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S&P FAQ: Wayne Charter County, Michigan's Mounting Structural and Financial Pressures Might Affect Credit Quality, but Bankruptcy Fears are Premature.

In early February, the newly elected Wayne Charter County, Mich., executive, Warren C. Evans raised concerns about the county's ongoing financial problems, highlighting liquidity concerns and the need for major structural fixes, without which a state takeover and bankruptcy could be considerations. Standard & Poor's Ratings Services views bankruptcy and a state takeover of the county as premature. To clarify our views, we are addressing some frequently asked questions regarding our Feb. 13, 2015, downgrade on Wayne County and our opinion of steps the county might take to remedy its financial problems.

Frequently Asked Questions

What was Standard & Poor's recent rating action on the county?
On Feb. 13, Standard & Poor's lowered its rating on Wayne County's limited-tax general obligation (GO) bonds to 'BB+' from 'BBB-', a change to speculative-grade from investment-grade. We based the downgrade on a differentiation between the limited- and unlimited-tax ratings and the county's weakened financial position and ongoing budgetary challenges. The county has no Standard & Poor's-rated unlimited-tax GO debt outstanding.

Standard & Poor's rates the county's limited tax GO bonds 'BB+' with a negative outlook. The rating reflects the county's chronic structural imbalance, brought on in part by cost overages in some of the county's major operating areas, such as the sheriff's department. Of course, falling revenues have also played a part in the imbalance. In addition, chronic management problems, including political gridlock and an inability to create meaningful structural reforms, constrain the rating. These conditions have led to Wayne County's inability to make sufficient changes to operations to eliminate the structural imbalance. (For further details, please see the summary published Feb. 13, 2015, on RatingsDirect.)

What does the negative outlook reflect?
Wayne County has significant, long-standing problems creating a balanced budget. With a new administration that faces such a chronic imbalance, we believed it was the appropriate time to signal that either management must address the imbalance in a relatively short time frame, or further negative rating action could be warranted. As such, the negative outlook reflects the magnitude of closing the county's structural budget gap and concerns that the time frame for making the changes could be drawn out beyond the county's current expectations.

What is Standard & Poor's view on the comments from the new county executive?
In our view, to start treating the county as if it is about to file for bankruptcy is a bit premature, given the process required in Michigan to file. As we recently saw in Detroit, bankruptcy is a significant issue, with serious potential repercussions for bondholders. We take very seriously any possibility of bankruptcy, but we don't want to rush to judgment before letting the process take its course.

What steps are necessary to file for bankruptcy?
Michigan's Act 436 addresses the circumstances under which local governments can file for bankruptcy, and it outlines numerous steps before a local government can reach that point.

First, the state financial authority must conduct a preliminary review, after which the governor can decide to appoint a formal review team. That team then prepares a report on the local government's financial condition and submits it to the governor's office so the governor can determine if a financial emergency exists. If the governor determines it does, two paths allow a local government to file for bankruptcy. One is that the local government can pursue the appointment of an emergency manager, who has the authority to file for Chapter 9 bankruptcy–but only with the governor's approval. The other path is to bypass the emergency manager and head directly to a Chapter 9 bankruptcy filing, but before this can occur, the governor must approve the action. Again, given this process, a rush to bankruptcy would be difficult for the county.

While many consider it a positive step to bring in a third party who has powers to make changes, such as the Emergency Manger option, given Detroit's recent experience and very rapid move to bankruptcy, our view on the county's trajectory could well change with the appointment of an emergency manager.

In addition to the pressure of the structural imbalance, what other pressures does the county face?
Although Wayne County does not have a lot of debt compared with many peers ($408.2 million in direct GO-only backed debt as of Sept. 30, 2013), it does have a significant other postemployment benefits (OPEB) liability ($1.6 billion at as of Oct. 1, 2012, the most recent actuarial report) and, perhaps most significantly, a pension funding issue. As the Wayne County Employees Retirement System is only 45% funded and carries an unfunded accrued actuarial liability of $878.3 million as of Sept. 30, 2012, (the most recent actuarial report) the pension funding level is clearly a rating factor, and the county definitely needs to address it to regain structural balance and solid financial footing. However, in the context of Detroit's bankruptcy, it is important to remember that although Detroit's pensioners did lose OPEB, the cuts that came out of bankruptcy were borne largely by bondholders, with relatively small—comparatively speaking—changes to pensions.

What issues could lead to a further negative rating action?
Outside of any actions taken toward filing for bankruptcy, an inability to make meaningful changes to the departments with chronic cost overruns is also a credit factor. The county has made progress in some areas, but these departmental overages are still adding to the structural imbalance. Wayne County's management score (Very Weak) is also a credit weakness, given the county's past political gridlock. A meaningful change to this is also important to prevent a further downgrade. Ultimately, we expect the county to show it can make meaningful spending cuts that allow it to regain–and maintain–ongoing structural balance. Without that, we could lower the rating further.

Under Standard & Poor's policies, only a Rating Committee can determine a Credit Rating Action (including a Credit Rating change, affirmation or withdrawal, Rating Outlook change, or CreditWatch action). This commentary and its subject matter have not been the subject of Rating Committee action and should not be interpreted as a change to, or affirmation of, a Credit Rating or Rating Outlook.

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