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S&P Widens Lead Over Moody's as Bond Upgrades Surge: Muni Credit.

Standard & Poor's is pulling away from Moody's Investors Service in the business of grading U.S. municipal bonds. Janney Montgomery Scott LLC's Tom Kozlik says the gains reflect local governments shopping for the best ratings.

Of the $164 billion of long-term, fixed-rate debt issued this year through July, about 86 percent carried an S&P grade, while 74 percent used Moody's, data compiled by Bloomberg show. The difference of 12 percentage points is the biggest since at least 2007 and up from 5 percentage points in 2011 and 2012. S&P says its market share ranged from 86 percent to 91 percent in the six years through 2013.

A new methodology that S&P began implementing last year to assess localities will elevate more credits than it lowers, the New York-based company has said. While Moody's cut more muni ratings than it lifted in the first half of the year — a trend that has held for 22 quarters — S&P says it upgraded 1,255 public-finance issuers and reduced 410. The six-month tally of S&P upgrades compares with 1,415 in all of 2013 and 543 in 2012.

"This differentiation in S&P and Moody's should be problematic to investors who are counting on these ratings and trading oftentimes based only on the ratings," Kozlik, a municipal credit analyst at Janney in Philadelphia, said in a telephone interview.

"Issuers' actions to not include Moody's anymore are oftentimes because Moody's is a notch or two or three lower," said Kozlik, who published a report last month titled "Are S&P's Local Government Ratings Too High?"

Conflicting View

Investors in the $3.7 trillion municipal market rely on the two biggest rating companies, both of which trace their roots back more than a century, to satisfy mandates requiring they buy bonds rated above specified levels. Yet they're skeptical because of outsize ratings changes on issuers as large as Puerto Rico and as small as Vadnais Heights, Minnesota. Both have faced single downgrades of three or more levels.

Investors' view of the companies is further muddied by the industry's reigning business model, in which issuers pay for credit grades and can choose among ratings. Dallas-Fort Worth International Airport and Chicago Park District are among borrowers that dropped ratings in the past year from Moody's. The airport is graded one step lower by Moody's than S&P, and the Chicago district five steps lower.

'Careful' Approach

In June, 11 issuers published only an S&P rating even though they also had Moody's grades, according to Kozlik. The S&P rating was higher in every case.

“Whether someone decides to use one rating or another, we don’t control that,” said Jeff Previdi, one of the primary analysts on the criteria change for S&P, a unit of McGraw Hill Financial Inc. (MHFI) “What we do control is our analytics. We’re going to be measured on our opinions as to how they perform over time, so you can be certain that we’re going to be very careful and informed.”

Thomas Lemmon, a Moody’s spokesman, declined to comment on market share or the decisions of specific issuers. For this year through July, the company’s market share in munis is the lowest in Bloomberg data starting in 2008.

S&P, the world’s largest credit grader by outstanding ratings, and its peers drew scrutiny after they helped fuel a global housing bubble by awarding top scores to subprime mortgage investments.

Ratings Campaign

McGraw Hill and S&P face a Justice Department lawsuit, filed in February 2013, which alleges S&P deliberately understated the risk of securities backed by residential loans. S&P has said it will defend itself “vigorously” against the “meritless” claims.

Moody’s, S&P and Fitch Ratings in 2011 also settled claims by Connecticut that they unfairly gave lower grades to public bonds, leading the state, municipalities and school districts to pay higher interest rates than they should have.

That followed a campaign in 2008 by muni issuers led by California Treasurer Bill Lockyer for raters to elevate grades on states and localities. Moody’s and Fitch recalibrated their muni ratings in 2010 to a global scale.

When S&P finishes applying its new criteria for local governments, it estimates that 30 percent of the more than 4,000 issuers will have higher grades. Previdi said the company first focused on municipalities most likely to have their ratings changed, which helps explain the pace of this year’s upgrades. A recovering economy has also contributed to the increase, he said.

Share Range

“Over the past several years our market share has generally been in the mid-to-high 80 percent range,” Ed Sweeney, an S&P spokesman, said in an e-mailed statement. “We haven’t seen a significant divergence from that trend following the criteria change.”

S&P has an 89 percent market share this year through July, the highest since 2010, according to Sweeney.

The new methodology involves scoring a municipality on a scale of 1 to 5, with 1 being the strongest, on areas including the economy, management and budgetary performance.

“The problem with changing their criteria is it materially impacts ratings sometimes,” even when issuers’ fiscal health is unchanged, said Lyle Fitterer, who oversees $34 billion of munis at Wells Capital Management in Menomonee Falls, Wisconsin. “If a bond is rated, you have to use the ratings that are out there. It does impact your willingness to own it or buy more of it.”

Makes Sense

Having multiple rating companies offers states and cities opportunities to seek higher grades to lower borrowing costs, which “makes all the sense in the world,” Kozlik said.

Dallas’s largest airport stopped getting a Moody’s rating this year, said Michael Phemister, the facility’s vice president of treasury management. It paid Moody’s about $500,000 to rate its 2013 bond deals, compared with ranges of about $350,000 to $400,000 for S&P and Fitch, he said.

Moody’s didn’t give enough credit to the region around the airport, Phemister said. The company also cut its debt in March 2013 to A2, one level lower than S&P’s A+ and two steps below the AA- assigned by Kroll Bond Rating Agency Inc. this year. The company began grading muni issuers two years ago.

The Chicago Park District, Chicago Transit Authority and the Wisconsin Department of Transportation have also turned to Kroll for ratings, all of which are higher than Moody’s.

“That’s the curse of a new rating agency,” Jim Nadler, president of Kroll in New York, said in a telephone interview. “No one is going to add a fourth rating that is lower. You’ll never see the ones that we turn away or gave lower ratings to.”

Fee Factor

Moody’s, for its part, is also seeing the ratio of downgrades to upgrades improve as the economy rebounds, said Naomi Richman, an analyst in New York. The company revised its outlook on local governments to stable from negative in December. In June, it raised ratings on California and New York, which combined have more than $148 billion in debt.

Fees can also play a role in choosing a ratings company. Wisconsin’s $587 million general-obligation deal last year had ratings from Moody’s, S&P, Fitch and Kroll, according to David Erdman, the state’s assistant capital finance director. It paid the firms $100,000, $76,000, $55,000 and $50,000, respectively.

Revenue matters even more now in the muni business than in the past few years because states and cities are selling less debt, leaving the market poised to contract for a record fourth straight year.

Kozlik concludes that ratings shopping will probably continue, with municipalities choosing S&P even though Moody’s grades better reflect localities’ fiscal vulnerability.

That could cause investors — particularly individuals — to lose out on extra yield because of the higher grades at a time when interest rates are close to generational lows.

“When I see ratings shopping going on, I think about those small investors who are relying solely on the ratings,” Kozlik said. “S&P’s new criteria for local governments is just increasing that differentiation.”

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