Article Title: ARCHIVE | Criteria | Governments | U.S. Public Finance: Standard & Poor's Refines Its Limited-Tax GO Debt Criteria Data: (EDITOR'S NOTE: — This criteria article is no longer current. It has been superseded by the article titled "Issue Credit Ratings Linked To U.S. Public Finance Obligors' Creditworthiness," published Jan. 22, 2018.) GO bonds are one of the traditional ways for governments to obtain market access and are generally considered to have the broadest and soundest security among tax-secured debt instruments. GO debt possesses two unique attributes: It is the obligation of a governmental unit with the power to levy and collect taxes and is repayable, in the first instance, or ultimately, from general revenues; and It is backed by a pledge of the full faith and credit of the issuer. Sometimes, as in New York, the phrase is "faith and credit." For most municipalities, and in some states, such as New Jersey, the ultimate backup security will be a levy on the property tax roll of so much as is necessary, together with other revenues, to meet debt service payments on time. The pledge of the full faith and credit does not, in itself, make a bond a GO, although the issuer is pledging all of its legally available revenues. Although other types of borrowers use these pledges, this piece refers specially to those bonds issued by governmental entities. The powers of taxation and the availability of revenues are key considerations since the power of taxation is basic to the concept of a government's GO. Some local governments across the country issue GO bonds but have legal property tax rate limitations. Limited-tax GO bonds lack the strong inherent protection of an unlimited-tax obligation; but their presumed claim on all resources of the government, subject only to the property tax limitation, gives them support lacking in strictly special or non-GO limited-tax obligations. Standard & Poor's has long recognized that financial flexibility can result in limited- and unlimited-tax debt being rated at the same level for issuers with sufficiently strong credit characteristics, as has been the case in states such as Texas and Ohio. Due to the 1978 "Headlee" amendment to the Michigan Constitution, however, S&P; Global Ratings has often differentiated GO unlimited- and limited-tax debt ratings in Michigan. This approach is being revised based on the performance of Michigan credits. The Headlee amendment restricts overall mill rates to certain levels while excluding from those limits all voter-approved property taxes, such as those approved for debt service on unlimited-tax secured bonds and levies to pay debt service on bonds issued prior to Headlee's enactment. Tax rates can only be increased above these limits if authorized by the electorate. The aggregate tax levy for a taxing entity may not grow by more than the CPI, excluding new construction. The school reform measures of 1993-1994 further restrict growth in assessments by tying maximum annual growth, exclusive of new construction, to some measure of inflation. Whereas Headlee had linked increases in taxation to the annual change in the CPI, Act 145 restricts assessment growth to the lesser of CPI or 5%. Furthermore, assessment limits apply to individual parcels of property, not to an aggregate tax base, as with Headlee. These stricter limits apply to a parcel only until it is transferred, at which time the assessment reverts to state equalized value, or 50% of true cash value. Assessment growth caps, much like tax limits, restrict the growth in tax revenues received by a government, resulting in budgetary pressure. From a credit perspective, the stricter assessment growth limits of Act 145 have had a minimal effect on municipal credits. Michigan credit ratings have generally trended upward despite the tax limits. During periods of low inflation, tax revenue growth should slow but should be offset somewhat by slower growth in operating expenditures. Furthermore, as properties are sold or transferred, assessments will be relieved of the temporary restraints. In general, the credits in the categories of single-'A' and up should possess the financial stability necessary to sustain identical ratings on their unlimited- and limited-tax GO bonds. For credits with unlimited-tax ratings in the triple-'B' category, the decision to differentiate between limited- and unlimited-tax GO ratings will continue to be based on the following factors: Revenue or tax rate flexibility: Standard & Poor's will examine the dollar amount that could be levied if the issuer increased its tax rate up to its cap, measured as a proportion of total budget. Also included in the analysis is the amount of predictable revenues coming from other local sources, such as a steadily growing income tax, and expense flexibility, which can be used if needed. If the combined potential effect of expense and revenue flexibility is substantial, then the risk of a municipality not being able to meet its debt obligations due to short-term budgetary stress is reduced. High reserve levels: In a fiscal emergency, or following an extended period of budgetary imbalance, despite the inability to further tap into its tax base, a municipal government may use accumulated fund balance reserves in the general fund or in other unrestricted funds to cover fixed costs. Because reserve levels can change quickly, however, only issuers with a track record of consistently strong reserve levels that can be expected to be maintained may achieve equivalent limited- and unlimited-tax ratings. Frequently Asked Questions The criteria state that "in general, the credits in the categories of single-'A' and up should possess the financial stability necessary to sustain identical ratings on their unlimited- and limited-tax GO bonds". Does that mean that S&P; Global Ratings never rates limited-tax GO obligations in these rating categories different from the unlimited-tax GO ratings? Similarly, the criteria state that "for credits with unlimited-tax ratings in the triple-'B' category, the decision to differentiate between limited- and unlimited-tax GO ratings will continue to be based on the following factors": (1) revenue or tax rate flexibility and (2) high reserve levels. Is that the exclusive set of factors that may result in assigning a limited-tax GO rating lower than the unlimited-tax GO rating? While S&P; Global Ratings typically equalizes the ratings on limited-tax GO ratings and unlimited-tax GO debt rated 'A-' and above, under certain circumstances, limited-tax GO obligations could be rated lower. For lower-rated unlimited-tax GO credits, the two factors already mentioned in the criteria are not the only factors that could lead to a rating differentiation. For instance, regardless of the unlimited-tax GO rating level, we believe that the presence of certain unusual risks or structural elements (see below) could also lead us to assign a limited-tax GO rating one or more notches below that of the unlimited-tax GO rating. What are some examples of unusual risk characteristics (i.e. risks that are not adequately reflected in the issuer's unlimited-tax GO credit) which may lead to a rating's differentiation? In cases where the limited-tax obligations present risks that are underweighted in the issuer's unlimited-tax GO rating or the transaction has unusual structural elements, we use analytic judgment to determine our view of the obligation's credit quality relative to the unlimited-tax GO rating. For instance, if we view the pledged tax base as not indicative of the tax base of the obligor (e.g., represents only a relatively small portion of the municipality issuing the debt) or having exposure to risks that are significantly different or disproportionate to those reflected in the unlimited-tax GO rating (for instance, if the pledged tax base is in an area prone to natural disasters or presents unique concentration risks compared to the risks affecting the entity as a whole), we could rate the limited-tax GO bonds one or more notches below the unlimited-tax GO rating. Related Criteria And Research U.S. Local Governments General Obligation Ratings: Methodology And Assumptions, Sept. 12, 2013 Principles Of Credit Ratings, Feb. 16, 2011 Unlimited Property Tax Basic Infrastructure Districts, March 17, 2009 GO Debt, Oct. 12, 2006 These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as Standard & Poor's Ratings Services' assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.