FitchRatings

Fitch Rates New York City's (NY) $900MM GOs 'AA'; Outlook Stable

Ratings Endorsement Policy
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Fitch Ratings-New York-09 March 2015: Fitch Ratings assigns an 'AA' rating to the following New York City, NY general obligation (GO) bonds:

--Approximately $900 million fiscal 2015 series C, D, and E, consisting of the following:

--Approximately $750 million in tax-exempt series C;
--Approximately $50 million in tax-exempt series D;
--Approximately $100 million in taxable series E.

In addition, Fitch affirms the 'AA' rating on the city's approximately $39.9 billion in outstanding GO bonds, including the following subseries of bonds which will be converted to the fixed rate mode on March 31 (the conversion date):
--Approximately $103.16 million, fiscal 2008 series J, subseries J-12
The Rating Outlook is Stable.

The series 2015 bonds are expected to be priced via negotiation on March 12. Proceeds of series C and D bonds will refund outstanding GO bonds. Series E proceeds will be used for capital projects. Proceeds will also be used to 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

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

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 were well under comparable national averages and recent job recovery has been strong.

LABOR SETTLEMENTS CONTINUE: Labor unions continue to ratify agreements that Fitch believes represent a sizeable but manageable funding need. Uncertainty remains regarding still-unsettled contracts, primarily for police and fire employees.

HIGH 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. Fitch expects the combined burden on the budget of long-term liabilities will remain elevated but fairly stable.

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

RATING SENSITIVITIES

BUDGET BALANCE CRUCIAL: Given the lack of accumulated reserves, the rating is sensitive to the city's ability to continue to address budget imbalances and demonstrate financial flexibility through sizable prepayments of future years' expenditures. Fitch expects these prepayments to grow while the economy and revenues remain strong.

LONG-TERM LIABILITY CONTAINMENT: Fitch is increasingly concerned about the city's large long-term liability burden. Notable 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 and four-year financial plan updates annually. Nascent gaps are dealt with quickly, and year-end results tend to be very close to break-even, with positive variation from budget.

Fiscal 2015 revenues forecast in the February 2015 financial plan (which includes a forecast for the current fiscal year, the budget for the upcoming fiscal year, and projections for the ensuing three fiscal years) are 4.7% above budget, due largely to above-budget personal income tax revenue and receipt of federal disaster recovery funding. Expenditures show a similar increase, reflecting use of the federal disaster recovery funding and an increase in prepayments of subsequent year expenditures. Consistent with prior results, the fiscal year is expected to end in balance.

The city's preliminary fiscal 2016 budget is balanced and totals $77.7 billion net of prepayments, slightly below fiscal 2015 forecast spending (but slightly above excluding the federal disaster recovery funding). The budget includes a general reserve of $750 million (about 1% of spending, which Fitch does not consider significant).

LOW RESERVES MITIGATED BY STRUCTURAL PREPAYMENTS

The city's inability to carry a meaningful 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 increase the level of accumulated surplus applied to out-year expenses during the current period of solid revenue and economic growth. A variation from this expectation would be viewed negatively by Fitch.

The city accumulated an $8 billion surplus to roll forward prior to the most recent economic downturn, with several consecutive years of operating surpluses. By fiscal 2014, the surplus had eroded to $2 billion. A small operating deficit in fiscal 2014 was due in part due to an accounting treatment, applied late in the fiscal year, that required recognition in that year of $1.8 billion in labor settlement costs that are payable to future year retirees. Management expects to end fiscal 2015 close to balance net of prepayments in and out.

FORWARD TREND IN OUT-YEAR GAPS IS KEY

Fitch expects that out-year gaps will continue to be moderate and addressed on an annual basis. Evidence of a trend of increasing gaps relative to spending would lead to negative rating pressure. The February 2016 preliminary budget and financial plan includes out-year gaps ranging from 1.2% of budget in fiscal 2017 to a still-modest 2.4% in fiscal 2019.

