MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns Aa2 to $850 million of New York City GO bonds; outlook stable

Global Credit Research - 05 Jun 2014

$41.9 billion of GO debt outstanding

NEW YORK (CITY OF) NY
Cities (including Towns, Villages and Townships)
NY

Moody's Rating

ISSUE		RATING
General Obligation Bonds, Fiscal 2014 Series J		Aa2
Sale Amount	$765,000,000	
Expected Sale Date	06/11/14	
Rating Description	General Obligation	
General Obligation Bonds, Fiscal 2014 Series K		Aa2
Sale Amount	$85,000,000	
Expected Sale Date	06/11/14	
Rating Description	General Obligation	

Moody's Outlook STA

Opinion

NEW YORK, June 05, 2014 --Moody's Investors Service has assigned Aa2 ratings to the City of New York's $765 million General Obligation Bonds, Fiscal 2014 Series J and $85 million Series K. Proceeds of the bonds, scheduled to price June 11, will be used to refund outstanding general obligation bonds for debt service savings.

SUMMARY RATING RATIONALE

The ratings reflect the city's large and resilient economy, its extraordinarily large tax base, its institutionalized budgetary and financial management controls, its proactive responses to budget strain during economic downturns, its reliance on a volatile financial services sector, and a high budgetary burden from the combination of debt service, pension, and employee and retiree health care costs. The outlook is stable.

STRENGTHS

-- Exceptionally large and diverse economy driven by city's position as an international center of the high-income financial services industry

-- Strong governance and financial best practices, tested through periods of fiscal stress

-- Strong liquidity

CHALLENGES

-- Cyclical economic base driven by the financial services industry

-- Ongoing need to close out-year budget gaps

-- High and growing burden from debt service, pension and retiree health care costs

DETAILED CREDIT DISCUSSION

CONTRACT SETTLEMENT INCREASES FUTURE YEAR BUDGET GAPS BUT SIZE IS MANAGEABLE

On May 1 the city announced a new contract agreement with its teachers that includes retroactive 4% pay increases each for 2009 and 2010 for employees who remain with the city during fiscal years 2015-2021 and for retirees during that period, which will be paid between fiscal 2015 and fiscal 2020. The contract - which teachers subsequently ratified last week - also includes a 10% total base wage and salary increase through fiscal 2018 and a $1,000 per employee "ratification bonus". The complex agreement will cost the city $1.1 billion in the current fiscal year ($830 million of lump sum payments to retires and $126 million for the ratification bonus) and an additional $4.7 billion through fiscal 2018 (the last year of the current multi-year financial plan) before expected offsetting savings. The city has a history of "pattern" bargaining in which raises for one union are what other union members agree to, and the financial plan assumes that outstanding contract settlements with the remaining unions will include the same 10% base wage increase. Based on that, the total fiscal 2014 costs for both teachers and other employees increases to $2.0 billion in the current fiscal year and $11.6 billion through fiscal 2018 before the expected offsets. Those anticipated savings reflect agreements between the city and labor to reduce employee healthcare costs by $3.4 billion between fiscal 2015 and 2018 and the use of $1 billion from a city labor fund that offsets healthcare premium costs for employees. The city's reserve for collective bargaining was already sized to reflect four 1.25% increases for all city employees. Reflecting the gross costs of the labor settlement for all employees, the expected health care savings and the collective bargaining reserve amounts, the city estimates a net cost of $5.6 billion through fiscal 2018.

Finally agreeing to what those costs are and incorporating them into the city's budget is significant because personnel costs drive city spending: salaries and wages average 31% of the city's total budget, while total personnel costs, which include pension contributions, fringe benefits such as employee and retiree health care and social security contributions, average 55% of total revenue. The new costs result in significant increases in the city's forecasted future year budget gaps. While no gap is estimated for fiscal 2015 (which starts July 1) even with the new costs, the gaps for fiscal years 2016, 2017 and 2018 are estimated to be $2.6 billion, $1.9 billion, and $3.1 billion, respectively. Those costs more than double the city's forecast budget gaps for the fiscal years ending June 30, 2016 and 2017, and triples the gap for fiscal 2018 compare to the prior version of the financial plan (which didn't include the full costs of settling outstanding contracts). Still, they are lower than the gaps the city faced during the recession (which for some years exceeded $5.5 billion) and are manageable given the time horizon it has to work to close them.

