Fitch: U.S. Municipal Ratings Higher than GO Ratings Not Usually Warranted.

Fitch Ratings-New York-22 September 2015: Market participants have expressed concern over a perceived increase in the incidence of widely divergent U.S. municipal ratings. One area in which Fitch Ratings' opinion differs from some other rating agencies' is the conditions under which dedicated tax backed (DT) debt may be rated higher than the general credit quality (GO debt) of the issuing municipality.

A notable example is the divergent ratings on the City of Chicago, IL sales tax bonds, which carry ratings ranging from 'AAA' to below investment grade. Bondholders should insist on a reasonable legal basis to separate ratings of DT bonds such as the Chicago sales tax bonds from the city's GO rating. Fitch notes that there is none in this case.

Fitch rates the bonds 'BBB+' with a Negative Outlook, on par with the city's GO debt rating. Certain other agency ratings (Kroll and S&P) are not capped by the city's general credit quality which Fitch believes may lead bondholders to mistakenly conclude that these DT bonds backed by general sales tax revenues are legally inoculated from the bankruptcy risk of the city. In Fitch's view, if the legal protections do not insulate revenues supporting the rated DT bonds from the automatic stay provisions of the bankruptcy code in a bankruptcy proceeding, the rating must be capped at the city GO. Although the risk of bankruptcy remains remote at 'BBB+', the city's GO rating is the clearest, most direct expression of both the risk of bankruptcy and the linkage its DT bond has to that risk. Rating above the city GO can only be supported by one of three legal structures, none of which apply to Chicago's DT bonds backed by general sales tax revenues.

SPECIAL REVENUE DESIGNATION ONE OF THREE LEGAL FRAMEWORKS SUPPORTING RATINGS DISTINCT FROM GENERAL CREDIT

One legal framework that permits Fitch to rate debt based on specific revenues free of the risk that a related municipality's bankruptcy proceeding would interrupt payments is created under the federal bankruptcy code in the provisions that define 'special revenues". Fitch could rate debt backed by a strong revenue source multiple categories above the general credit of the municipality if Fitch believes the case for special revenue status is very clear.

The concept of "special revenues" is unique to Chapter 9 and the municipal bankruptcy process. Special revenue bonds are insulated from the municipality's bankruptcy in two powerful ways. First, the lien interest in the special revenues continues even if it is a mere consensual lien. If the revenues are not special revenues, then the lien is lost as applied to revenues collected post-bankruptcy. Second, the application of special revenues and actions to apply them to debt payment is exempt from the automatic stay provision of the bankruptcy code. This exemption means that the trustee can continue to apply the pledged special revenues to pay debt service on qualified DT bonds. The power of these protections was evident in both the Stockton bankruptcy and the Detroit bankruptcy where water system bondholders were continuously paid debt service. Additionally, Fitch rates the Chicago water and sewer senior and junior debt as special revenue obligations at 'AA+' and 'AA, respectively, notably higher than the city’s GO.

In Fitch’s opinion, there is no plausible basis to claim that the pledged sales taxes are “special revenues”. The Chicago sales taxes supporting the DT bonds are unmistakably general revenue for general governmental purposes and as such, are excluded from the definition of ‘special revenues’ in section 902 of the U.S. Bankruptcy Code. Fitch expects the sales tax revenues would be subject to the automatic stay and default of the DT bonds would be likely in the case of a city bankruptcy. Therefore, an accurate and fair signal of the likelihood of in-full and on-time payment of the sales tax bonds must incorporate the city’s GO credit quality and ratings which ignore it understate bondholder risks.

SECURITIZATION AND SEPARATE REVENUE OWNERSHIP ALSO SUPPORT DISTINCT RATINGS

A second legal framework is a securitization authorized by state law where a municipality is empowered to “sell” its future revenues and these revenues are in turn used to support an asset backed security. This legal framework is the technique used by the New York City Transitional Finance Authority whose debt Fitch rates ‘AAA’. A third legal framework supporting higher ratings is a state intercept program where the state creates a flow of revenues and establishes a legal framework that directs those flows into a trust account solely for benefit of bondholders in which the municipality has no property rights except to flows released from the trust. In both of these frameworks, the basic idea is that the flows into the account are not property of the municipality. The municipality’s interest is only in residuals as they emerge, so the flows available to the debt are not interrupted when a municipality files a bankruptcy proceeding. The Chicago sales tax bonds fall into neither of these two categories.

RECOVERY PROSPECTS AND RECOVERY NOTCHING

Fitch’s ratings of municipal debt obligations are default risk ratings and are not “notched up” from default risk to incorporate an assessment of recovery. However, even if some form of notching methodology was applied, it is unlikely to benefit the rating of the Chicago sales tax bonds and certainly not by full rating categories. As the sales tax bonds are clearly not special revenue obligations, the consensual lien on revenues granted by the city would not continue following a bankruptcy filing. Bondholders would be competing with pension claims and GO debt holders for recovery. Of course a statutory lien could improve prospects for bondholders compared to general obligation debt and pension claims as a statutory lien continues post-bankruptcy. But there is no statutory lien benefiting the Chicago sales tax bonds. Even if there were one it would not in Fitch’s view support a multiple category separation.

LACK OF CHAPTER 9 OPTION IN ILLINOIS NOT A CREDIT FACTOR

Fitch does not make rating distinctions between municipalities in states where bankruptcy is an option and those where it is not. If bankruptcy is not currently authorized, Fitch believes it likely that the state could authorize it if necessary, or absent that, the municipality in severe fiscal distress would default on its obligations and take its chances in state court lien enforcement proceedings. Recent proposals and discussion in Illinois to allow municipal bankruptcy as an option for financially stressed issuers illustrates the basis for this approach.

Kroll acknowledges the risk when it writes in its Local Special Revenue Report on Chicago sales tax debt that a key rating concern on its AA+ rating of the sales tax debt is “the uncertainty of the lien on pledged revenues that would result if the city were granted the ability to seek relief under Chapter 9 of the Bankruptcy code and in addition if such relief was sought.” Fitch’s view is that this risk needs to be reflected in the rating up front. Failing to signal this connection in the ratings sets up a scenario in which bond pricing and yield can change radically when DT bond ratings inevitably begin aligning to the GO rating if distress increases and the GO rating declines.

For more information see ‘Statutory Liens Do Not Boost Debt Ratings’, dated July 21 of this year and available at ‘www.fitchratings.com’ or by clicking on the link at the end of the press release.

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