LABOR COSTS STILL LARGEST SPENDING UNCERTAINTY DESPITE IMPRESSIVE PROGRESS ON CONTRACT SETTLEMENTS

Salary increase rates in the labor settlements are fairly modest, and most are now incorporated into the financial plan.
Most settled civilian contracts are modeled on the pattern set by the District Council 37 contract, which grants the same level of wage increases received by the United Federation of Teachers (UFT), in the last seven years of the UFT agreement (through 2018).

Recent settlements with the Uniformed Superior Officers Coalition (USOC) which includes eight unions, and the

Sergeants Benevolent Association, yield slightly more generous wages. The cost of these contracts is modest relative to the budget. Fitch believes the establishment of a pattern with uniformed employees is a significant step, but remains concerned about the significant uncertainty surrounding settlement with other uniformed bargaining groups. In particular, members of the Policemen's Benevolent Association, the largest uniformed bargaining group, has recently experienced significant friction with the mayor.

The financial plan includes funding for unsettled uniformed labor contracts that match the pattern set by the USOC. If the city is unable to negotiate contracts, they could be settled by binding arbitration. However, an arbitration award would only cover 2010-2012, leaving significant exposure to additional retroactive settlements.

While the financial plan incorporates most of the cost of the settled labor contracts, about $1.6 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 modest percentage increase puts on the city's budget.

The city and citywide civilian bargaining units (the Municipal Labor Council, or MLC) have agreed that the unions will achieve $3.4 billion in healthcare savings through fiscal 2018, and recurring thereafter, that will reduce the net cost of the contracts. Enforcement of the healthcare savings will be subject to arbitration, so the savings appear likely to be realized. However, a failure or delay in implementation could increase out-year gaps by up to $1.3 billion in fiscal 2018. Management reports that the $400 million in agreed-upon fiscal 2015 savings are on track for at least the negotiated level. The benefit of any additional healthcare savings beyond the amount currently negotiated would be shared between the city and employees.

In addition to labor costs, Fitch views the impact of the changing overall healthcare landscape on the operations of the Health and Hospitals Corp. (HHC), to which the city now provides a modest operating subsidy and more sizable capital funding, to be potential budget uncertainty.

HIGHLY DETAILED ESTIMATES OF DIVERSE REVENUE MIX; RISKS REMAIN

The city benefits from a diversity of revenue sources, although many are subject to economic volatility. Fitch believes that the city's revenue estimates, based on a highly detailed and frequently-reviewed analysis, are reasonable. The property tax is the largest source, at 28% of fiscal 2014 audited funds, followed by personal income tax at 14% and sales tax at 9%. State and federal sources, primarily for education and social services programs, make up 15% and 10% of fiscal 2014 revenue, respectively. Combined taxes make up 66% of total revenue. The city has a moderate amount of room to increase the property tax levy under the cap.

Assessed value (AV) grew by a healthy 6.1% in fiscal 2015, following 5.7% in fiscal 2014. Fiscal 2016 AV is forecast to grow 5.8%, followed by 5.8%, 4.8%, and 4.1% in fiscal 2017-2019, respectively. The phase-in of value changes over five years evens out year-to-year volatility and enhances predictability.

Real estate transaction taxes (real property transfer and mortgage recording), which Fitch views as among the most highly volatile and market-sensitive revenues, totaled $2.5 billion or 3.4% of fiscal 2014 revenues and are forecast at a similar amount for fiscal 2015. The large numbers reflect, in part, closing of a few large, high-profile commercial transactions. Evidence of increased reliance on this source would concern Fitch.

Recent budgets have included modest amounts of non-recurring revenue; Fitch would be concerned if such funding sources grew to be significant. In addition to reimbursements for storm damage resulting from Superstorm Sandy that are offset by expenditures, the city expects to receive $896 million from a penalty paid by BNP Paribas, which will be subject to use restrictions and is not budgeted.

Management estimates the gross cost to public sector facilities (including HHC and the New York City Housing Authority) from Hurricane Sandy to be $9.9 billion. Of this amount, $2.2 billion will come from the operating budget and the rest from reimbursable capital spending. The city expects all costs to be reimbursed from non-city sources. The damage cost estimate does not include the cost of enhancements for future damage mitigation.

