Commonwealth of Virginia

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Commonwealth's Credit Ratings

- Commonwealth General Obligation Debt is rated Aaa/AAA/AAA by the three major credit rating agencies, Moody's Investor Service, Standard & Poor's Ratings Service and Fitch Ratings.
  - G.O. full faith and credit pledge is the broadest security a state can provide to the repayment of its long-term debt.
  - The Commonwealth is only one of 10 states rated triple-A by all three rating agencies.
  - The Commonwealth is the oldest triple-A by Moody's.

- Commonwealth Appropriation Debt is rated Aa1/AA+/AA+ by Moody's, S&P and Fitch.
  - Appropriation debt viewed as a lesser long-term commitment to repayment.

- Factors in determining the rating, an assessment of the ability and willingness to make repayment:
  - Economic factors
  - Debt factors
  - Financial performance
  - Governmental factors

Economic Factors

- The economic base ultimately generates the resources that repay the debt.
  - Current resources and future prospects are assessed.
  - Emphasis is on extent of activity, wealth and diversity.

- Measurements used:
  - Population trends
  - Personal income and gross state product
  - Employment and unemployment
  - Property values

Debt Factors

- The states issue debt in various forms, with different security features and different ratings.

- The G.O. rating is most commonly used and cited but debt burdens include all debt that is payable from tax revenues.

- Important components:
  - Debt as % of personal income
  - Rate of amortization
  - Debt service as % of revenues
  - Expected growth of debt
  - Pension and OPEB unfunded liabilities.

Financial Performance

- Financial performance measures the ability of a government to carry out its functions.

- Important components:
  - Structural balance
  - Revenue reserves
  - Tax systems
  - Revenue forecasting phases
  - Service levels
  - Liquidity

Governmental Factors

- The government is examined to ascertain that it is structured to allow responsibilities to be achieved.

- Important components:
  - Budgetary control
  - Long-term planning
  - Institutionalized best practices
  - Cooperation among the branches of government
  - Lack of restrictive constitutional or statutory limits
  - Consistent record of strong management

Rating Agency Approaches

- Fitch Ratings
  - Evaluates the four major credit factors to establish the credit quality of the state.
  - Reviews sub-factors and generally categorizes these attributes as Above Average, Average or Below Average.
- Moody's Investors Service
  - Moody's introduced a new state methodology scorecard in April 2013, with weights applied to the four major factors, which are broken down to sub-factors with their own weights.
  - Overall weighted scores range from 1 (strongest) to 9.7 (weakest).
  - Quantitative and qualitative factors are used and analytical judgment can be applied that leads to a rating outcome that differs from the scorecard.
  - Moody's does not expect the new methodology and scorecard to result in rating changes for states.
- Standard & Poor's
  - S&P assigns ratings based on qualitative and quantitative analysis with respect to the factors: government framework, financial management, economy, budgetary performance, and debt and liability profile.
  - Each factor has a set of indicators that are assessed a score on a scale from 1 (strongest) to 4 (weakest). These scores are averaged for each factor to come up with a score for the factor, which carry equal weight.
  - The overall score to provide an indicative rating level and overriding factors are assessed to determine the final rating.

Fitch Ratings – Rating Sub-factors

- Fitch reviews sub-factors and generally categorizes these attributes as Above Average, Average or Below Average.

Attributes for Economy	Attributes for Financial Performance
▪ Diversity and stability of economic base ▪ Trends in population and employment growth levels ▪ Stability and diversity among major employers ▪ Wealth indicators, including personal income per capita ▪ Demographic factors, including average age, education levels	▪ Diversity and broadness of sources of operating revenue ▪ Ability and willingness to make structural budget adjustments as needed, either as part of the budget process or during the fiscal year. ▪ Trend of operating margins ▪ Reserve levels ▪ Liquidity level, without requiring external short-term borrowing
Attributes for Debt and Other Long Term Liabilities	**Attributes for Governmental Factors**
▪ Debt burden as measured by debt to personal income ▪ Debt service burden ▪ Level of future capital and debt needs ▪ Rapidity of repayment ▪ Consistent full funding of pension ARC ▪ Combined debt and unfunded pension liability as percent of personal income ▪ OPEB liability	▪ Efficiency of decision-making process, focused on financial prudence ▪ Evidence of consistent cooperation among elected officials ▪ Financial and debt management policies ▪ Budgeting process with level of interim reviews, contingency planning, and the ability to make adjustments as needed during the fiscal year ▪ Long-term financial planning process ▪ Frequency of intrayear budget reports and timely financial reporting on a GAAP basis

