FitchRatings

Fitch Rates New York City's (NY) $850MM GOs 'AA'; Outlook Stable

Ratings Endorsement Policy
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Fitch Ratings-New York-05 June 2014: Fitch Ratings assigns an 'AA' rating to the following New York City, NY general obligation (GO) bonds:

--Approximately $850 million fiscal 2014 series J and K, consisting of $765 million in series J and $85 million in series K.

In addition, Fitch affirms the 'AA' rating on the city's approximately $41.9 billion in outstanding GO bonds.

The Rating Outlook is Stable.

The series 2014 bonds are expected to be priced via negotiation on June 11. Proceeds will refund outstanding GO bonds and pay costs of issuance.

SECURITY

The bonds are general obligations of the city secured by a pledge of the city's full faith and credit and the levy by the city of ad valorem taxes (without limit as to rate or amount) on all real property within the city subject to taxation. The city is not subject to New York State's property tax cap.

KEY RATING DRIVERS

SOLID ECONOMIC UNDERPINNINGS: The city has a broad economic base and serves a unique role as a national and international center for commerce, culture, and tourism. Recession-related job declines have been well under comparable national averages and job recovery has been strong, although the unemployment rate remains elevated.

HIGHLY EFFECTIVE BUDGET MANAGEMENT: The city's sound approach to budget development features reasonable revenue and expenditure forecasting, proactive budget monitoring, and effective actions to eliminate projected deficits.

LABOR SETTLEMENT REDUCES UNCERTAINTY: A recently ratified agreement with the United Federation of Teachers (UFT), which represents nearly a third of city employees, reduces uncertainty about the resolution of long-expired labor agreements. Fitch believes the overall package represents a sizeable but manageable funding need.
Uncertainty remains with the financial plan's assumption that remaining open contracts achieve similar terms as the UFT's through fiscal 2018.

HIGH & GROWING LONG-TERM LIABILITIES: Fitch anticipates a continued high debt burden given the city's significant capital commitments and expected future tax-supported issuance. Post-employment liabilities are also high. However, Fitch expects the combined burden on the budget of long-term liabilities will remain fairly stable.

DIVERSE BUT CYCLICAL REVENUE: Economically sensitive revenues, including personal income, business, and sales tax, comprise a sizable share of the city's budget and are highly vulnerable to variability in the financial services industry. Recent performance shows a trend of sound growth with some year-to-year variability.

RATING SENSITIVITIES

PRUDENT BUDGET MANAGEMENT: The rating is sensitive to the city's ability to keep out-year budget imbalances contained in light of limited spending flexibility and proposed labor settlements. Evidence that the newly-higher gaps are the beginning of a trend, rather than a one-time adjustment, would likely result in negative rating action.

LONG-TERM LIABILITY CONTAINMENT: Fitch is increasingly concerned about the city's large and growing long term liability burden. Growth in the budget burden associated with these liabilities would reduce overall financial flexibility and negatively affect the rating.

CREDIT PROFILE

RECENT TRENDS REINFORCE EXPECTATION FOR CONTINUED BUDGET BALANCE

The key credit strength underpinning Fitch's 'AA' rating is the city's tight budget monitoring and control as demonstrated by its ability to achieve consistent balance and manage out-year gaps. Regular reviews by various external financial oversight entities enhance the city's own internal analysis which includes monthly reporting and three detailed budget updates annually. Nascent gaps are dealt with quickly, and year-end results tend to be very close to break-even, with modest, positive variation from budget.

Current fiscal 2014 estimates show revenues a sizable 7.3% above the level forecast in Junes 2013, due largely to a surge in real estate transaction-related taxes and receipt of federal disaster recovery funding. Expenditures show a similar increase, reflecting an increase in prepayments of subsequent year expenditures, the retention of $1 billion in the OPEB trust that had previously been planned for use in the current fiscal year, and costs related to the tentative labor settlement. Consistent with prior results, the fiscal year is expected to end in balance.

The city released its executive fiscal 2015 budget and four-year financial plan on May 8 (subsequently modified on May 21). Total fiscal 2015 budgeted spending of $75 billion is 2% below current fiscal 2014 estimates before consideration of prepayments and an increase in the general reserve to $600 million (still less than 1% of spending, which Fitch does not consider significant) from $50 million. Fiscal 2014 includes increases to labor costs that in fiscal 2015 are offset by health care savings and use of a billion-dollar labor stabilization fund. At least two of the city's fiscal monitors (the Independent Budget Office and the New York City Comptroller) have commented that they believe the city's out-year revenue estimates are conservative.