CARRYING COSTS EXPECTED TO REMAIN LARGE BUT MANAGEABLE

Fitch expects carrying costs for debt service, pensions and other post-employment benefits (OPEB) to remain a stable burden on the budget despite 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 $6.2 billion, or a moderate 7.9% of fiscal 2015 forecast spending. However, debt service is projected to increase to $8.1 billion (9.3% of total spending) by fiscal 2019. Management uses as a guideline a cap on debt service of 15% of city tax revenue. By this measure, which Fitch views as a reasonable level (most local governments use a more expansive denominator), debt service equaled 11.6% for fiscal 2014, rising to 13.9% by fiscal 2019. Principal amortization is slightly below average.

A more notable concern is spending on pension and OPEB, which totaled $8.6 billion and $2.1 billion, respectively (a combined 13.6% of expenditures), in fiscal 2015. The city projects that pension costs will flatten during the financial plan period, showing modest decreases from prior projections for the same years. OPEB payments, while lower, continue to grow and reflect funding on a pay-as-you-go basis. While Fitch views favorably the increase to $2.4 billion in the balance in an OPEB trust fund, the amount does little to offset the liability and could in future years be used to alleviate spending pressures instead. Carrying costs for debt service, pensions and OPEB were 21.7% of governmental spending in fiscal 2014, which Fitch considers to be in the moderate range. Overall carrying costs are forecast to grow moderately through the financial plan period.

Fitch believes cost pressures associated with pensions will continue, but views positively the early implementation of GASB Statement 68. As of the most recent actuarial valuation date of June 30, 2012, pension funded ratios were weak at an aggregate of 58% (excluding the New York City Employee Retirement System, a cost-sharing multiemployer plan). The aggregate unfunded accrued actuarial liability as of June 30, 2014, was a large $64 billion. The city uses an expected investment return rate of 7%.

The city's actuary projects the aggregate funded ratio for all plans will increase to 71% by fiscal 2019, based on an actuarial valuation of assets. Fitch would be concerned if pension payments began to increase by more than a moderate pace or unfunded liabilities showed a trend of measurable growth. Fitch recognizes that year-to-year variation in the liability will be greater since GASB 68 requires a market rather than smoothed asset valuation method.

The unfunded actuarial accrued liability for OPEB is a very high $69.9 billion as of June 30, 2014, and the net OPEB obligation is even higher at $89.5 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 $8,968 per capita, and 8.8% of fiscal 2015 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 $41.1 billion for fiscal 2015-2018, including $8.2 billion for self-supporting water and sewer projects and $11 billion for education (of which roughly one quarter is expected to be paid with state aid). A Ten-Year Capital Strategy is anticipated to be released this spring with the executive budget. Fitch does not expect significant deviation in the overall pace of capital spending 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 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 2.8% since 2010.

The city's tourism sector is performing exceptionally well, attracting a record 56 million visitors in 2014, the fifth record year in a row. The city estimates that continued strong visitor-related spending and moderate economic growth will yield sales tax growth of 4.4% in fiscal 2015, after 5.9% growth in fiscal 2014.

The economic profile of the city also benefits from good wealth levels; per capita personal income is 128% 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 local economy (and operating budget) is strongly linked to the financial sector, which accounts for approximately 11% of total employment but 29% of earnings according to 2013 data. Financial activities employment declined 0.3% in 2013, and the high-earning securities and commodities component of the sector dropped 2.2% jobs following a 1.6% decline in 2012.

Overall resident employment increased by 2.7% in 2014, well-outpacing the state and nation. The unemployment rate decreased to a still-high 7.3% in 2014, a significant improvement from 8.7% in 2013. Recent data show continued improvement; the December 2014 city unemployment rate (not seasonally adjusted) was 6.4%, down from 7.5% a year prior, with strong 3.4% employment growth. The most recent rate is still above the state and federal averages but the gap is narrowing.

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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
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