
Fitch: Recent Healthcare Outlier Downgrades Not Reflective of Wider Trend.

Fitch Ratings-New York-09 July 2018: Fitch Ratings does not consider two recent multi-notch downgrades affecting healthcare issuers in South Carolina, driven by extraordinarily large net pension liabilities, harbingers of wide-ranging rating actions in the healthcare sector or other sectors, including higher education. Rather, these outliers highlight outsized pension liabilities under any measure compounded by constraints in the healthcare business model given its more limited revenue defensibility when compared to other sectors in U.S. public finance.

ISSUER-SPECIFIC ACTIONS CONSIDERED IN BROADER PORTFOLIO CONTEXT

On Jan. 9, 2018, Fitch released its updated “U.S. Not-For-Profit Hospitals and Health Systems Rating Criteria”. The updated criteria place a heightened emphasis on maintenance of leverage ratios and liquidity consistent with an issuer’s operating profile through the cycle in a forward-looking rating case stress. These leverage ratios explicitly incorporate lease and net pension liabilities as direct debt equivalents. Since the release of the criteria, Fitch completed a review of 138 separate health care providers, with reviews focused predominantly on issuers where the potential for change due to the application of new elements of the criteria might lead to changes in ratings.

As noted when Fitch released the new criteria, the agency’s expectation was for affirmation to be the predominant outcome of application of the new criteria. The review group of 138 credits reflects approximately 50% of Fitch’s total hospital and health system portfolio. There were a total of 35 upgrades (13% of the total portfolio) and 25 (9%) downgrades as a result of these reviews. The majority of rating changes were one notch. Of the upgrades, three credits were upgraded 3+ notches and of the downgrades, a total of five moved 3+ notches. To place these changes in a broader context, Fitch does not expect further rating changes solely based on criteria revisions for the remainder of the 270+ portfolio.

GASB PENSION LIABILITY ALLOCATED WHERE FUNDING BURDEN RESIDES

Rating actions included reviews of government-sponsored healthcare providers, a relatively small subset of Fitch’s overall healthcare portfolio. These reviews incorporated the first application of Fitch’s approach to evaluating public, defined benefit pension liabilities in revenue-supported entities. For many of these issuers, which participate in state-administered, cost-sharing multi-employer plans, Fitch looks to GASB 68 when considering where the proportionate share of a net pension liability should be placed among governmental units participating in such plans. GASB 68 generally assigns the liability where the primary funding obligation resides absent a clear legal and financial assumption of the liability by the state government.

Fitch applies this approach to both local government participants and to government enterprises participating in a state-administered cost-sharing plan, such as health care, utility and higher education enterprises. There is no basis to treat the government issuers and the government enterprises differently when considering where the burden rests in a common plan. Just as direct employers are responsible for the current salaries of their own employees, Fitch views them as being responsible for deferred compensation/future pension benefits, including when insufficient resources have been set aside and an unfunded liability exists.

CAPACITY TO RESPOND VARIES ACROSS SECTORS; HEALTHCARE RELATIVELY CONSTRAINED

Fitch notes however, that the capacity to respond to and absorb an increased pension burden, regardless of plan type, through either revenue tools or operating cost flexibility varies very dramatically among issuers. Fitch explicitly considers this by assessing an issuer's revenue defensibility and operating risk flexibility to set a context for review of an issuer's financial leverage. The ability of a government with general taxing capacity is at the high end of revenue flexibility, as would be a public university that has flexibility both to raise tuition and fees and to shape the cost and extent of its offerings.

Absent general taxing powers, health care providers have among the lowest revenue and operating flexibility of participants with pension obligations. Under Fitch's rating approach, issuers with stronger revenue defensibility and operating risk flexibility assessments can have higher ratings at every level of leverage compared to issuers with more limited revenue and operating flexibility. Leverage tolerance at each rating level for health care providers is significantly lower given the nature of the business model. As a result, different types of participants having a large unfunded liability will be affected very differently, including when they carry proportionate shares of the liability of a cost-sharing, multi-employer plan.

SOUTH CAROLINA DOWNGRADES – LARGE PARTICIPANTS IN UNDERFUNDED PLAN

Fitch recently downgraded Spartanburg Regional Health Services District (Spartanburg Health) and Lexington County Health Services District (Lexington Health), both participants in the state-administered South Carolina Retirement System (SCRS), a cost-sharing multi-employer plan. Each is a statutory public hospital and a political subdivision of the state. Neither has direct authority to levy a tax in support of its operations. Each issuer reported its proportionate share of the system's large net pension liability in its financial statements in accordance with GASB 68. The state, as another participating employer in SCRS and several other state-administered plans, also reports its proportionate share of the net pension liability. As of fiscal 2017, the state reported carrying 12.9% of the SCRS net pension liability, with additional amounts from four other plans. Altogether, Fitch measures the state's aggregate net pension liability, adjusted by Fitch to a 6% discount rate at 2.6% of personal income. Combined with tax-supported debt brings the total to only 4% of personal income, a level which Fitch views as being a low burden on the state's resource base despite the weakening trajectory of SCRS in recent years.