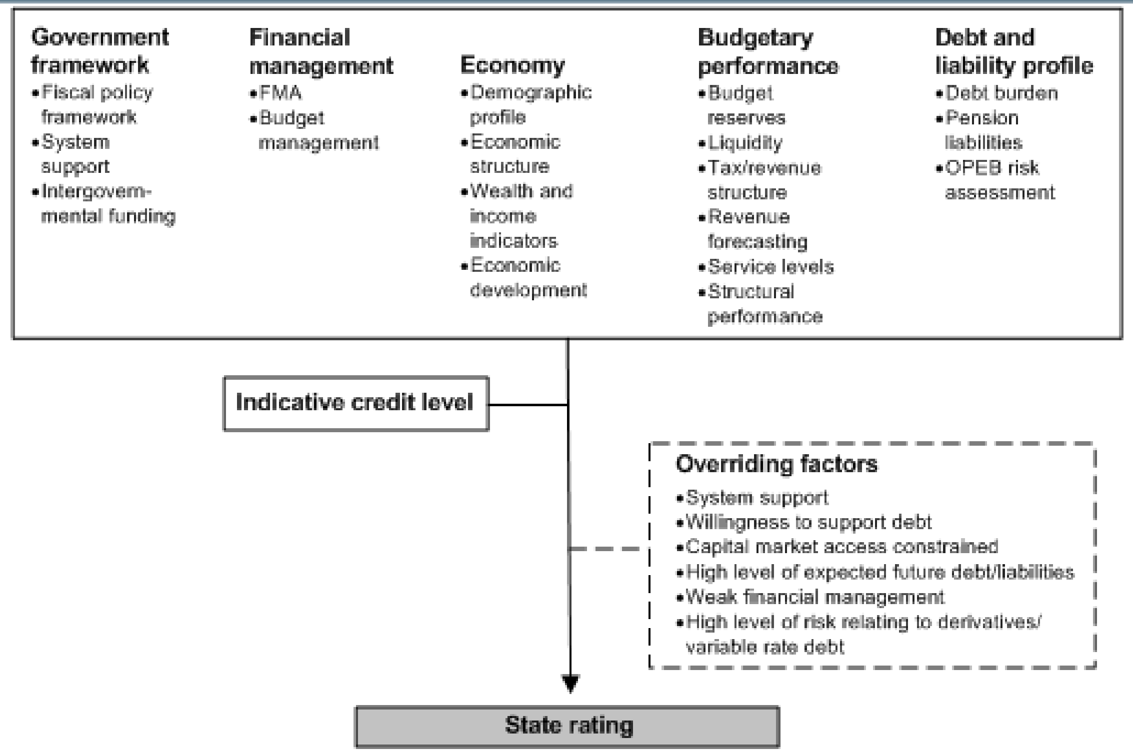
Moody's Scorecard

Rating Factor	Factor Weighing
Economy Income (10%) Industrial Diversity (5%) Employment Volatility (5%)	20%
Governance Financial Best Practices (15%) Financial Flexibility (15%)	30%
Finances Revenues (10%) Balances and Reserves (10%) Liquidity (10%)	30%
Debt Bonded Debt (10%) Adjusted Net Pension Liabilities (10%)	20%

Standard & Poor's – Analytic Framework

- S&P assesses a score on a scale from 1 (strongest) to 4 (weakest) for each indicator. These scores are averaged for each factor to come up with a score for the factor, which carry equal weight.

Chart 1
Standard & Poor's Analytic Framework For Rating U.S. States



Moody's and Standard & Poor's Score Cards

- The overall score provides an indicative credit rating and overriding or additional factors may be applied, resulting in a rating different from the indicative rating, but generally within a half notch to multiple notches for Moody's and one notch of the indicative credit rating for S&P.

Moody's Score Card

Indicated Rating	Overall Weighted Score
Aaa	1 to 1.7
Aa1	1.7 to 2.7
Aa2	2.7 to 3.7
Aa3	3.7 to 4.7
A1	4.7 to 5.7
A2	5.7 to 6.7
A3	6.7 to 7.7
Baa1	7.7 to 8.7
Baa2	8.7 to 9.7

S&P Score Card

Indicative Credit Level	Score
AAA	1 to 1.5
AA+	1.6 to 1.8
AA	1.9 to 2
AA-	2.1 to 2.2
A+	2.3 to 2.4
A	2.5 to 2.6
A-	2.7 to 3
BBB category	3.1 to 4

Outlook for State Sector

- States have inherent strengths with broad based economies and tax bases and substantial control over revenues and spending.

- However, there are significant challenges.
  - Uncertainty related to Federal Government
    - Tax reform
    - Sequestration
    - Government shutdown
    - Debt ceiling threat
  - Slow economic and revenue recovery
  - Ongoing spending pressures
    - Healthcare
    - Education
    - Transportation
  - Managing pension OPEB liabilities

Rating Agency Approaches – Pension Liability

- Pension funding has become an increasingly important factor in state credit and ratings.
- The rating agencies are taking different approaches to evaluating pension liabilities.

- **Fitch Ratings**
  - Apply 7% investment return to pension liability to improve comparability across plans.
  - Pension liability measure: Debt plus unfunded pension liability (using a 7% investment return) as a percent of personal income.

