Fitch Releases Revised U.S. Public Finance Tax-Supported Rating Criteria.

Fitch Ratings-New York-03 April 2018: Fitch Ratings has released an annual update to its "U.S. Public Finance Tax-Supported Rating Criteria." The revised criteria, which replace criteria dated May 31, 2017, include changes related to the analysis of moral obligation pledges and state dedicated tax bonds, as discussed in further detail below. Fitch expects these changes will affect fewer than 10 ratings. Other revisions to the criteria simply clarify certain aspects of our approach for U.S. state and local government credits.

The ratings that may be affected by the criteria changes will be reviewed in the near term..

Moral Obligation Analysis Change (Appendix D of revised criteria)
Under the revised criteria, all Fitch ratings on moral obligations will be notched down from the credit quality of the moral obligation provider. Formerly, the moral obligation enhancement was recognized either based on this "top down" approach or by notching up from the underlying security rating, depending on the nature of the transaction. This change generally aligns to the framework used for appropriation-supported debt, but with somewhat wider notching from the moral obligation provider's general credit quality as expressed through its Issuer Default Rating (IDR). Moral obligation debt will generally be rated three notches below the provider's IDR, although moral obligation debt that is currently rated two notches below the provider's IDR based on identified strengths is not affected by the criteria change.

The change to the analysis of moral obligations is expected to result in upgrades to a small number of credits.

State Dedicated Tax Bond Analysis Change (pages 29-31 of revised criteria)
The revised criteria specify more limited situations in which a state dedicated tax security can be rated without regard to the state's general credit quality. Additionally, the revised criteria now include detail on circumstances in which a state dedicated tax security, while not considered distinct from the state IDR, can nonetheless be treated as stronger than but still linked to the state's general credit risk. In these cases, Fitch will limit the rating on most state dedicated tax securities to no more than three notches above the state's IDR. For either approach to be applicable, dedicated revenues must be structurally insulated from the state's general financial operations.

As there is no bankruptcy framework available to U.S. states, evaluation of the prospects for varying security structures at a time of fiscal distress is by necessity somewhat judgemental. Absent a bankruptcy framework, the primary limit on state action and source of protection for state bondholders is the contract clause of the U.S. constitution and equivalent clauses in state constitutions. Although contract clause protections under federal and state constitutions restrict the ability of a state government to impair its obligation to pay bondholders from dedicated tax revenue, the judicial interpretations of the contract clause indicate that it does not impose an absolute constraint where a state confronts a fiscal emergency. In such a situation, one of the key legal tests of whether a contract can be impaired is whether the impairment is necessary and reasonable.

Given this legal backdrop, under the revised criteria, the only cases in which Fitch can rate a state dedicated tax bond distinct from and without regard to the state IDR are situations where Fitch believes that the nature of the dedicated revenue stream or the legal structure render remote the possibility of a successful impairment argument. This approach is similar to Fitch's rating framework for local government dedicated tax bonds. The security must be very clearly segregated from state operations and have no nexus with general state functions. Examples include bonds issued to fund state unemployment compensation and worker's compensation systems.

In other cases, Fitch believes that the state dedicated tax security enhances the prospects for full and timely payment but does not have a sufficiently strong non-impairment argument to allow for a rating determined without regard to the issuer's general credit quality. The revised criteria cap the rating on such securities at no more than three notches above the state's IDR, indicating that they are more vulnerable to an assertion by the state that impairment is necessary. The degree of allowable notching is informed by: the breadth of the dedicated revenues (the narrower the better); the nature of the borrowing program (the more specific the better); and the use of residual revenues (the more segregated the better).

The option to rate a dedicated tax security above but linked to the government's IDR can only be used for bonds issued by U.S. states. Fitch does not apply this approach to debt issued by local governments because expectations for the likely performance of local government security structures at times of fiscal distress are guided by Chapter 9 of the U.S. Bankruptcy Code. The automatic stay under Chapter 9 applies with few exceptions to all tax-backed debts issued by a local government. A local government security's exposure to the government's general credit risk is therefore predictable under the provisions of the Code: the pledged revenues are either subject to the automatic stay, and the dedicated tax rating is capped by the IDR, or they aren't, allowing for a dedicated tax rating distinct from the local government's IDR.

This criteria change represents a refinement of Fitch's approach to rating state dedicated tax bonds and is a continuation of our ongoing focus on legal security in relation to issuer ratings. The change is expected to result in downgrades to a small number of credits.

Fitch's approach to rating dedicated tax bonds issued by U.S. local governments is unchanged in the revised criteria.

Bankruptcy risk to local governments generally precludes dedicated tax bonds issued by that government from being rated higher than the entity's IDR, regardless of the strength of the security. Fitch considers four exceptions where a dedicated tax bond rating above the IDR is possible: (1) bondholders are granted a lien on and pledge of revenue that Fitch concludes would be considered special revenues under Chapter 9 of the U.S. Bankruptcy Code; (2) the debt is issued pursuant to a specific state intercept program; (3) the debt is structured as a securitization specifically authorized by state law; or (4) Fitch can identify the likelihood of enhanced recovery prospects.

Fitch's updated "U.S. Public Finance Tax-Supported Rating Criteria' is available at 'www.fitchratings.com" or by clicking on the link above.

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