Under Fitch's healthcare criteria, Fitch assesses leverage on an adjusted basis, including leases and Fitch-adjusted net pension liabilities. Spartanburg Health reported a net pension liability of $656 million and Lexington Health reported a net pension liability of $739 million, based on the 7.25% discount rate used by SCRS to calculate the liability. Just as when assessing state and local issuers, Fitch adjusts the reported net pension liability using a standard discount rate (6%) to provide consistency among issuers and better reflect the magnitude of the commitment posed by pensions. For Spartanburg Health, the Fitch-adjusted pension liability is $904 million. For Lexington Health the Fitch-adjusted pension liability is $1.1 billion. Even without the Fitch adjustment, the size of the net pension liability as reported would have driven a rating action.

Fitch assigned a 'BBB' rating to Spartanburg Health based on its cash to adjusted debt of 57% and net adjusted EBITDA to adjusted debt of 2.7x over a five-year horizon. (Downgrade from A). Fitch assigned a 'BB+' rating to Lexington Health based on its cash to adjusted debt of 40% and net adjusted EBITDA to debt of 5.1x over a five-year horizon. (Downgrade from A+) .

SOUTH CAROLINA STATE LAW OUTLINES PARTICIPANT OBLIGATIONS

In determining the level of net pension liability to include in Spartanburg Health’s and Lexington Health’s leverage profile, Fitch considered state law that applies to funding the statewide multi-employer plan and past state practices to assess whether either issuer’s burden was likely to be relieved or reduced through direct state funding.

State law provisions relevant to this analysis are found in the South Carolina constitution and the act governing the statewide plan. Read together it is clear from these provisions that the state is obligated to assure actions are taken to maintain long-term solvency of the plan. . Fitch believes the most likely scenario to closing the unfunded liability is that the state will increase both employer and employee contributions, with the bulk of the burden falling to employers, consistent with the state’s historical practice. While recent statewide reforms should positively affect the trajectory of the plan’s unfunded liability over time if plan assumptions are met, a significant gap remains, and recent changes to contribution and amortization practices will have only a gradual impact, similar to how reforms to other public defined benefit pensions generally have worked.

Further, Fitch believes it would be wrong to conclude that the pension obligation belongs at the state level. Fitch includes in the state rating the NPL attributed to it as reported in the state’s audited financial statements. Although additional appropriations by the state are an available tool, Fitch believes it unlikely the state will address unfunded liabilities directly from its own resources and relieve local government and public authorities of contributions funded by their own revenues. Fitch also believes it unlikely in a common plan for a state to give relief to one plan participant and not others in the plan, whether done directly or indirectly.

SIMILAR FRAMEWORK ACROSS STATUTORY SCHEMES; ULTIMATE BURDEN ON EMPLOYERS

Statutes governing cost-sharing plans often have a broadly similar framework, as exemplified by South Carolina’s plan. Public employees are required to become members and participating employers are liable for contributions. Benefits owed to individual employees are declared a liability of the plan and not a liability of any participating employer (including the state). Because the direct liability for pension benefit payments lies with the plan, it is sometimes argued that the employers therefore have no liability that should be considered in their rating. Fitch does not believe this withstands reasonable scrutiny, however, because the statutes also typically provide that the plan is obligated to meet its responsibility through mandatory assessments on participating employers and employees where needed, to complement returns from invested assets. The net pension liability is, in effect, a measure of the burden of future mandatory contributions that will need to be made by employers to meet their obligation to their own employees.

The statutory framework typically includes state oversight and state responsibility for assuring plan solvency through assessments on plan employers. Typically, once an employer opts to participate in the plan, participation is irrevocable, with a state intercept mechanism in the event a participating employer does not make the mandatory contribution; benefits cannot be forfeited. A state government generally has the power to appropriate as an alternative to assure plan solvency whether this is in the statute or not. Fitch does not factor this power into a rating where it has not generally been exercised to restore balance to a statewide common plan or provide direct funding on behalf of participating employers.

TEXAS HOSPITAL DISTRICTS IN CONTRAST

As noted above, how an issuer's unfunded pension obligation and overall leverage profile affect a rating outcome depends very much on an assessment of an issuer's capacity to respond to an increased burden with either available revenue tools or operating cost flexibility. Fitch's ratings on Texas hospital districts provide a helpful contrast. Texas hospital districts have independent taxing powers and can levy property taxes within certain bounds to enhance revenues from operating resources.