LOW RESERVES MITIGATED BY STRUCTURAL PREPAYMENTS

The city's inability to carry a fund balance somewhat limits financial flexibility. Management consistently offsets this constraint by using accumulated surpluses to prepay debt service and other expenses in subsequent years. Fitch expects the city to retain at least a modicum of accumulated surplus and continue the practice of prepaying out-year expenses. A marked change in this long-standing approach would be viewed negatively by Fitch.

The city accumulated an $8 billion surplus to roll forward prior to the economic downturn, with several consecutive years of operating surpluses. Between fiscal years 2009 and 2012, annual operating deficits eroded the amounts available for future years' budgets. Fiscal 2013 reversed the trend however, showing a moderate operating surplus. The current forecast for fiscal 2014 shows an operating deficit of $1.2 billion (the net of the amount rolled in from the prior year and the expected amount rolled into subsequent years), although this amount has declined throughout the year and could decline further or be eliminated by fiscal year-end.

FORWARD TREND IN OUT-YEAR GAPS IS KEY

Fitch expected labor settlements to result in a moderate increase in out-year budget gaps, and therefore views the gaps as a neutral credit factor They are still fairly low relative to spending on a historical basis, but the trend from this point will be a key determinant in rating trajectory. Fitch's expectation is that gaps will continue to be moderate in the out-years and addressed on an annual basis. Evidence of a trend of increasing gaps relative to spending would lead to negative rating pressure.

The fiscal 2015 executive budget includes out-year gaps growing to 3.6% of budget in fiscal 2018 from 3.2% in fiscal 2016, still well below levels at the time the fiscal 2012 budget was presented of 6-7% of spending. The increased gaps result from the city's inclusion of the cost of a proposed labor settlement with the UFT and applies the same costs (except for retroactive payments to UFT and other union members for 2009 and 2010) to the city's other bargaining units. The UFT contract, which was recently ratified, removes a significant uncertainty from the city's budget. Talks with other unions are reportedly ongoing.

LABOR SETTLEMENT COSTS MODERATE BUT NOT ALL FUNDED IN FINANCIAL PLAN PERIOD

Salary increase rates are fairly modest, but the impact on the budget is nonetheless notable. The city estimates the gross cost for the UFT contract and those of other unions whose contracts expired at the same time at $17.8 billion. Approximately $4.2 billion of the total represents retroactive payments for increases from the 2008-2010 round of bargaining that will not be paid until fiscal 2019-2021 (beyond the current financial plan). Management anticipates that the use of reserves and negotiated healthcare savings will reduce the overall budget impact to $8 billion.

The UFT contract restructures 4% salary increases for both 2009 and 2010 as annual 2% increases in fiscal 2015-2018, and includes increases of 1% in each of 2013-2015, 1.5% in 2016, 2.5% in 2017, and 3% in 2018. All increases are effective May 1. Retroactive payments will be made as lump sums on Oct. 1 of 2015 and 2017 (12.5% each), and 2018-2021 (25% each). UFT members who leave but do not retire prior to the end of this period will not receive the full retroactive payment.

Estimated costs assume 5% annual attrition through fiscal 2018 and 2.5% thereafter. The lump sums amount to $7 billion in total, of which about $4.2 billion (60%) in gross costs, or $2.3 billion net of healthcare savings, is deferred beyond the current financial plan period. Fitch views the postponement of payment of salaries earned a decade earlier to be a sign of the strain that even the moderate percentage increase puts on the city's budget.

If the same salary increases (net of the retroactive component, which the city's other bargaining units have already received), are applied to other bargaining units, the city calculates the gross cost for all unions to be $13.6 billion through fiscal 2018. Netting out pre-existing reserves of $4.5 billion, including the $1 billion healthcare stabilization fund and a $3.5 billion collective bargaining reserve, the total budgetary impact would be $9.1 billion.

The city has negotiated $3.4 billion in healthcare savings with bargaining units citywide that management expects will further reduce the net cost of the contracts to $5.7 billion. Enforcement of the healthcare savings will be subject to arbitration, so appear likely to be realized. However, a failure or delay in implementation could increase out-year gaps by up to $400 million in fiscal 2015, increasing to $1.3 billion in fiscal 2018.

