FitchRatings

# Fitch Rates New York City, NY's $830MM GO Bonds 'AA'; Outlook Stable

Fitch Ratings-New York-03 August 2018: Fitch Ratings has assigned a 'AA' rating to approximately $830 million New York City general obligation (GO) bonds, fiscal 2019 series A, B, and C consisting of the following:

--Approximately $660,000,000 tax-exempt bonds, series A;
--Approximately $110,000,000 tax-exempt bonds, series B;
--Approximately $60,000,000 taxable bonds, series C.

In addition, Fitch has affirmed the city's Issuer Default Rating (IDR) and outstanding GO bond ratings at 'AA' and the ratings on the following obligations, which the city supports through its commitment to appropriate for debt service at 'AA-':

--Approximately $703 million in New York City Health and Hospitals Corp (NYHHC) health system bonds;
--Approximately $50 million special revenue bonds (New York City-New York Stock Exchange Project) series 2009A and bank bonds associated with $30 million in special revenue bonds (New York City-New York Stock Exchange Project) series 2004B, issued by the New York City Industrial Development Agency (IDA).

The Rating Outlook is Stable.

The series A and B bonds are scheduled to price via negotiation with the institutional order period on Aug. 8. The series C bonds are scheduled to be sold via competitive bid on Aug. 8. The bonds are being issued as multi-modal bonds in the fixed rate mode. Proceeds will be used to refund outstanding bonds and to pay costs of issuance.

On the Aug. 22 conversion date, the city expects to reoffer $41,000,000 of outstanding fiscal 1994 series H, subseries H-3 adjustable rate bonds in the fixed rate mode. These bonds are included in Fitch's affirmation of the city's outstanding GO bonds, as stated above.

SECURITY
The GO bonds are 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.

The health system bonds are a general obligation of NYHHC (now known as New York City Health + Hospitals, or NYCHH), which includes all revenues derived from provision of patient care. Pursuant to the New York City Health and Hospitals Corporation Act, a capital reserve fund equal to maximum annual debt service on all

outstanding NYHHC GO debt can only be used for debt service. The act obligates the city to replenish any deficiencies in the capital reserve fund.

The IDA bonds are payable under a facility financing agreement, whereby the city agrees to provide for debt service on the bonds, subject to annual appropriation.

## ANALYTICAL CONCLUSION

Exceptionally strong budget monitoring and controls have been in place since the city's fiscal crisis in the 1970s. Positive economic prospects also contribute to sound overall credit quality and the expectation that the liability burden will not increase notably. However, the large long-term liability burden relative to other highly rated local governments and pressure to increase capital spending is an ongoing concern. Changes to the pension plan for newer employees should over time moderate the pension liability. Fitch expects debt levels to be controlled by the city's longstanding policy cap on debt service as a percentage of tax revenues. The NYHHC and IDA bonds are rated one notch below the city's IDR, reflecting the slightly higher degree of optionality associated with payments subject to appropriation.

### Economic Resource Base

Fitch considers the city's unique economic profile, which centers on its identity as an international center for numerous industries and a major tourism destination, to be a credit strength. The character of the New York City economy contributed to its relative employment stability during the great recession and sound growth in recent years. The local economy and operating budget are still strongly linked to the financial activities sector, which accounts for approximately 24% of earnings compared to 9% for the U.S. according to 2016 data.

## KEY RATING DRIVERS

### Revenue Framework: 'aaa'

Revenues have shown strong growth and little volatility. Future growth rates may be less robust given the slow shift of job growth away from the high-wage financial services sector to a more diverse mix, but Fitch expects revenue performance to remain strong over time. The city has sound independent legal ability to adjust property tax rates and a variety of fees and charges to offset the modest expected revenue declines in an economic downturn. Rates for other important revenue sources (mainly income and sales taxes and state aid) are not within management's independent control.

### Expenditure Framework: 'a'

Carrying costs are sizable and many labor contracts are subject to binding arbitration, but the city has demonstrated adequate expenditure flexibility. Fitch expects pressures in a number of service areas would cause the pace of spending to exceed that of revenues over time if offsetting policy actions were not taken.

### Long-Term Liability Burden: 'a'

Debt and pension liabilities represent an elevated but still moderate burden in relation to the resource base. New debt issuance will likely exceed the amount of outstanding debt that amortizes each year. The future trajectory of the liability burden will depend in

part on whether economic growth matches the increase in debt levels, which Fitch expects will grow at least as quickly as pension liabilities. Unusually large other post-employment benefit (OPEB) liabilities are also likely to grow.

Operating Performance: 'aaa'
The 'aaa' assessment reflects the city's tight budget monitoring and control as demonstrated by its ability to achieve consistent balance and manage out-year gaps. Sound budgetary reserves and expense prepayments, along with adequate accumulated reserves and solid budgetary flexibility; provide protection against anticipated mild cyclical revenue declines and unforeseen conditions. Budget oversight from a number of outside parties supplements the city's own careful and thorough planning and monitoring.

