S&P Credit FAQ: COVID-19, Recession, And U.S. Public Finance Ratings.

As the COVID-19 pandemic continues, public finance issuers across the U.S. are navigating the financial and economic effects of the disease. We have been and will continue to publish updates on credit conditions across sectors and will update the market with our credit opinions. In our regular communications with municipal market participants including our bi-weekly newsletters and webcasts we have received many inquiries on the current environment and our rating approach. Below, S&P Global Ratings answers frequently asked questions on the possible impact on public finance ratings as we incorporate the effects of the pandemic and recession. For more information related to our credit rating activity and commentaries related to COVID-19, please see "COVID-19 Activity In U.S. Public Finance," which we update regularly. Additional information on our analytical process can be found in " Credit FAQ: The Ratings Process And The COVID-19 Pandemic ."

Frequently Asked Questions

What does the negative sector outlook mean? How long will it stay on?

All of our sector outlooks in U.S. public finance are now negative due to COVID-19 and the rapid onset of the recession with projections of sharp GDP decline, surging unemployment, and decreased consumer spending. To start 2020, all were stable except higher education (negative for three years), ports, and mass transit. A sector outlook is a macro, forward-looking view on where we see credit trends in the year ahead. For the remainder of 2020 we would expect to see more negative than positive rating actions across U.S. public finance. We typically update our sector outlooks in January, or sooner as credit conditions warrant. A change in a sector outlook doesn't mean individual issuer or issue-level outlooks are changed.

What has been your approach to surveillance and what actions have been taken?

We are performing portfolio reviews across all municipal sectors and these efforts confirm that sectors such as health care, transportation, higher education, and subsets of the state and local government portfolios are heavily affected by the demand/revenue challenges associated with the health and safety measures in place. We expect to continuously update these views across the various sectors. To date, rating and outlook actions have represented about 4% of our rated universe. The vast majority of actions to date have been outlook revisions (97%). Rating outlooks address the potential for an event or trend to change a rating with a one-in-three likelihood over a period up to two years. This compares to CreditWatch which has a more immediate time horizon of 90 days with a 50% probability of a rating change.

Do you expect to take additional rating actions?

We expect to continue to update our credit rating opinions as economic data and forecasts become available, in line with applicable methodologies and policies. While we may look holistically at credit conditions for certain sectors to consider outlook changes that apply broadly to a group of credits, any rating change will include a full review of an entity's individual credit characteristics.

What is the time horizon you are looking at as part of your review?

The rapid onset of the recession with swift GDP decline and sharp rise in unemployment is making this look more like a natural disaster event than a typical recession. Given the rapid deterioration of revenues and absorption of unbudgeted costs, there are near-term pressures related to liquidity that we are evaluating across sectors. We expect that revenue and expenditure alignment over the next year will be challenging and the pace of economic recovery along with response of management and policymakers will also inform our credit views.

How are you developing forward-looking views on the potential decline of revenues/taxes across U.S. public finance?

Our forward-looking view of credit conditions across public finance sectors is informed by our team of S&P Global economists and their opinion of those macroeconomic trends that directly or indirectly influence the entities we rate. Our views are also informed by available information at the state, regional, or local/entity level that provide additional detail on events or trends that contribute to our forward-looking analysis of an entity. These views are highlighted in the outlooks and upside/downside sections of our credit reports. In the current environment with varying levels of economic stress and a high degree of uncertainty, these forward-looking views may influence rating and outlook changes.

When assessing credit quality, how does S&P Global Ratings account for the post-pandemic environment? In other words, is there a through-the-cycle approach?

“Rating through the cycle” can be a misleading term that means different things to different people. What we always strive for is to be timely, transparent, and–most important in the current environment–forward-looking. How we look at the credit deterioration on a borrower depends not only on the severity of the sector stress but on where the particular borrower is on the credit spectrum.

The majority (approximately 98%) of U.S. public finance ratings are investment grade and would be expected to have a greater ability to weather adverse credit conditions than speculative grade entities. To be clear, there has been and will continue to be rating actions, but we generally expect them to be less frequent and less stark because of these borrowers’ financial flexibility. We note that this flexibility varies across our rated universe. For example, an entity rated ‘AAA’ will likely have more capacity to weather adverse credit conditions than an entity rated ‘BBB’.

Is S&P Global Ratings continuing to receive timely information from issuers during the pandemic, and how will it respond if there are delays in receiving financial or other information?

