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Moody's: US State and Local Government Credit Quality Underpinned by Strong Federal Disaster Support.

New York, May 26, 2015 — US state and local governments vulnerable to major disaster events will continue to rely upon strong federal assistance to sustain their relatively high credit quality, Moody's Investors Service says in a new report "US Federal Disaster Aid is Critical for State and Local Governments".

These issuers typically lack the financial resources and borrowing capacity to independently fund their own post-disaster rebuilding of infrastructure and maintenance of core services.

"Without strong federal support for recovery from hurricanes, earthquakes, floods, tornadoes and other disasters, the credit quality of affected issuers would be weaker," says Moody's Associate Analyst Aaron Ampaw.

While the federal government rarely provides financial support to alleviate financial management challenges or bankruptcies, we expect federal resources to support state and local issuers that lack the capability to absorb major disaster costs on their own. In many cases, the federal government is the only level of government able to afford disaster costs because of its large budget and ability to finance deficits. Any federal policy or action that constrains future disaster relief funds would be a credit negative development for state and local issuers.

However, the safeguard of federal support does not ensure municipal credits will avoid downgrades post-event. Without the availability of federal aid after a disaster, however, issuers would have much greater credit risk and lower ratings.

Following a disaster event, both state and local governments experience short, medium, and long-term risks amid their recovery. But local government credit quality is more vulnerable to disaster-related expenses than states because of smaller budget and borrowing capacities, which can be inadequate to tackle unexpected costs and damages.

This includes short-term liquidity risks stemming from unanticipated spending during the federal application process, and a medium-term risk associated with the timing and amount of approved reimbursements. For some issuers, economic risk can linger long after a disaster event, though for most, federal reimbursement absorbs the costs and stimulates rebuilding spending.

Local government issuers often issue short-term emergency spending notes backed by future operating revenues to alleviate liquidity pressure while they await federal reimbursements. Some issuers have pledged federal imbursements to secure these notes.

"Some notes issued in the past few years have been backed by pending federal disaster reimbursements, a narrower pledge that increases risk for investors," Ampaw says. These notes secured solely by federal payments are subject to timing and reimbursement risks and can present additional liquidity pressure for issuers. Instead of easing municipal liquidity strain, notes with narrow pledges could actually become long-term obligations that worsen liquidity risk if federal reimbursements are not received prior to note maturity and refinancing options are limited, an unintended consequence, according to Moody's.

The report is available to Moody's subscribers here.

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