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Fitch: U.S. Local Government Liquidity to Face Stress Due to Coronavirus

Fitch Ratings-New York-03 April 2020: Challenges to U.S. local governments' ability to maintain historically sound liquidity levels in light of the coronavirus pandemic will come from multiple sources, according to Fitch Ratings. As with states, Fitch considers liquidity to be the most significant near-term risk to local government credit quality related to the pandemic (see 'Tax Filing Delays Will Hit Near-Term Liquidity for State Govts', March 2020). While Fitch expects most local governments — with an average Issuer Default Rating (IDR) of 'AA' — to retain sufficient liquidity to offset significant near-term revenue declines, some will undergo enough strain to trigger rating downgrades. Fitch expects even financially stressed issuers to take whatever measures are possible and necessary to continue to make full and timely debt service payments during this challenging period, which may include deficit financing or other cash flow conservation measures considered unusual through normal economic cycles. Failure to create adequate liquidity and financial buffers that protect debt repayment capacity even during a potentially protracted crisis would be inconsistent with an investment-grade rating. A missed debt service payment, even if on a temporary basis, would be treated by Fitch as a default.

Cash management tools are not typically the focus of Fitch's analysis of U.S. local governments, as liquidity is sufficient for operating needs for nearly all issuers through cyclical downturns. However, given the uncertain nature of the coronavirus pandemic and the depth and duration of its impact on the economy, Fitch believes many local governments may explore extraordinary cash flow support measures in the near term, particularly those governments that do not carry large liquidity balances relative to operating needs. These may include financial market solutions such as lines of credit and tax/revenue anticipation notes, either through public sales or private placements. Since local governments are generally labor-intensive, these working capital management measures might also include layoffs and furloughs that necessitate service reductions, or payroll deferrals. In addition, Fitch expects some entities to delay vendor payments, reduce equipment purchases and postpone capital spending.

Liquidity strains are more likely for local governments that exhibited negative financial trends prior to the outbreak, or those with lower IDRs and financial resilience assessments, reflecting more limited flexibility to address the emerging economic and revenue challenges. Local governments with a disproportionately large exposure to economically-sensitive revenues such as sales and income taxes, or economies with significant tourism and retail sector dependence, are also considered more vulnerable.

Property taxes, which typically are due annually or semi-annually, have been a predictable and stabilizing factor for revenues but even those may be subject to uncertainty. Fitch is not aware of any local governments proposing to delay property tax due dates, although at last count 38 of the 44 states that levy a personal income tax have extended their filing or payment deadlines to as late as July 15, in line with the federal filing delay. For many taxpayers who have mortgages, escrowed property tax payments have historically contributed to high current property tax collection rates. However, a relaxation of mortgage payment due dates, already instituted for Fannie Mae and

Freddie Mac borrowers, could result in delays in property tax collections. Fitch expects to develop an analytical framework for measuring this risk relative to an issuer's available cash management options. In addition, the coronavirus pandemic could negatively affect home prices, thereby eroding tax base values and property taxes, although the impact on tax revenues would not be felt until future fiscal years (see 'Coronavirus Could Precipitate Decline in U.S. Home Prices', March 2020).

Fitch also views state aid, upon which school districts and counties typically rely heavily, as at higher risk to cutbacks in fiscal 2021, which begins on July 1 for many. The ability to reduce or delay local government transfers is an important financial tool for states. Fitch believes this flexibility is likely to be invoked given states' near-term revenue and liquidity stress. While the Coronavirus Aid, Relief and Economic Security (CARES) Act will distribute $150 billion in aid to state and local governments in the near term, it provides expense reimbursement rather than a pure cash flow infusion. The high IDRs in the local government sector indicates most will be able to withstand even this period of unprecedented stress; Fitch is reviewing the adequacy of each issuer's available tools as well as management's willingness to utilize them.

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