RATING SENSITIVITIES
STRONG BUDGET MANAGEMENT CRUCIAL: The rating is sensitive to the city's ability to continue to address budget imbalances and demonstrate financial flexibility through maintenance of a reserve cushion and the ability to adjust revenues and spending. An erosion of financial flexibility beyond expected performance in an economic downturn or a notable increase in spending growth pressures would put downward pressure on the rating.

LONG-TERM LIABILITY CONTAINMENT: Fitch expects the long-term liability burden and its impact on the budget to stay near current levels. Notable growth in the burden associated with these liabilities would reduce overall financial flexibility and negatively affect the rating.

CREDIT PROFILE

The U.S. census-estimated population for 2017 is 8.6 million and continues to grow moderately. The economic profile of the city provides for good wealth levels; per capita personal income is 130% of the U.S., and market value per capita is well over $100,000. However, the above-average individual poverty rate indicates significant income disparity. The city's tourism sector is performing exceptionally well, attracting a reported record 62.8 million visitors in 2017. Financial activities employment has shown some growth over the last four years and is now slightly above the pre-recession peak. Overall resident employment is well above pre-recession levels. Likewise, the unemployment rate continues to improve and approximates the U.S. average.

Revenue Framework
The city has a diverse revenue profile, in part because it serves the functions of a city, county, and school district. Property tax revenues are the largest source, and the tax levy for operations is limited to 2.5% of the average full value of taxable real estate of the current and last four fiscal years. This phase-in process both stabilizes the maximum tax levy and provides good visibility on future-year revenue growth and limitations. Taxable assessed value has grown by over 6% in each of the last several fiscal years.

Property tax revenues made up 30% of audited fiscal 2017 general fund revenues. Sales and income taxes are also substantial components of revenues at 10% and 22%, respectively; their rates are controlled by the state. Intergovernmental revenues

made up another 28% of the general fund total in fiscal 2017.

Revenue growth has been quite strong for such a dense, mature city. As financial services jobs remain fairly steady, growth comes from a more diverse mix including technology and a variety of services that are generally not as high-paying. The strength of revenue growth over the last 10 years, above the rate of national GDP despite the financial crisis, indicates fundamental resilience. Fitch estimates revenue growth would have been slightly above GDP absent property tax rate increases.

The city's operating levy is generally at least slightly below the 2.5% cap even with the inclusion of a portion of GO debt service; affording sound flexibility to offset what Fitch assumes would be a modest revenue decline in a moderate recession. Components of the sales and income tax rates are subject to periodic state legislative renewal. Fitch considers such approval pro forma, although modest changes to certain components (such as increases in exclusions) are expected.

Expenditure Framework

The city's responsibilities are very broad, as it provides city, county, and education services to an estimated population of 8.6 million. In addition, New York State counties are responsible for a portion of Medicaid spending, and the city's public hospital system (NYCHH) is a component unit that receives ongoing general fund support. The largest expenditure category is education, representing 32% of fiscal 2017 general fund spending, followed by health and social services at 22%. Public safety's share is 13% of spending, an unusually low share for a local government due to the city's broad responsibilities.

Fitch has some concerns about recent increases in the city's contribution to NYCHH due to the adverse impact of overall changes in health care delivery methods and funding support at the federal level. A substantial increase in the city's ongoing financial support for NYCHH, whose budget is about 10% the size of the city's, could increase the pace of expected spending growth and/or reduce the city's flexibility to reduce spending in an economic downturn. NYCHH's management has committed to increasing the operation's efficiency.

Other notable spending pressures include funding for mass transit repairs and maintenance of New York City Housing Authority (NYCHA) facilities. Some of the funding will be for capital projects and likely debt-financed, which may pressure already sizable carrying costs. The state's enacted budget for fiscal 2019 includes a requirement for the city to provide $418 million of operating and capital funds in calendar year 2018 to the Metropolitan Transportation Authority. A recent consent decree related to health and safety concerns in NYCHA properties requires $1 billion in capital funds in fiscal 2019-2022 and $200 million annually thereafter until the concerns have been addressed. Fitch expects continued pressure on the city to increase contributions to both authorities as they provide vital city services and have widely reported repair needs beyond levels now being addressed.

Given these pressures, Fitch believes the natural pace of spending will be above natural revenue growth. Carrying costs (debt service, pension actuarially determined contribution [ADC] and OPEB actual payment) are sizable at about 21% of fiscal 2017 spending and are also expected to increase somewhat. Robust capital planning and

debt projections should keep debt service beneath the city's policy cap of 15% of tax revenues (about 10% of total spending), although the city's projections show this ratio rising from about 11% currently to 13% by fiscal 2022. The city consistently pays the ADC using more conservative assumptions than many municipal pension plans.

Prior labor agreements with many of the city's unions, including DC 37 and the Patrolmen's Benevolent Association (PBA) which together represent about one-half the city's workforce, have expired. Following fiscal 2019 budget adoption, the city reached a tentative contract settlement with DC 37 (representing about one-quarter of the city's employees) which includes a retroactive 2% raise effective September 2017, followed by a 2.25% increase effective September 2018 and 3% effective October 2019.

