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Once-Safest Muni Bonds Tainted as Investors Await Downgrades.

- **Rating cut to Illinois sales-tax bonds may herald others**
- **SNW Asset Management sees less value, shifts to 'underweight'**

Late last month, Fitch Ratings downgraded $2.5 billion of Illinois's sales-tax bonds by five steps, dropping them closer to debt backed only by the state's promise to repay.

It may not be the last ratings cut for state and local-government bonds backed by dedicated revenue including tolls, fees or specific taxes — a pledge that investors once assumed protected them from a government's financial distress.

SNW Asset Management, a unit of OppenheimerFunds, sees less value in such bonds because of the risk of deep downgrades, said Mark Stockwell, a municipal analyst at the Seattle-based firm. He said the sector is "devolving" and becoming more closely correlated with general-obligation debt or securities repaid with money that lawmakers have to appropriate each year.

In a research note to clients last week, the company said it has shifted its recommendation on the tax-backed bonds to "underweight."

"Some of these bonds that look like they provide value may be downgraded," said Stockwell. "We could see AA or AAA rated bonds go to single A or triple B. In some cases, you could have a BBB dedicated tax bond go to a non-investment grade category."

The reassessment is coming after some recent cases made it clear that the securities aren't necessarily immune from the impact of a government's fiscal strains. Puerto Rico sales-tax bondholders haven't received payments amid the island's bankruptcy, belying the perceived safety that kept the securities investment grade after the territory's rating was dropped to junk. A trustee is holding the revenue pledged to bondholders while creditors face off in court.

In 2015, S&P Global Ratings downgraded Illinois' Metropolitan Pier & Exposition Authority's sales-tax bonds to BBB+ from AAA after the Illinois legislature failed to appropriate the revenue needed to cover monthly debt payments amid a stalemate over the budget. The state eventually allocated the funds.

"You have these bondholder protections and you thought it was going to work, and then it didn't," Stockwell said.

S&P is currently considering whether to change its method for rating "priority lien" bonds to tie them more closely to a municipality's full faith and credit. The rating company currently grades about 1,300 of those securities.

Less Safety

Moody’s Investors Service already discounts the safety of the securities. It generally caps the ratings of dedicated-tax bonds at the same level as an issuer’s general-obligation bonds. The ratings can be higher only when the pledged revenue stream is legally separated from the issuer’s general finances, such as through a constitutional amendment to pledge certain revenue to the debt.

Fitch lowered its rating on the Illinois sales-tax bonds to A- as a result of changing its state dedicated tax rating criteria in April. The securities have a first claim on the state’s share of the 6.25 percent sales tax. But because the revenue flows to the general fund after paying debt service, Fitch applied its new criteria, which takes into account the state’s BBB rating.

Fitch changed its rating criteria on state tax bonds because there’s more uncertainty about how they would be treated during a time of severe financial pressure, given that states can’t file for bankruptcy the way cities can, said Eric Kim, an analyst for the company. By contrast, Chapter 9 precedents provide a framework for how the debt would be treated if a municipality goes broke, he said.

Local dedicated tax bonds are generally capped at the issuer rating by Fitch, although there are instances in which the securities could have a higher rating.

Fitch is evaluating whether to downgrade Pennsylvania Turnpike Commission bonds backed by registration fees and revenue debt issued by transit agencies in the Philadelphia and Pittsburgh metropolitan areas. The local transit agencies get some revenue from a state transportation fund, which in turn relies on state sales-tax money.

“For certain types of state dedicated-tax bonds, while the legal structure may permit a rating above the credit quality of the state issuer default rating, we think in most cases there will continue to be some linkage to the state because of the potential for impairment of bondholders,” said Kim.

Bloomberg

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June 20, 2018, 5:28 AM PDT Updated on June 20, 2018, 11:10 AM PDT

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