So far, information has continued to flow between issuers and S&P Global Ratings. We expect that there could be some delay in the release of financial information or other relevant disclosure. We evaluate these situations based on the information’s importance to the rating analysis and whether alternative information is available or sufficient to support the ratings. We could decide to refer the matter to a committee for potential rating action, including a CreditWatch placement or a rating suspension or withdrawal.

Our receipt of information on a timely basis from issuers and obligors and their agents and advisors is essential to the maintenance of our ratings. For municipal issuers and obligors, we view proactive disclosure and dissemination of information as a positive management characteristic. Conversely, we view the lack of timely disclosure and information flow negatively.

What is the impact of short-term borrowing on credit quality?

Many public finance issuers regularly borrow or establish lines of credit for cash flow purposes. We expect that this could accelerate in the coming months due to the projected decline in revenues, extension of the filing deadline for income tax returns, and unexpected spending related to the pandemic. The credit focus would be on the size of the borrowing relative to revenues, repayment terms, and how it fits into the overall budget and financial plan. If we view a line of credit to be an interim measure, it would not be counted as debt. However, if the line is regularly used for operational purposes we would look at repayment plans and regularly evaluate this relative to the debt profile.

The pace of revenue decline may lead to fund balance/operating reserve fund reductions, pay-go capital deferrals, deficit bonds, or other one-time measures. Will this result in credit rating changes?

Most public finance entities steadily improved their financial reserves during the record economic recovery and this provides some financial flexibility to react to budget shortfalls or other unforeseen circumstances in a timely manner. In our view, the use of budget stabilization reserves or other non-recurring measures would not in and of itself be a credit weakness. It would be important for us to understand how a reserve draw or other non-recurring measure fits into the overall financial plan. If budget balance is achieved solely by non-recurring measures it will translate to a more significant structural budget gap in the following year if economic trends continue to be weak. The issuance of deficit bonds would be evaluated on a case-by-case basis with a focus on how it fits into the overall financial plan and what it means for the debt profile.

Would there be a rating impact if tax or revenue decline translates to a swift decline in coverage but it’s temporary?

A temporary decline in revenues doesn’t necessarily translate to a lower credit rating but it would be evaluated against the level of coverage and revenue recovery prospects.

How does S&P Global Ratings define default? How will various forms of technical default be treated?

Our ratings address the willingness and ability of an obligor to pay its obligations fully and on time. If the lack of ability or willingness lead to a failure to fulfill the payment obligations in full or on time, and if we believe that a payment will not come within the grace period, we would typically view that as a default and lower the rating to ‘D’, in accordance with our published ratings definitions.

We typically consider technical defaults to be those rare instances when we believe that the obligor had both the willingness and the financial ability to make a payment but could not make the payment on time due to a temporary glitch or impediment that we believe is highly likely to be resolved in the short term. In these instances, we might not lower the rating to ‘D’.

How would you view a debt service reserve fund draw?

Across U.S. public finance there are no criteria references that specify the direct implication of a draw on a debt service reserve fund on a bond or issuer rating. However, the potential credit risk associated with a draw would be analyzed in various parts of our criteria, particularly in liquidity and financial capacity analysis. It is important to note that there is a broad range of credit structures in U.S. public finance so a draw would be evaluated on a credit-by-credit basis. In nearly all circumstances it is an indication of credit pressure.

Key elements that we would consider to gauge the magnitude of the risk and its potential credit impact:

- The rating level of the specific issue;
- The reason for the draw including a review of pledged revenues and our view of the near term and longer term expectations for revenue performance, including the issuer's plan to address potential future shortfalls; and
- The specific legal structure in place for the bonds, including reserve replenishment, flow of funds, and other relevant security provisions.

Do you expect an uptick in defaults or bankruptcy filings in public finance?

Defaults and bankruptcies remain rare in our rated U.S. public finance universe. While there could be some uptick in both reflecting fiscal stress, we would not expect this to be widespread. Our criteria specifically reference the fact that states are not eligible to file for bankruptcy protection under the U.S. Bankruptcy Code. This has been fundamental to our analysis of the institutional and government framework that is part of our review of the sector. We note there are also some limitations at the local level, which vary by state.

Has S&P Global Ratings changed any of its methodologies in determining credit risk because of the coronavirus?

We have not changed our U.S. public finance ratings criteria due to the coronavirus to date. We believe our ratings criteria continues to provide us with a framework that generates relevant forward-looking opinions of overall creditworthiness. We review our methodologies on a regular cycle. In connection with this process, we monitor and analyze current and historical performance metrics and market feedback.

14 May, 2020

This report does not constitute a rating action.