Platte County, Missouri and the Risks of Complex Debt Portfolios

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In September 2018, Moody's downgraded Platte County, Missouri's general obligation (GO) rating eight notches to Ba1 from Aa2. The Moody's super downgrade resulted not from any change in the county's financial standing, but from Moody's view of "the county's lack of willingness to fulfill a contractual obligation" surrounding its current level of support for a local economic development project for which there are bonds outstanding. The project, and its bonds, carried a secondary pledge through the county's appropriation mechanism, and its decision to not appropriate for the project led to the downgrade action.

Table 1
Platte County September 2018 Rating Impacts

	Moody's	S&P
General Obligation	Ba1 from Aa2	Not Rated
Appropriation	B1 from A1	B- from A

Source: Moody's, S&P

Platte County is certainly not the first example where a general obligation bondholder has been substantially hurt by a lower-standing credit event. Other governments have offered support, through a weaker legal pledge, to bond-financed projects that did not meet expectations, and those investors have absorbed significant GO-level downgrades.

A thorough understanding of the debt structures in the local government sector can serve to mitigate or alleviate these derivative impacts within a fixed income credit portfolio. This approach should incorporate the view that prescribed rating agency methodologies could be arbitrarily and capriciously applied, and that the resulting rating actions may not directly speak to a government's financial wherewithal.

Table 2
No Collateral, Damage

Entity	Action Date	GO Rating Action	# of Notches
Lombard, IL	February 2014	B from BBB	6
Vadnais Heights, MN	September 2012	Ba1 from Aa2	8
Wenatchee, WA	May 2012	Ba2 from A3	5
Collingswood, NJ	September 2011	Ba1 from A1	6
Buena Vista, VA	June 2010	Ba1 from A1	6
Menasha, WI	June 2009	Ba2 from Baa2	3

Source: Moody's

While mitigating factors may anchor any given issuer or bond to a particular rating category, proper credit research must accurately assess the risk of deterioration and contagion. A sound credit process ought to include a full and accurate accounting of the debt portfolio in order to minimize the risk of having a lesser pledge adversely affect the GO rating of the parent. Although most issuers maintain a simplified, one-level debt stack (i.e. GO debt only), the remainder may be vulnerable to rating outcomes in the same manner as Platte County, Missouri. Debt complexity may be accompanied by an inclination to test "willingness" to pay, especially if those lesser pledges financed noncritical projects or endeavors, such as sports stadiums or dubious projects that fall under the rubric of economic development. While by no means all-inclusive, Table 3 comprises some examples of issuers with complex or multi-layered debt structures whose investors risk falling victim to GO downgrades in the same manner as those listed above.

Table 3
Complex Debt Structure Examples

Local Government	GO Ratings	Ratings of Lowest Pledge
Cincinnati, OH	Aa2/AA	Aa3/AA*
Ridgeland, MS	Aa2/NR	Baa2/NR
Placentia-Yorba Linda Unified School District, CA	Aa3/AA-	A2/A+
Greensboro, NC	Aaa/AAA	Aa2/AA+
Oklahoma City, OK	Aaa/AAA	Aa2/AA+

*S&P upgraded certain non-GO pledges in February, 2018

Source: Moody's and S&P

While the foregoing examples represent only a sliver of the market, in both debt outstanding and number of investors potentially affected, contagion of the remaining local government population is hard to ascertain. The resulting ratings transitions may prove to be deleterious to bond valuations, as mark-to-market prices adjust to the corresponding ratings downgrades. Conversely, municipal investors may opt to view the super-downgraded bonds as investment opportunities, positing an issuer's "unwillingness" on the lesser pledge as an affirmation of strength for the GO obligations.

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