

State And Local Government Ratings Are Not Directly Constrained By That Of The U.S. Sovereign

Primary Credit Analyst:

Gabriel Petek, CFA, San Francisco (1) 415-371-5042; gabriel_petek@standardandpoors.com

Secondary Contacts:

Robin Prunty, New York (1) 212-438-2081; robin_prunty@standardandpoors.com

Steven J Murphy, New York (1) 212-438-2066; steve_murphy@standardandpoors.com

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State And Local Government Ratings Are Not Directly Constrained By That Of The U.S. Sovereign

Despite Standard & Poor's Ratings Services' downgrade of the U.S. sovereign debt rating to AA+/Negative/A-1+, we may still assign a 'AAA' rating to some state and local governments.

We do not directly link our ratings on U.S. state and local governments to that of the U.S. sovereign debt rating for reasons outlined in our criteria. However, we recognize generally that U.S. state and local governments' economic performance is frequently similar to the nation and they share responsibility for some spending items with the federal government. Yet individual state and local governments' funding interdependencies with the federal government vary considerably. A minority of state and local obligors rated by Standard & Poor's have achieved the highest long-term rating of 'AAA'. We expect that many of these obligors, particularly those with relatively low levels of funding interdependencies with the federal government or those that, in our view, are likely to manage declines in federal funding without weakening their credit profile, should be able to retain ratings above the U.S. sovereign rating if we would otherwise assign ratings above the U.S. sovereign rating based on our view of other rating factors. However, in light of the potential for common economic and credit environments between the U.S. and state and local governments, we expect that in most instances in which state and local governments have ratings above that of the U.S., the differential will be limited to one notch.

Overview

- It is possible for state and local governments to have higher ratings than the U.S. sovereign rating, most likely by no more than one notch.
- We derive our credit ratings by evaluating a borrower's individual credit factors based on our credit rating criteria.
- A factor in rating a state or local government above the U.S. is whether it is insulated from negative federal intervention in fiscal management.

Our credit rating criteria allow for a higher rating on a state or local government than on the sovereign if, in our view, the state or local government demonstrates the following characteristics:

- The ability to maintain stronger credit characteristics than the sovereign in a stress scenario,
- An institutional framework that is predictable and that is likely to limit the risk of negative sovereign intervention, and
- The projected ability to mitigate negative sovereign intervention by a high degree of financial flexibility and independent treasury management.

Pursuant to our criteria, the fiscal autonomy, political independence, and generally strong credit cultures of U.S. state and local governments can support ratings above that of the U.S. sovereign.

Ability To Maintain Stronger Credit Characteristics Than The Sovereign In A Stress Scenario

A central feature of our U.S. public finance criteria is the independence of individual state and local governments from the federal government. In part, this is based on our view of the Tenth Amendment to the U.S. Constitution, which provides that rights not expressly given to the federal government remain with the states. Although our ratings reflect the role of the federal government in state and local finances and economies, we believe that this decentralized governmental structure in the U.S. suggests that we also analyze state and local government credit quality independent of the federal impact.

When viewing credits on a standalone basis, we expect that some state and local governments in the U.S. are capable of maintaining relatively consistent credit quality even through a period of stress at the sovereign level. Compared with many of their peers on a global basis, U.S. state and local governments function with a high level of revenue independence. Specifically, most state revenues (including almost all discretionary revenue) are derived within the states themselves, i.e., they do not come from the federal government. Revenues are even less linked to the federal government at the local level (although some state-shared revenues originate with the federal government). In addition, historically we have found that state and local governments generally have distinct credit cultures backed by well-established frameworks that provide for enforcement of important public finance laws. We view this to be important in the U.S. public finance setting because we predominantly assign issue ratings as opposed to issuer credit ratings. Debt issues in the U.S. municipal market tend to be backed by dedicated taxes, revenues, or fees and include specific protections that are legally enforceable in the U.S. context.

Given the depth and magnitude of the U.S. economy, state and local governments operate within a wide range of disparate economic bases throughout the country. We have found that some state or local economies regularly perform differently from that of the U.S. as a whole. Our criteria describe how we analyze the attributes of state and local economies and incorporate our analysis into our ratings. Beyond analyzing economies in isolation, however, we have observed that some state or local governments have more favorable balances between resources and responsibilities (i.e., they may be less leveraged) than the federal government. We believe that certain state and local governments have historically shown a greater commitment to fiscal discipline or a more resilient local economy, which may be reflected in ratings higher than that of the U.S. government. In a minority of cases (3.9% of U.S. public finance ratings), state and local governments currently demonstrate what we consider to be particularly strong credit characteristics consistent with our highest rating and, thus, are rated 'AAA'. Because we have assigned these ratings based on our view of individual rating factors pursuant to our criteria, we believe these ratings are appropriate notwithstanding the downgrade of the U.S. sovereign debt rating.

A Predictable Institution Framework, Financial Flexibility, And Independent Treasury Management

In our view, the institutional framework for U.S. public finance is among the most stable and predictable in the world. We believe this is primarily a result of the constitutional separation of power between the central and sub-national levels of government that is intended to restrain intervention in state and local government administration.

U.S. state and local governments enjoy considerable financial autonomy from federal intervention. State—and in

many cases local--governments have authority to establish and maintain laws pertaining to tax rates and collections, as well as the ability to add new taxes and other forms of revenue generation. In practice, receipt of federal funding typically requires a state or local government to satisfy various mandates, such as providing certain levels of service. And yet, participation in some of the programs for which federal funding is provided is voluntary. This includes Medicaid, the largest federal-state jointly financed social service.

In addition, U.S. state and local governments' treasury management is independent from the U.S. federal government. Although we consider stress scenarios in which federal disbursements could be delayed or reduced, thereby inflicting cash flow disruptions, state and local government obligors with 'AAA' ratings have, in our view, strong access to liquidity, likely allowing them to bridge such episodes.

Criteria Support Possibility Of 'AAA' State And Local Government Ratings

Participation in the U.S. economy and legal system provides a platform in which state and local governmental obligors can generally manage their finances and debt portfolios with considerable independence and without material risk of negative sovereign intervention. In light of this independence, our ratings largely reflect our view of local economic characteristics or state-level laws that may impede or strengthen state and local credit quality to varying degrees. Credit implications from these factors are detailed in our relevant criteria documents.

Related Criteria And Research

- USPF Criteria: GO Debt, Oct. 12, 2006
- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- Methodology: Rating A Regional Or Local Government Higher Than Its Sovereign, Sept. 9, 2009
- Where U.S. Public Finance Ratings Could Head In The Wake Of The Federal Fiscal Crisis, July 21, 2011
- U.S. State Ratings And Outlooks: Current List

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