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New Tennessee Law Insulates State Credit Rating from Cities' Financial Problems.

Credit markets view the move as a positive for the state but negative for municipalities.

As the debate about how much financial help states should offer their distressed cities takes place across the country, one state has made a move to avoid the question altogether.

In July, a new law goes into effect in Tennessee that forbids the state from spending its own resources to repay the debts of distressed municipal governments. The legislation does not alter Tennessee's emergency loan assistance program, which puts the onus on local governments to request assistance before any default. But the new law is a win-lose in that it's viewed by the credit markets as a positive for the state and a negative for its local governments.

As Tennessee has historically had a policy of not paying debt service for stressed municipalities, the action is more of a clarification, rather than a change in policy. Still, said Julius Vizner, assistant vice president at Moody's Investors Service, it's an important distinction.

Financially Distressed Cities Isolate Poor and Minorities, Former Receiver Says

"The state is drawing a line here between its fiscal responsibilities and realities," Vizner said. "In general, the fact that the state is not incurring a liability for any potential future case of a local government [wanting direct aid], is a credit positive."

States vary in how involved they get with their distressed municipalities and there are arguments for and against doing so. A big reason to intervene is that state intervention can reduce any chilling effect - that one government's distressed finances could spread to neighboring localities. Michigan, for example, views state intervention as key to its survival and has had long history of state involvement in city finances. Typically, aid comes in the form of a state-appointed emergency financial manager for its cities. But in the case of Detroit's bankruptcy, this year the state went the beyond that. In June, Gov. Rick Snyder signed into law a funding package that allocated nearly \$200 million in state funds for a so-called grand bargain to try to help the Motor City emerge from bankruptcy. The package also included \$366 million pledged over 20 years by philanthropic foundations and would go toward pension payments for Detroit's retired city workers and keeping the Detroit Institute of Art's work from being sold to pay creditors.

There are, however, counterarguments for states getting very involved in their distressed municipalities and Tennessee's desire to keep its high credit rating protected isn't unfounded. (Tennessee is rated either AAA or one notch below, depending on the rating agency.) Recently, Standard and Poor's rating agency revised its outlook on Michigan's credit down to stable from positive. The state maintained its AA- rating but S&P noted that Michigan's budget reserve fund will decrease because of the transfer to Detroit. In their comments, the analysts said the "appropriation to the Detroit bankruptcy settlement also raises questions as to potential future state contributions to other distressed localities and school districts" and that S&P would continue to monitor the situation.

Unlike Michigan, Tennessee does not allow its municipalities to file for bankruptcy and none of its local governments are rated below investment grade. So, even if a government were to default on debt, it wouldn't necessarily present the same threat to the state economy the same way that similarly distressed municipalities in Michigan might. It would depend on the circumstances, said Vizner, but Tennessee's overall economy is healthy so a local government default would likely be viewed as an anomaly.

Pew Charitable Trusts, which has conducted extensive research on state interventions, said that not every state actually needs a program. It advises that states design programs to be proactive in detecting and tackling local government financial challenges. However, most programs are reactionary.

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