[Bond Case Briefs]

Municipal Finance Law Since 1971

[The New Normal for Local Governments and Credit Rating Downgrades.]

Between unemployment and underemployment at the individual level to impaired income sources for local governments, credit score downgrades are emerging as an inevitable shared reality.

As more and more states and local governments are grappling with the new reality of COVID-19, credit rating agencies are actively monitoring their fiscal health and quickly changing their outlook for these agencies to withstand the current financial recession. According to a recent report from S&P Ratings, " U.S. public finance saw continued downgrade activity in June, including multiple notches for entities affected by a severe drop in hospitality taxes (local governments), cancelled social events (student accommodations and conference centers), and some universities' decisions on remote learning."

In this article, we will take a closer look at how credit rating agencies are assessing the financial health of states and local governments and what they think the future holds for municipalities.

Credit Rating Methodology

Before diving into what municipal downgrades mean for the health of municipalities around the U.S., let's take a look at the methodologies credit rating agencies use for both general obligation (GO) bonds and revenue-backed debt when assigning their credit ratings and outlooks.

In the credit rating analysis of GO debt, there are two main areas typically considered by rating agencies:

- The demographic and socio-economic make of the municipalities and the level of taxation that is suitable.
- Understanding the level of services that are offered by the municipality and paid by the general fund expenditures.
  Rating methodology.

Here are the few areas that are closely examined before rating a GO debt:

- **Sustainability of the Local Economy Paired with the Tax Base:** This is one the most important areas when assessing the fiscal strength of a municipality. This entails analyzing the local economy, knowing more about the largest employer, learning about the diversification of employment, and figuring out how a fiscal downturn might impact the sustainability of the tax base for the local government. Furthermore, the population size, property values and the median income of a household are some of the key factors included in the GO debt risk analysis.
- **Financial Preparedness:** As currently seen during the COVID-19 crisis, the municipalities that established a financial preparedness plan prior to COVID-19 are much more resilient to the impact of sudden revenue loss due to the pandemic. This preparedness isn't limited to its reliance on general fund revenues, but the current fund balance reserves put aside for an unforeseen event

per the reserve fund policy, liquid resources and feasibility of long-range financial plans.
- **Current Management of the Municipality:** This section of the risk assessment for GO debt looks at the institutional framework for the agency and effectiveness of the management in putting successful financial measures in place for successful operations.
- **Current Debt and Pension Obligations:** With respect to the local government's debt portfolio and retiree pension obligations, it's critical that these obligations are taken into account, including the debt to revenue and net pension to revenue ratios, for every debt issuance and understand the current liabilities for the agency.

In the credit rating analysis of revenue-backed debt, it's about understanding the nature of the services provided that generate the revenues. Often, these revenues are pledged to service the debt issued to fund the respective projects. The credit analysis includes the size, the coverage or service area, the strength of rate management and the financial strength of its overall operations.

Here are the few areas that are closely examined before rating a revenue backed debt:

- **System Characteristics:** This parameter measures a utility's ability to fund its operations and capital needs in the future, based on the size and complexity of its operations, financial strength of its service base, and health of its capital assets.
- **Financial Strength:** This area is very similar to the GO debt where you are understanding the fiscal preparedness of an agency. For example, due to the droughts in California, the state's government introduced many measures for people to conserve water, which substantially decreased the water usage in California and in turn had a huge negative impact on local utility revenues.
- **Management Track Record:** This area refers to how the management team manages the utility rates charged to consumers, prepares and allocates the budget, and develops contingency planning to face adversaries in the future.

How Does a Rating Downgrade Impact a Municipality

Here are some ways a credit rating downgrade can impair a municipality financially:

- **Ability to Access to Capital Market:** Similar to an individual with a low credit score, a municipal credit downgrade will limit a municipality's ability to issue debt at favorable rates or access the markets completely, depending on the severity of the downgrade.
- **Increase in Cost of Capital:** With a downgrade comes the increase in the cost of raising capital; this applies to both existing credit facilities like lines of credit as well as new issuances. All the new issuances will consider the impact of COVID-19 on the collateralized revenues and what kind of risk it carries – which will determine the credit rating and the coupon.
- **Reporting and Monitoring:** All agencies that face some kind of change in credit rating or outlook have to self-report the change to the Municipal Securities Rulemaking Board (MSRB), which provides free public access to municipal market information to investors, municipal entities and other related entities.

The Bottom Line

Due to COVID-19, as businesses confront operating constraints due to social distancing and diminished consumer demand, the recovery path will likely be rocky. This economic shock in the private sector would trickle into the fiscal health of municipalities around the U.S. Municipal debt investors must subscribe to and carefully review all content coming out of rating agencies on the different sector of local governments and agencies.

dividend.com

Sep 21, 2020