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Fitch: U.S. Downgrade Has Limited Effect on Public Finance Ratings

Fitch Ratings-New York-04 August 2023: The recent downgrade of the U.S. sovereign Long-Term Foreign Currency Issuer Default Rating (IDR) to 'AA+'/Stable from 'AAA'/Rating Watch Negative does not directly affect the risk profile of most state, local government, and revenue-supported entities' ratings within the U.S. Public Finance (USPF) sector, Fitch Ratings says. Most USPF ratings are not affected, except where bond repayment depends on federal agencies or instruments.

U.S. state and local governments possess significant autonomy to provide services that they believe appropriate and impose the taxes needed to fund those services. The very high ratings assigned to many states and local governments reflect their record of using these powers to balance budgets and limit leverage. While the U.S. sovereign and U.S. sub-sovereigns share certain credit characteristics, the downgrade to 'AA+' does not lead Fitch to re-evaluate state or local government 'AAA' ratings absent a direct reliance on federal agencies or instruments.

Federal budgets directly support a wide range of functions carried out by USPF entities, and broader federal spending is meaningful to the economic activity that underpins the credit quality of issuers in the USPF sector. The ability of state and local governments to respond to changes in federal funding, primarily with their own spending adjustments, reflects their significant autonomy within the U.S. federal structure. States benefit from strong legal and fiscal powers enshrined in the U.S. Constitution, and states in turn delegate substantial fiscal powers to local governments. Local governments bear the added risk of having to absorb potential state tightening, although they typically have broad budgetary tools and reserves to cushion unforeseen developments. Additionally, many states and local governments exercise prudent fiscal management and currently benefit from unusually high reserves and solid liquidity given federal economic stimulus and extraordinary tax revenue growth in recent years. Rated revenue-supported USPF entities are also generally well-positioned to adjust to federal funding fluctuations.

Bonds directly linked to the sovereign rating include municipal housing bonds primarily secured by mortgage-backed securities issued by Ginnie Mae, Fannie Mae and/or Freddie Mac, pre-refunded municipal bonds where escrowed funds deposited with a trustee to advance refund the bonds are invested in U.S. government treasuries or federal agency obligations, and bonds fully enhanced by FHLB letters of credit.

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