- **Moody's Investors Service**
  - In April 2013 adopted adjustments to pension data for the stated purpose of enhancing transparency and comparability.
  - Do not expect the new methodology and scorecard to result in rating changes for states.
  - Pension liability measure: 3-Year Average Adjusted Net Pension Liability/Total Governmental Fund Revenues.

- **Standard & Poor's**
  - Assess pension liability using information from audit reports and actuarial reports.
  - Pension liability measures:
    - Pension Funded Ratio
    - Pension Funding Levels
    - Unfunded pension liabilities per capita
    - Unfunded pension liabilities to personal income

Pension Liability - Fitch Ratings

- Fitch reviews defined benefit pension plan and OPEB funding as part of the analysis of debt and long-term liabilities.
- Factors analyzed:

▪ Magnitude of liability	▪ Liability as a percentage of resource base
▪ Trends in funded ratio	▪ Amount of state's budget used for pensions
▪ Commitment to fund ARC	▪ Historical commitment to system funding
▪ Size of resource base	

- Allocates cost-sharing multi-employer pension system plan liabilities among state/local governments.
- Considers all of a state-sponsored multi-employer plan's unfunded actuarial accrued liability (UAAL) as a contingent liability of the state.
- Views favorably well-funded pension plans and consistent full funding of the ARC.
- Fitch creates standardized investment return scenarios, applying a 7% investment return to the funded ratio. Pensions with funded ratios of at least 80% considered to be well-funded.
- Pension Liability Measure: Net tax-supported debt plus portion of UAAL (adjusted for 7% investment return) that are the responsibility of the state as a percentage of personal income.

▪ Low burden: <6%	▪ Moderate burden: < 10%	▪ Elevated burden: >10%

- OPEB is a legally softer obligation than debt or pensions and in most cases, subject to modification, and therefore Fitch does not calculate a metric that includes the state's OPEB liability.

Pension Liability – Moody’s

- Moody’s will calculate adjusted net pension liabilities. Adjustments will be made in four areas.
  - Individual governments are to be broken out of multiple employer plans.
  - Accrued liabilities are to be adjusted for a return based on a high grade corporate bond index.
  - Asset smoothing is replaced with market value.
  - Required annual contributions will be amortized over a period of 20 years.

- Moody’s will consider debt and pension liability separately. The debt category will carry 20% weight with bonded debt comprising 10% and adjusted net pension liabilities comprising 10%.
- Pension Liability Measure: 3-year average Adjusted Net Pension Liability/Total Governmental Fund Revenues.

▪ Aaa-Rating: Less than 25%	▪ Aa3-Rating: 80%-120%
▪ Aa1-Rating: 25%-40%	▪ A-Rating: 120%-180%
▪ Aa2-Rating: 40%-80%	▪ Baa and below: Greater than 180%

- Flexible scoring can reflect qualitative considerations (funding history and governance factors).
- Moody’s has stated there will be no immediate impacts on state ratings.
  - Focus on pension pressure has resulted in several rating downgrades prior to Moody’s adoption of its pension adjustments (Pennsylvania, Illinois, Connecticut, New Jersey).
- Moody’s pension adjustments will increase pension liabilities and decrease funding levels.
- Moody’s plans to publish median adjusted pension statistics.

Pension Liability – Standard & Poor's

- S&P has not included pension liabilities in the calculation of net tax-supported debt because of the variation in how the liabilities are calculated but do review state pension liabilities and trends related to funding progress.
- Assessment of pension liabilities include four indicators, and S&P typically derives the information from audit reports and actuarial reports.

Pension Funded Ratio	
Strong (1)	90 % or above
Above Average (2)	80%-90%
Below Average (3)	60%-80%
Weak (4)	60% or below

Unfunded State Pension Liabilities Per Capita	
Strong (1)	Below $500
Above Average (2)	$501-$2,000
Below Average (3)	$2,001-$3,500
Weak (4)	Above $3,500

Ratio of State Pension Liabilities to Personal Income	
Strong (1)	Below 2%
Above Average (2)	2.1%-4%
Below Average (3)	4.1%-7%
Weak (4)	Above 7%

Pension Funding Levels	
Strong (1)	Consistently funds annual required contributions (ARC)
Above Average (2)	Funds ARC in most years but occasionally contributes less
Below Average (3)	Has not funded ARC for 3 years
Weak (4)	Has not funded ARC for more than 3 years

Major Take-Aways From Presentation

- More attention is now being paid to pension liabilities
  - Accounting/measurement standards adopted (GASB)
  - Formal recognition of liabilities as debt on balance sheet

- Bond rating firms have increased their focus on pension liabilities
  - Progress toward obtaining comparable data for state/local governments
  - Efforts to formally include in rating methodology
  - Variation in assigned weights/importance (need for flexibility)

- Outcomes may change thinking and actions
  - Assignment of previously “unassigned” liabilities
  - Drag of added debt on balance sheet
  - Commitment to fund actuarial required contributions
  - Inherent risks for some entities/governments