CARRYING COSTS EXPECTED TO REMAIN LARGE BUT MANAGEABLE

Fitch expects the carrying costs for debt service, pensions and OPEB to remain a stable burden on the budget despite the large capital and fringe benefit pressures. Fitch recognizes the city's conservative budgeting of debt service expense and views positively the city's ability to achieve sizable interest rate savings from debt refinancing over the last several years. Debt service consumes $5.7 billion, or a moderate 7.6% of fiscal 2014 forecast spending. Debt service is projected to increase to $7.8 billion (9.3% of total spending) by fiscal 2018. Management uses as a guideline a cap on debt service of 15% of city tax revenue. By this measure, debt service is projected to be about 11.9% for fiscal 2014, rising to nearly the cap at 14.4% by fiscal 2018. Principal amortization is slightly below average.

A more notable concern is the cost of pension and other post-employment benefits (OPEB), which total $8.3 billion and $2.1 billion, respectively (a combined 13.9% of expenditures), in the current fiscal 2014 forecast. The city projects that following rapid escalation in pension costs (from $1.5 billion in fiscal 2002), costs will grow slowly during the financial plan period. OPEB payments, while lower, grow more quickly and reflect funding on a pay-as-you-go basis. While Fitch views favorably the retention of $1 billion in an OPEB trust fund rather than spending it in the current fiscal year, the amount does little to offset the liability, and could in future years be used to alleviate spending pressures. Carrying costs for debt service, pensions and OPEB were 19.7% of governmental spending in fiscal 2013, which Fitch considers to be in the moderate range.

Fitch believes cost pressures associated with pensions will continue. As of the most recent actuarial valuation date of June 30, 2011, pension funded ratios were weak at an aggregate of 60.7%, and the unfunded liability was a large $72 billion. The city uses an expected investment return rate of 7%. The city's actuary projects the aggregate funded ratio will increase to 67% by fiscal 2018. Fitch would be concerned if pension payments increased more than anticipated or unfunded liabilities grew measurably. Fitch views favorably the city's decision to implement GASB 68 for fiscal 2014, and does not anticipate that this change will result in rating action.

The unfunded actuarial accrued liability for OPEB is a very high $669.3 billion as of June 30, 2013, and the net OPEB obligation is even higher at $92.5 billion. Efforts to reduce the liability appear to be limited to the afore-mentioned contractual healthcare savings.

HIGH AND RISING DEBT IS A CREDIT CONCERN

Debt metrics are expected to remain high but stable relative to the city's vast tax base. Fitch-calculated net tax-supported debt including Transitional Finance Authority (TFA) future tax secured bonds equals approximately $9,233 per capita, and 8.6% of fiscal 2014 full value. If unfunded pension and OPEB obligations were included, the long-term obligation burden would more than triple.

The city's capital commitments are extensive, totaling $46.1 billion for fiscal 2014-2018, including $9.2 billion for self-supporting water and sewer projects and $12.7 billion for education (of which roughly half are expected to be paid with state aid). Fitch does not expect significant deviation in the overall size of the plan or debt needs, but believes adequate funding for aging infrastructure and expansion initiatives in the context of already-high debt levels will continue to be a challenge.

ECONOMY HAS INHERENT STRENGTHS BUT NOT WITHOUT CHALLENGES

Fitch considers the city's unique economic profile, which centers on its singular identity as an international center for numerous industries and major tourist destination, to be a credit strength. The character of the New York City economy has contributed to its relative employment stability during the recession and ability to regain by March 2012 the number of private sector jobs that existed prior to the recession. Population, which grew modestly during the first decade of the century, has increased 1.6% since 2010. The city's tourism sector is performing exceptionally well, attracting a record 54 million visitors in 2013, the fourth record year in a row.

The city's economic profile also benefits from good wealth levels; per capita personal income is 130% of the U.S. and market value per capita is over $100,000. Both per capita money income and median household income have grown more rapidly over the last five years than either the state's or nation's. However, the above-average individual poverty rate of 19.4% in 2011, compared to 14.3% for the U.S., indicates significant income disparity.

The city's economy (and operating budget) is strongly linked to the financial sector, which accounts for approximately 12% of total employment but 30% of earnings. Financial activities employment declined 0.4% in 2013, and the high-earning securities and commodities component of the sector dropped 2.2% jobs following a 1.6% decline in 2012.

Fitch will publish a full rating report on NYC on or about June 9 which will be available at www.fitchratings.com.

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In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria, this action was additionally informed by information from Creditscope, CoreLogic Case-Shiller Home Price Index, and Global Insight.

Applicable Criteria and Related Research:
--'Tax-Supported Rating Criteria' (Aug. 14, 2012);
--'U.S. Local Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

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Additional Disclosure
Solicitation Status