We also note that the city's revenue assumptions in the current plan are somewhat more conservative than prior versions, a prudent approach especially since the growth in future property market values is expected to slow (although the city expects property taxes themselves, 43% of total tax revenue to average 4.2% growth). Additionally, personal income taxes (19% of forecasted fiscal 2015 tax revenue) can be volatile and recent collections in other jurisdictions around the country have fallen short of expectations; the city estimates in fiscal 2015 personal income tax collections will decline by 1.3%. Indeed, the city comptroller recently estimated that the financial plan's revenue forecast is conservative and that including the costs of the labor settlements, the city's out year gaps could become significantly smaller. Although the city has negotiated the right to enforce the health savings through arbitration, there could still be roadblocks to reaching its targets in the years and amounts it expects, although we note labor's overall agreement to the targets and provisions that would share savings greater than $3.4 billion between labor and the city as an inducement to work towards the targets. However, if all unions negotiating do not agree to the pattern settlement, the budget gaps and the city's challenges to close them would intensify.

LIQUIDITY IS NOTABLY STRONG

The city's liquidity position has been strong in recent years and it continues to strengthen. Ending cash balances increased by 72.5% between fiscal 2010, the lowest cash balance of the last five years, and fiscal 2013. The average daily cash balance during fiscal 2013 was $5.9 billion, and the ending balance of $7.9 billion was the largest the city has recorded. Similarly, through December 2013 (the second quarter of fiscal 2014), the ending cash balance was the highest ever recorded for that period and the fiscal 2014 year-to-date average cash balance is 28% greater than the prior year. The city comptroller's current forecast for fiscal 2014 ending cash balances range from a high of $12.3 billion to a low of $10.4 billion. Even assuming the $1.1 billion of lump sum labor settlement-related payments expected to be paid before June 30, the ending cash balance would still be strong.

CITY ECONOMY RECOVERS BUT FINANCIAL SECTOR EMPLOYMENT STILL LAGS

The city's economy is notably large, with 2013 real GDP that is larger than all but two US states. Its employment picture has recovered remarkably well. Private sector employment as of April 2014 was 7.3% greater than the pre-recession peak in August 2008 and it continues to increases at an annual rate of about 2.8%. By comparison, national private employment is still 0.1% lower than its pre-recession peak. Nonetheless, as city residents re-enter the labor force and seek jobs, the unemployment rate has increased. The city's unemployment rate for April was 7.9%,up slightly from recent months, compared to the US rate of 6.3%.

The important financial services sector, which accounts for 11.3% of the city's employment, played a key role in helping the city regain jobs. Following three consecutive years of declines in financial sector employment in 2008, 2009 and 2010, jobs increased in 2011 by 2.5% but was flat in 2012 and fell 0.4% in 2013. Employment trends remain weak, however, with jobs just beginning to grow again. Employment in the securities industry sub-sector - which accounts for 20% of wages in the city - increased by 3.6% in 2011 after declining by 10.0% in 2009 and 0.6% in 2010, then declined in 2012 by 1.6% and by 2.2% in 2013. The overall number of financial services jobs is only at levels that it was in 2004 and securities employment is at 2009 levels. More positively, tourism in the city has reached record levels, with 54 million visits in 2013, 3% more than the prior year. Additionally, the city's economy continues to diversify, with strong higher education and health care sectors and a burgeoning high tech industry. Growth in those areas will continue to mitigate the volatility of finance.

