

*"This current set of fiscal challenges will require that the city again carefully manage its expenditures to close the current budget gap. Our current rating assignment and outlook presumes that the city will, in fairly short order, effectively close that gap and replenish its reserves. **A failure to do so or protracted recovery would apply negative pressure to the rating."** (emphasis added)*

<u>Excerpt from the June 3, 2009 Standard & Poor's Rating Report</u>

*The stable outlook reflects our view of **management's demonstrated commitment to a strong financial position** (emphasis added), resulting in the **maintenance of good reserves** , even as the local and regional economic base have weathered relatively severe downturns in key industries (tech and real estate) over the past decade. We believe **strong financial performance is exhibited** (emphasis added) in healthy GAAP-based reserves **as well as an ongoing focus on pro forma budgetary shortfalls** (emphasis added). In particular, we note that **city management continues to resolve structural gaps between recurring revenues and expenses on a budgetary basis.** (emphasis added)*

/s/
SCOTT P. JOHNSON
Director, Finance

For questions please contact Scott P. Johnson, Director of Finance, at (408) 535-7001.

Attachment A – Credit Rating Factors

Fiscal Factors

Financial results have the most significant impact on the rating process. This review involves an examination of results of operations, including a review of the actual fiscal performance versus planned budget performance, with deviations from the plan to be explained. The general fund financial statement is examined with emphasis on current financial position and fund balances, as well as three- to five-year trends in planning and budgeting procedures. Pension liabilities are also important in the analysis process. The early production of the City's Comprehensive Annual Financial Report is a positive step in providing meaningful, valuable, and timely information to rating agencies.

Economic Factors

The overall economic strength of the City is heavily weighted in the evaluation of the City's creditworthiness by diversity of both the economic base and tax base. The diversity of the City's industries reflects its ability to weather industry-specific downturns as well as general economic recession. In either scenario, stronger surviving industries carry the ailing industries through the period of downturn. In a truly diverse economy, it is rare that all industries will deteriorate to the same level at the same time.

The strength of the City's tax base is equally crucial. The City relies on taxes collected from residents and businesses for the majority of its revenues. The ability of the City to continue to receive those revenues is directly related to the ability of its taxpayers to pay their taxes. Property values, employment, unemployment, income levels, costs of living, and other factors impacting the wealth of the taxpayers provide an indication of the strength of the City's tax base.

Debt Factors

The City's overall debt burden is considered in the credit analysis process. In addition to government regulated debt ceilings, the City's ability to maintain manageable debt levels and debt service coverage is evaluated. Other positive indicators are proper management of existing debt, proactive efforts in identifying and executing financially prudent refunding opportunities, and closely matching capital financing structures to the funding needs of the project.

Administrative/Management Factors

These factors include the examination of the form of government and assessment of the City's ability to implement plans as well as to fulfill legal requirements. The focus is on the capabilities of the management staff within the City, which is seen as a vital ingredient in assessing its credit quality. Managerial and legislative willingness to make difficult decisions, development of financial policies, and the reliability and continuity of regularly-updated accounting and financial information are key. Management that maintains regular contact with the rating agencies is well-regarded.