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S&P's Proposed Changes In U.S. State Rating Methodology: FAQ.

On May 25, 2015, S&P Global Ratings published a request for comment (RFC) on its proposed changes to the rating methodology for assigning ratings to U.S. states and territories. The comment period ends on June 27, 2016. This article addresses some likely questions following the release of the RFC.

Frequently Asked Questions

Why is S&P Global Ratings proposing changes to its U.S. state rating methodology?
The purpose of the proposed criteria is to align the pension assessment section of the criteria with accounting changes in Governmental Accounting Standards Board (GASB) 67 and 68, reduce volatility in certain factors, and to use related disclosure to enhance our analysis with a more comprehensive and forward-looking assessment of pension funding discipline. We also propose to revise and expand a few of our rating overrides and rating caps to provide for greater transparency for ratings below the 'BBB' category.

How do the proposed criteria differ from the current criteria?
We are proposing changes to our pension assessment and to several rating caps and overrides. Specifically, we propose to revise rating overrides for situations in which a state has weak liquidity and capital market access or a high level of expected future debt and liabilities. The proposal also includes additional guidance for overriding factors related to weak structural budget performance as well as high levels of contingent liquidity risk.

Another key difference is the proposed methodology to arrive at the pension score, although we would continue to analyze many of the same elements as we do today. Under current criteria, we average four indicators to arrive at the overall pension assessment. Under the proposed criteria, we would begin with an assessment of the pension funded ratio and pension funding discipline, as the anchors for the initial pension score. Then we would adjust the initial score in cases where we characterize the state's unfunded pension liability compared to population or income as extremely large or extremely small. We believe that the core focus on the pension funded ratio and funding discipline provides us with a more forward-looking measure of a state's potential future liability challenges.

How do the proposed criteria assess pension funding discipline?
We believe a commitment to funding annual contributions that address the long-term pension liability is a key credit consideration. Our existing criteria assess a state's historical track record of meeting its annual required contribution. However, the new GASB accounting standards no longer define an annual required contribution and reported required contributions will vary based on funding policy.

Therefore, in addition to our analysis of a state's funding policy and track record, we are proposing to use additional disclosure provided by new GASB standards to evaluate whether plan contributions usually cover certain accrued annual costs, to offset annual growth in the liability and avoid negative amortization, as well as make some progress in funding the estimated liability over time. Specifically, we propose to analyze whether total annual plan contributions are usually sufficient to cover the aggregate annual plan service cost, as well as an annual interest cost and amortization cost component. We assume that there is some amount of likely funding progress if the annual plan contributions cover (1) the present value of benefits earned by participants in the year, (2) a portion of the annual interest cost related to pension liabilities unmatched by plan assets, and (3) some amortization of the beginning unfunded pension liability.

We recognize that actuarial assumptions vary across plans. Therefore, we also propose to assess certain pension plan management characteristics and actuarial assumptions. What we view as particularly conservative or aggressive assumptions or management practices could influence our view of pension funding discipline.

What will be the rating impact? Will there be any changes to U.S. state ratings as a result of the proposed criteria?
We maintain ratings on all 50 U.S. states and two territories. Our testing suggests that there will be no rating changes as a result of the revised criteria.

Where can I get more information on the proposed criteria?
The RFC, “U.S. State Ratings Methodology,” is on RatingsDirect and on www.standardandpoors.com. Further information will be provided via a webcast on June 7, 2016. Please see https://www.spratings.com/en_US/topic/-/render/topic-detail/u-s-states for relevant links to register for the webcast.

How long is the request for comment period? How do I submit comments on the proposed criteria?
We encourage all market participants to submit written comments on the proposed criteria by June 27, 2016. Please send your written comments to https://www.standardandpoors.com/en_US/web/guest/ratings/rfc. Once the comment period is over, we will review the comments, potentially adjust the proposed criteria to reflect relevant market input, and publish the final criteria. The final criteria will be effective immediately upon publication.

Only a rating committee may determine a rating action and this report does not constitute a rating action.

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