Fitch recently downgraded Dallas County Hospital District (Parkland) to 'A+' based on application of the updated criteria. Parkland has a reported net pension liability for its own single employer plan of $423 million and a Fitch-adjusted net pension liability of $588 million. Its relevant metrics include net adjusted debt to EBITDA of 4.1x and cash to adjusted debt of 37%. However, the district has substantial unused taxing power that can be tapped to maintain its financial balance and meet any increased pension liability without straining its financial profile. Fitch noted the 'A+' Issuer Default Rating (IDR) and limited tax General Obligation (GO) ratings reflect Parkland's weaker net leverage profile under a stress scenario through the cycle relative to its mid-range operating profile and exceptionally strong revenue defensibility. Fitch views Parkland's unusually strong 'aa' revenue defensibility, as demonstrated by Fitch's estimated $1 billion taxing margin available for operations, as mitigating a weaker net leverage position, allowing Fitch to place the final rating in the 'A' category despite a weak financial profile, which would typically result in a lower rating.

The importance and relevance of individual issuer characteristics particularly as it relates to pension liability is also illustrated by Fitch's 'AA+' rating of Bexar County Hospital District, in Texas. The district's cash-to-debt and cash-to-adjusted debt of 133% and 94%, respectively, as of Dec. 31, 2017 (based on unaudited data at the time), reflect unrestricted cash and investments of $895 million in relation to $670 million of long-term fixed rate GO debt and adjusted debt. Under Fitch's criteria, adjusted debt includes Fitch's capitalization of operating leases (estimated at $60 million) and the Fitch-adjusted net pension liability (estimated as of its fiscal 2016 audit at $224 million based on a 6% discount rate, instead of the $139 million level reported by the district, which uses a 7.5% discount rate). The district, which participates in a statewide agent multi-employer plan, migrated to a cash balance plan in 2012, limiting exposure to future significant pension liability changes. Net adjusted debt-to-adjusted EBITDA, which is a measure of how many years of cash flow is needed to repay long-term debt outstanding, was solid at 0.3x at Dec. 31, 2017.

CASE STUDY – SOUTH CAROLINA CONSTITUTION & RETIREMENT PLAN STATUTES

The following excerpt from South Carolina's Retirement Systems Act describes the pension obligation as one of the retirement system (not the state itself), which is not uncommon among U.S. plans. Fitch uses GASB treatment of the allocation of the liability among plan participants as its reasonable-basis methodology. The language below further states that employers participating in the plan are obligated to appropriate and that benefits to members are non-forfeitable:

Section 9 1 1690: "Credit of State is not pledged for payments; rights in case of termination of System or discontinuance of contributions.

All agreements or contracts with members of the System pursuant to any of the provisions of this chapter shall be deemed solely obligations of the Retirement System and the full faith and credit of this State and of its departments, institutions and political subdivisions and of any other employer is not, and shall not be, pledged or obligated beyond the amounts which may be hereafter annually appropriated by such employers in the annual appropriations act, county appropriation acts and other periodic appropriations for the purposes of this chapter. In case of termination of the System, or in the event of discontinuance of contributions thereunder, the rights of all members of the System to benefits accrued to the date of such termination or discontinuance of contributions, to the extent then funded, are nonforfeitable."

The state constitution (excerpted below) describes the obligation of the state to assure adequate funding of the plan by all members. In the event of an unfunded liability, Fitch believes the most likely scenario to closing it is that the state will increase both employer and employee contributions, with the bulk of the burden falling to employers, consistent with the state's historical practice. Lexington Health is the third largest, and Spartanburg Health is the eighth largest participant in SCRS by covered employee as of the system's fiscal 2017 financial statement.

Article X, Section 16: "[t]he General Assembly shall annually appropriate funds and prescribe member contributions for any state-operated retirement system which will insure the availability of funds to meet all normal and accrued liability of the system on a sound actuarial basis as determined by the governing body of the system."

Finally, the following section from the Retirement Systems Act describes state remedies in assuring employer funding of the pension obligation including withholding of state funding until the defaulted payment is cured. This mechanism is essentially an intercept provision. Fitch believes certain revenues received from the State, including Medicaid and others, could and would be withheld in the unlikely event a participating entity did not make its required pension contributions. This mechanism further supports Fitch's view that the liability ultimately is the responsibility of the employer and there is no flexibility associated with the pension contribution burden.

SECTION 9 1 1170, Collection of Employers' Contributions:
"If . . . .the full accrued amount of the contributions and interest provided for under this section due . . . from an employer other than the State has not been received by the System from the chief fiscal officer of the employer within thirty days after the last due date as provided in this item, then upon notification by the Board to the State Treasurer and Comptroller General as to the default of the employer as provided in this item, any distributions which might otherwise be made to the employer from any funds of the State must be withheld from the employer until notice from the Board to the State Treasurer that the employer is no longer in default."

In 2017, South Carolina enacted Act 13, which reformed contributions and actuarial assumptions of SCRS, positioning the system to gradually reduce the burden of liabilities in the coming decades if the lowered 7.25% investment return and other actuarial assumptions can be achieved. This rate, while below average for major systems, is above the 6% level assumed by Fitch in assessing expectations for pension liabilities and long-term investment returns. Other reforms included a gradual reduction in the amortization period for the unfunded pension from 30 years to 20 years by fiscal 2028.

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