Quality of Life and Bond Ratings: One Agency's Viewpoint

Quality of Life Factors Can Not Be Ignored

Vickie Tillman

A municipal bond credit rating is an opinion of a local government's creditworthiness based upon relevant risk factors. It is recognized by a letter-grade rating symbol (for example, AAA). Credit ratings are widely accepted by investors as efficient tools for differentiating creditworthiness.

The purpose of a rating is to evaluate credit risk, which only is one element in the investment decision-making process. A rating does not constitute a recommendation to invest in or avoid a prospective bondholder, nor is it a general purpose evaluation.

Issuers rated include states, cities, utilities, and special districts, reflecting the breadth and complexity of the entire market. A wide range of options is rated—from general government bond issues, backed by a full faith and credit pledge, to projects financed by single revenue streams.

Assessing Municipal Creditworthiness

A bond credit rating analysis generally includes four areas of concern covering established sectors of credit. These are: economic, debt, administrative, and fiscal factors. Standard & Poor's (S&P) also scrutinizes changing trends in the economy, marketplace, and in demographics. It recognizes that assessing creditworthiness is more complex than examining a balance sheet or a revenue-expense statement, much more demanding than a cursory review of selected facts, and much more inclusive than a mechanical sum of the parts.

In an effort to gain as complete a picture of a local government's well-being as possible, S&P examines such quantitative socioeconomic issues as the quality of infrastructure and social welfare. This provides the agency with an understanding of the policies and goals of the bondholder without which accurate assessment of credit would be impossible.

The primary determinants of creditworthiness, however, remain measurable financial and economic factors. When conducting an evaluation, S&P examines the issuer's employment, tax, and income trends. Ultimately, job creation and sustainable income levels enable a bondholder to service (or repay) its debt. Debt factors considered in the rating process include the type of security being pledged to service debt, overall debt burden, and debt history. Fiscal factors reviewed include the examination of budgetary management and current financial statements. Regarding administrative factors, S&P examines the form of government and assesses its ability to implement plans and fulfill legal requirements.

Using Socioeconomic Factors

In addition to financial and economic underpinnings, accurate analysis requires a thorough understanding of the policies and goals of an institution and its constituents. Unfortunately, there is no quantitative basis for accurately measuring or forecasting human behavior or social ills that will be important in shaping the economy and determining the ability to repay debt obligations.

In addition to being difficult to measure, the socioeconomic factors that make up quality of life are hard to define, and therefore can not be easily incorporated into rating criteria. They do, however, have some impact on S&P's overall assessment of creditworthiness. Societal wants and needs particularly affect the financial demands and economic choices of government. Quality of education, homelessness, crime, and health care—and the policy choices associated with them—all have potential long-term effects on the ability of cities, counties, and states to meet their debt obligations. To ignore quality of life issues when rendering opinions on creditworthiness would be shortsighted.

Societal wants and needs particularly affect the financial demands and economic choices of government.

Much has been written and debated about quality of life and bond ratings. Perhaps an examination of a local government's long-term socioeconomic prospects, a school district's voter-support levels, a hospital's ability to control spiraling expenses, or even a utility company's ability to preserve the environment should become more significant parts of the credit assessment process. In most instances, they already are, but within a traditional measurable analytic methodology examining a local government's economic, debt, administrative, and fiscal situation.

Thus, when analyzing credit, S&P considers quality of life issues that impact the main economic concerns it reviews. The agency never has upgraded or downgraded a local government bond issuer based on such issues. Again, the most important determinants of creditworthiness are financial and economic factors. These must be interpreted against the complex fabric of a community's needs, desires, and social policies—in essence, its quality of life.

Many might dispute the importance of these elements in traditional municipal analysis. The real challenge, however, is to assess the relative degrees of risk and an entity's ability to service its debt. The approach used to reach a better understanding of what makes a city or county work is constantly being redefined to improve S&Ps analytic process. PM

Vickie Tillman is executive managing director, Municipal Finance Department, Standard & Poor's Ratings Group, New York, New York.