

# Bond Case Briefs

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## Do Credit Ratings Matter Anymore?

Jan. 01-Chicago's finances aren't in great shape. And they've been getting worse in recent years. The city's pension debt has ballooned to eight times its operating revenue. Between 2002 and 2012, Chicago tripled its debt load. During that time, the city's population — its tax base — fell. As a result of all those factors, the credit market has reacted harshly. Fitch Ratings has downgraded the city's debt rating two notches, to A-, just since 2010. Meanwhile, Moody's Investors Service downgraded Chicago three notches over that time, to Baa1. That's just three steps away from junk bond status.

But then there's Standard & Poor's. Over the same period of time in which the other two ratings agencies have been gutting Chicago's score, S&P has kept its rating for Chicago locked at A+. These aren't minor differences. In fact, Chicago's three credit ratings are now spread across four of the 10 possible rating levels for investment grade bonds.

So what gives? How could three agencies look at the same set of numbers and come up with such disparate results? And how could two groups see a financial decline when a third sees economic stability? "We're talking about very dramatic differences," says Matt Fabian, managing director of Municipal Market Advisors (MMA). "When the rating agencies are so divergent, what guidance are investors left with?"

It wasn't very long ago that most governments could just buy a top-grade AAA rating no matter what their actual financial health was. Thanks to the bond insurance business, a government issuing bonds could just pay for an insurer to wrap the bonds with a AAA rating. Lower-rated bonds mean governments have to pay higher interest rates to investors. So in most cases it was still a better deal to pay a little extra for bond insurance upfront rather than higher interest rates down the road. The system worked — as long as the insurance companies could offer a AAA rating. But as those companies became more aggressive with their own investments, they too became victims of the financial market collapse in 2008. Those companies were downgraded, and a business that had once insured nearly half of all municipal bonds dropped practically out of existence. It changed everything.

Without the cloak of bond insurance, governments had to rely on their credit quality alone for the first time in decades. It was an unfamiliar practice, and not just for those issuing the bonds. Municipal market investors were, for the first time, required to look under the hood. What they found was often confusing. For one thing, the muni bond market is vastly different from the corporate market. And governments vary significantly from one another in terms of their level of disclosures and financial savviness. Complicating things further was the fact that credit ratings themselves increasingly began to vary. More and more, two different agencies would issue two different ratings for the same bond.

As a result, credit ratings — which were once essentially the only thing that mattered to investors — are today just one of the myriad things investors look at. A rating is an important starting point, but it doesn't have to dictate the kind of reception a government will actually get in the municipal market. Investors want to look at a whole host of factors to assess a city's fiscal health, and government finance officials are today much more likely to work directly with investors. Against that

backdrop, the ratings agencies' wildly divergent opinions on the overall health of the municipal market has led to increased skepticism about their own credibility.

In other words, if investors don't care about ratings as much as they used to, and if ratings agencies can't even agree on which way the muni market is trending, then what purpose do they serve?

Since the market crash, credit rating agencies' image as a whole has suffered greatly. They were blamed for helping to precipitate the crisis in the first place, by giving overly generous ratings to mortgage-backed securities that later turned sour. In February 2013, the Department of Justice even sued Standard & Poor's for \$5 billion, claiming that it knowingly issued unduly high ratings. (S&P says the lawsuit is simply a retaliation for the agency's high-profile downgrade of the nation's credit rating in 2011.)

When it comes to the municipal market, some observers see credit rating agencies in the middle of an alarming shift. Increasingly, two agencies will issue a different rating for the same municipal credit. In fact, today about 40 percent of municipalities that have ratings from different agencies have what's called a split rating, according to data from MMA. From the agencies' perspective, the variance is simply a result of their different approaches. And those differences help inform the market, says Bob Kurtter, Moody's managing director of U.S. public finance. "For the most part we see things similarly, and in some cases we don't," he says. "Investors are looking for a range in opinions and, for the most part, I think that's a good thing."

But to those on the outside looking in, the divergence is sending a different message to investors, says MMA's Fabian. "It does undermine the agencies' credibility," he says. "In theory, independent views should generally align with one another. So when they don't, it underscores a degree of subjectivity."