HIGH FIXED COSTS FOR DEBT SERVICE AND PENSIONS

Unlike most other large cities, no separate school district or county government exists that also finances New York City's capital costs, which results in a relatively greater bonded debt load. Based on the current financial plan, fixed costs for debt service, pensions and retiree health benefits are high, estimated to reflect nearly 35% of tax revenue and 22% of total revenue in the current fiscal year. Including employee healthcare and certain other payments, the fixed cost ratio is higher, at 47% of fiscal 2014 tax revenue and 30% of total revenue. The city's ability to control the growth of those expenses continues to be a key rating factor.

The city's four largest pension plans include the New York City Employees Retirement System (NYCERS), a multiple-employer cost-sharing plan, and separate plans for fire, police and teachers. Reflecting those plans, the city's adjusted net pension liability, under Moody's methodology for adjusting reported pension data, is $68.9 billion, or 1.06 times operating revenues. Moody's uses the adjusted net pension liability to improve comparability of reported pension liabilities. The adjustments are not intended to replace the county's reported liability information, but to improve comparability with other rated entities.

WELL-MANAGED VARIABLE RATE AND DERIVATIVES PORTFOLIOS

New York City, through general obligation, Transitional Finance Authority (TFA) and other debt issuance vehicles uses variable rate debt to lower its borrowing costs. Variable rate debt (reflecting general obligation, lease and TFA debt) amounts to 14% of the city's total outstanding net tax-supported debt. While that amount is sizeable, the annual interest rate risk it poses is manageable in the context of the city's nearly $74 billion proposed fiscal 2015 all-funds budget, its strong liquidity, and the favorable terms of its bank liquidity facilities and interest rate agreements. The city has $5.7 billion of general obligation variable rate demand debt outstanding, and the Transitional Finance Authority (TFA) has a total of $3.4 billion of outstanding variable rate debt. Additionally, the city has $30 million of appropriation-backed variable rate debt outstanding. Counterparty risk is mitigated through the use of a diverse array of liquidity providers: 22 banks provide liquidity support for general obligation variable rate debt and 17 support TFA variable rate demand debt. The city monitors its variable rate portfolio closely and proactively works to renew or replace expiring liquidity facilities or to convert variable rate bonds to fixed rate or other interest rate modes if necessary. More recently, in an effort to reduce its overall borrowing costs and mitigate bank exposure, the city has converted various variable demand bonds to floating rate index modes, as it is continuing to do with the current transaction. Those bonds do not have the put risk associated with demand debt but the city must refinance them at specific dates or interest rates will step up to higher levels; those risks are manageable given the city's record of market access. The city currently has $819 million of general obligation index mode bonds outstanding and $377 million outstanding issued through TFA.

The city has 11 outstanding interest rate swap agreements associated with its general obligation bonds, with five separate counterparties, and two swaps related to city-appropriation backed debt issued through the Dormitory Authority of the State of New York (DASNY) with two counterparties. In our analysis, the swap portfolio's potential risks to the city are manageable: rating triggers that would cause the agreements to terminate early or post collateral are low, ranging between Baa1 and Baa3. As of March 31, 2014, the combined outstanding notional amount of the swaps was $1.8 billion, with a mark-to-market value of -$131.8 million.

OUTLOOK

The outlook for New York City's general obligation bonds is stable. The city's institutionalized budgetary controls and early recognition of future budget pressure help it maintain a balanced financial position and weather economic downturns. The city's economy is reliant on a volatile financial services sector, but it continues to diversify, and its finances will benefit. Despite its strong budgetary controls, mounting costs for debt service, pensions and retiree health care will continue to be a challenge for the city.

WHAT COULD MAKE THE RATING GO UP

-- Sustained reduction in the growth of the city's debt burden and other fixed costs, and establishment of formal policy for managing debt within prescribed constraints

-- Improved and continuing growth in city employment and the property tax base

-- Establishment of significant formal budget reserves to buffer the inherent volatility of the financial services sector

WHAT COULD MAKE THE RATING GO DOWN

-- Inability to manage rapidly rising costs in non-discretionary spending such as debt service, personnel costs, or pensions

-- Divergence from well-established fiscal practices

-- Emergence of significant liquidity strain and the need for large cash-flow borrowings

The principal methodology used in this rating was US Local Government General Obligation Debt published in January 2014. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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