Extending the DC 37 pattern (assuming it is ratified) to all city employees would result in an annual cost increase of $3.4 billion by fiscal 2022, $2 billion above the reserve for collective bargaining included in the financial plan. However, management assumes additional healthcare savings beyond those previously agreed upon with the Municipal Labor Council (MLC), the union's umbrella organization, will reduce the net fiscal 2022 cost to $1.3 billion. The healthcare savings are contractually enforceable through arbitration.

While there have been meaningful savings to date from such efforts as plan design changes and eligibility audits, more than half of reported savings are derived from provider rate increases below budgeted levels. The gap between budgeted and actual increases has narrowed significantly in fiscal 2018 and 2019, indicating further savings may be increasingly difficult to achieve. Without more dramatic cost savings, OPEB payments will likely grow substantially from their currently modest 3% of governmental spending.

Management has implemented a citywide savings program that Fitch believes could be expanded to address projected deficits if conditions warranted. While the workforce framework itself is rather inflexible and the tentative DC 37 contract's inclusion of retroactive increases and ascending salary hikes (2.0% effective September 2017, 2.25% effective September 2018 and 3.0% effective October 2019) indicate some wage pressure, Fitch believes the city retains a reasonable amount of flexibility to contain growth in employee compensation or reduce headcount if needed.

Long-Term Liability Burden

Debt, pensions, and OPEB liabilities are all large even relative to the city's vast resource base. Debt and pension liabilities (adjusted by Fitch to reflect a 6% investment return rate) combined equal to about 29% of the city's personal income, split fairly equally between the two. Debt should not increase at a significantly higher rate than the resource base given the cap on debt service as a percentage of tax revenues and state restrictions on debt amortization rates. Fitch recognizes that the age and size of the city's infrastructure make capital needs nearly insatiable; increases to MTA and NYCHA spending are recent examples. However, Fitch assumes that the city will continue to keep a close eye on affordability and would alter its capital spending plans if conditions made debt more of a burden on resources.

The city maintains five pension systems, of which two (for police and fire) are single-employer plans. Although the other three are cost-sharing plans, the city bears the

responsibility for the majority of the liabilities, and virtually all for the two education-related plans. On a combined basis, the ratio of assets to liabilities is 71% on a reported basis, or approximately 64% using a 6% investment return assumption.

Without significant action, the exceptionally high OPEB liability (currently about 16% of personal income) is likely to grow more quickly than either debt or pensions, as it is funded on a pay-go basis. Fitch expects the liability to remain sizable even with the city's efforts to reduce the cost of employee and retiree healthcare.

Operating Performance

Fitch believes budget monitoring and control is a key strength of the city's operating environment. Fiscal discipline instilled following the city's financial crisis in the 1970s is institutionalized. The city is required to present a balanced budget on a GAAP basis, publish a four-year financial plan which is updated three times per year, and present a biennial 10-year capital strategy. Plans are thorough and highly detailed and tend to be based on realistic assumptions, in Fitch's view. Outside monitors who regularly report on the city's budget and financial plan include the Financial Control Board (first set up by the state in the 1970s), the state comptroller, the city's charter-required Independent Budget Office, and the privately-funded Citizen's Budget Commission.

Fitch believes that the combination of the city's strong revenue control, adequate spending flexibility and available financial cushion leave it well positioned to address the impact of a moderate economic downturn. Due to the city's practice of prepaying future year expenses to afford budgetary flexibility, Fitch does not believe reported CAFR numbers provide a complete picture of financial cushion.

Prepayments in recent years have been in the range of 5% of spending. Fitch expects the city to maintain the practice of prepayments, with the amounts varying somewhat with the economic cycle. Fitch considers the city's OPEB reserve ($4.7 billion at the end of fiscal 2017, with another $100 million added in fiscal 2018) to be an operating reserve rather than an offset to the OPEB liability, since it has been used that way in the past. At the end of fiscal 2017, Fitch calculates operating cushion (OPEB reserve plus prepayments) to be about 10% of spending. In addition, the city has recently built in a budgetary reserve ($1.1 billion for fiscal 2019), which if included in the cushion (not Fitch's standard practice) would bring it to about 12% of spending.

The adopted budget for fiscal 2019 totals $89.2 billion, incorporating $4.6 billion in prepayments from fiscal 2018 resources. Net expenditures are similar to fiscal 2018 projected actual levels. The financial plan indicates a small operating surplus for fiscal 2018, with the $4.6 billion prepayment rolled into fiscal 2019 slightly exceeding the $4.2 billion in prepayments of fiscal 2018 expenditures.

Out-year budget gaps through the financial plan period (ending fiscal 2022) are small at about 2%-3% of spending annually. They do not incorporate the estimated impact of the DC 37 contract, resulting in a possible understatement of future budget gaps. Fitch's rating assumes that any budgetary gaps will be addressed promptly and in a fiscally sustainable manner, as they have been historically.

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**Applicable Criteria**

U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018) (https://www.fitchratings.com/site/re/10024656)

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