Exactly which agency's creditability has suffered more is, well, subjective. Last summer, municipal credit analyst Tom Kozlik released a scathing report that called into question the revamped ratings methodology that S&P had been applying over the prior year to reassess its local government ratings. The new criteria score municipalities in seven categories: management, economy, budgetary flexibility, institutional framework (governance), budgetary performance, liquidity and debt/liabilities. As a result of the new criteria, S&P has issued about 10 times as many upgrades as it has downgrades over the past year (although most of its ratings did stay the same). S&P acknowledges that the number of upgrades was higher than its analysts initially expected. But the agency attributes that to the unexpectedly positive results from the qualitative portion of its analyses of governments. In other words, the more subjective measures — particularly government management — were looking pretty good.

Meanwhile, Moody's — which has done a smaller revamp of its criteria, applying stricter standards to governments' pension liabilities — has been issuing about twice as many downgrades as upgrades.

All of this has led governments to pick and choose the agency they think will give them the best rating, according to Kozlik's report. More governments today are issuing just one rating when they go to market, he says — and their rating of choice is S&P. All three agencies have lost market share since their business boomed following the collapse of bond insurers, but S&P has held on to a greater share than either Moody's or Fitch. Even larger issuers, which traditionally have always needed to obtain more than one rating on new bond issues, are finding that they can get by with just one. Last year, Cook County, Ill., issued \$90 million in sales tax bonds and only used an S&P rating. "Years ago we would have done all three agencies," says county Chief Financial Officer Ivan Samstein. "But we thought that we could go with just one rating, and we chose to use S&P."

So who's getting it right? S&P's sunnier outlook or the more negative viewpoint of Moody's and Fitch? Unsurprisingly, that depends on whom you ask. Samstein says the mere fact that he was able to sell \$90 billion in bonds with just one rating, from S&P, means the muni market as a whole is more in line with S&P's more optimistic assumptions. And CFOs also have a duty to get the best price for taxpayers — after all, he says, a lower rating would have increased the county's borrowing costs. Still, adds Samstein, who previously worked as a public finance credit analyst at Moody's: "Most of the market knows, if you're a sophisticated institutional investor, you shouldn't really trust the ratings by themselves."

Governments these days are selling their product to a much more knowledgeable investor. After the collapse of the bond insurance industry, financial firms had to get smart — quickly — about municipal bonds. Analyst desks began opening up or expanding at major financial firms across the country. The Securities and Exchange Commission even established a new Office of Municipal Securities to keep watch over the market. It's no longer a cut-and-dried picture, says Washington, D.C., CFO Jeff DeWitt. The difference now, he says, is that cities and states must market themselves to investors. "The bonds aren't going to get sold as well if you don't get involved."

In fact the District of Columbia is looking to join the growing number of major municipalities that hold investor conferences, a convenient way for issuers in a particular region to connect directly with potential buyers. States like California and Massachusetts have well-established investor relations programs dating back several years. Last March, Massachusetts began selling bonds directly to investors, opening up a two-week period each month in which people can buy general obligation bonds directly from the state. The goal with MassDirect and all these types of programs is to create more competition for bonds, thus lowering the overall borrowing cost for governments.

The blossoming relationship between governments and investors means, among other things, that bond ratings don't carry the same weight as they used to. Of course, no CFO can schmooze his way out of an unfavorable financial status. A bad credit is a bad credit. But in the growing number of cases where municipalities receive two different ratings, finance officers can explain to investors why they believe the higher rating is more accurate and what the lower rating might not be taking into account.

A government's credit rating will always matter. An upgrade or a downgrade on a credit, especially a general obligation bond, still makes headlines. And ratings give everyone a rough idea of what kind of borrowing costs to expect.

But government finance officers are increasingly finding that a credit rating doesn't have to keep them from getting the deal they want — if they're willing to work for it. "Before 2007, I rarely talked to an investor," says DeWitt. "They'd call occasionally to ask a few questions. But after 2007, I talk to them all the time."

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