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Fitch: Statutory Liens Do Not Boost U.S. Municipal Debt Ratings.

Despite its growing use in U.S. municipal debt, the presence of a statutory lien will not enhance a municipality's debt rating, according to Fitch Ratings in a new report.

The role that statutory liens play when a municipality files for bankruptcy protection has been a topic of increased attention. Perhaps the most notable example of late is California's new law (Senate Bill 222) which automatically attaches a statutory lien to all future general obligation (GO) debt issued by cities, counties, school districts and community college districts. 'While the presence of the statutory lien will enhance a creditor's post-default recovery prospects, it doesn't avoid the interruption of payment upon a bankruptcy filing by a municipality,' said Managing Director Thomas McCormick. 'The simple reason is that in a bankruptcy scenario, the pledged tax revenue could be subject to interruption and default would be likely.'

While statutory liens do not protect a creditor from payment interruption in the event of a bankruptcy, a security defined as 'special revenue' under Chapter 9 of the U.S. bankruptcy code does. The definition of special revenues in the code includes enterprise revenues and such revenues are exempt from the automatic stay in the event of bankruptcy. Fitch's ratings for Detroit's credits reflect the distinction between general and special revenues. Fitch rated Detroit's water and sewer debt distinct from the city and as high as 'BBB+' following Detroit's July 2013 bankruptcy filing despite a 'C' rating on Detroit's unsecured GO debt. Another notable example is the City of Stockton, CA's water bonds, which Fitch rated distinct from the city and as high as 'BBB' during Stockton's bankruptcy notwithstanding defaults on other bond debt by the municipality.

As a result, Fitch caps the ratings on bonds supported by non-special revenues at the unsecured GO debt rating of the municipality. A recent example of the rating cap is the City of Chicago. Like the City's GO debt, Fitch rates Chicago's sales tax bonds 'BBB+' with a Negative Outlook despite high coverage of maximum annual debt service at over 15 times. 'The revenue flows from Chicago's sales tax bonds could be subject to interruption if Chicago were to file for bankruptcy,' said McCormick. 'Additionally, because there is no statutory lien, the lien interest would end with respect to future general sales tax revenues upon a bankruptcy filing by the city and recovery prospects could be no higher than general credit quality recovery.'

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