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Rise in Single-Rated Municipal Bonds Spurs Investor Concerns.

A trend toward single-rated municipal bonds has accelerated this year, raising concern among investors who were accustomed to two or three rating agency opinions to support their purchasing decisions.

Single-rating transactions represent about a quarter of new sales by par value so far this year, a 17.5% increase from the rate in all of 2017, according to a report this month from independent research firm Municipal Market Analytics.

The trend, driven by the need for cost savings as underwriting spreads narrow, has been underway since the financial crisis. That in turn has heightened the competition to provide ratings, as a fourth agency — Kroll Bond Rating Agency — made inroads in serving muni issuers along with Moody's Investors Service (MCO), S&P Global Ratings, and Fitch Ratings.

"If rating agencies lower their standards to appeal to issuer 'rating shoppers,' they essentially risk diluting their reputation and relevance," Richard Ciccarone, chief executive officer and president of Merritt Research Services, said this week.

Perhaps the most concerning aspect of the trend, buyside experts said, is that issuers have an incentive to opt for the highest single rating, which cuts down on transaction costs, but can deny investors comprehensive credit research, disclosure, transparency, and surveillance that was the norm for decades. The trend toward single opinions also reduces issuers' accountability, the experts said.

"Since rating criteria are more transparent that ever, it is easier to pick a rating that might favor a borrower based on how it stacks up with agency criteria, pre-screening and existing ratings," Ciccarone said. "Having one rather than two or more ratings becomes a risk especially to less sophisticated investors if issuers are shopping for only the ratings that cast them in the best light."

According to MMA analysts Matt Fabian and Lisa Washburn, the single-rated market has increased to 25% — up from only 13.4% of the par issued that carried one rating back in 2007.

Dual and triple-rated transactions — those rated by Moody's, S&P, and Fitch — dropped by 4% year to date to 36.1% and 32.3%, respectively, the report showed.

Triple-rated, dual-rated, and non-rated transactions also shrank during the first five months of 2018 from 2017 levels, the report showed.

"We see little evidence that this trend will abate — at least in the near to medium term," the analysts wrote.

In aggregate, there were 1.94 ratings per dollar of par issued year to date in 2018, compared with 1.97 in 2017 and 2.29 in 2007, according to the MMA data.

Due to a changing market, issuers have to worry about keeping their fiscal houses in order, and controlling costs is part of that equation, Ciccarone said. “Lower margins on underwriting and a greater urgency to hold down issuance costs puts more pressure on issuers considering whether two or more same grade ratings is worth the price.”

The trend toward single-rated deals raises the possibility of rating shopping, said David Litvack, head of tax-exempt research of U.S. Trust.

“Whenever I see a bond rated by only one agency, I have to ask myself, ‘Did the issuer do this to save on rating fees, or would the other agencies have rated this bond lower?’ ”

Other analysts said the impact will vary for different investors.

Mark Tenenhaus, director of research at RSW Investments, said while most buyers prefer two ratings, most retail investors do not distinguish about the number of ratings on a transaction, and don’t look askance at issues just because they are single-rated.

“It is no longer a stigma for quality credits,” he said.

In addition, seasoned issuers with one rating do not present an issue, as buy side firms rely on their own analytics, according to Tenenhaus.

“Buy side analysts can typically tell if an agency was dropped because of a lower historic rating or threat of one,” he said, adding that the larger investors are the best prepared for a continuation of the trend.

“While the rating agencies provide value with their reports, institutional buyers rely on their own assessments,” he said.

Ciccarone said there are probably fewer institutional investors that require two or more major agency ratings than there were years ago.

The need is diminished, he said, since “they exercise and tout the strength of their own research teams.

“Over the past 10 years, institutional investors have been building stronger research efforts on their own, including quantitative screen and credit scoring capabilities that reinforce and enhance their own ability to distinguish credit quality and defend those positions with clients — and even regulators,” Ciccarone said.

While institutional investors do have their own credit teams, that doesn’t alleviate all concerns, especially in the secondary market.

“If an issuer is an infrequent borrower and only rated by one agency, we are concerned that no one has looked at the credit in detail for several years,” said John Donaldson of Haverford Trust.

He said the firm passed on a recent offering for a municipality that had not issued bonds since 2012.

“The lack of transparency was compounded as the sole rating agency has a policy that the issuer was too small for them to assign an outlook,” Donaldson said. “That is when only one rating is a real issue for us.”

Some experts said the competition among rating agencies has intensified as Kroll made inroads.

“While some time ago Fitch was the new kid on the block, now there is a fourth agency at a time when one-rating-only gains traction,” Donaldson said.

Ciccarone agreed that not only Fitch, but KBRA has made more “inroads” in the rating sector lately and that has helped the trend of shopping for ratings “gain traction.”

Other factors that can drive the market share of single-rated deals are sector and state issuance trends, MMA said.

S&P remained the lead rating agency in terms of market share, rating 74.1% of the year to date par issued, compared with 71.1% and 48.8% for Moody’s and Fitch, respectively, based on Bloomberg data included in the firm’s report.

While S&P also dominated single ratings with 55% of the par year-to-date, it was the only one of the three agencies that saw a decline in overall market share, from 77.1% in 2017.

The analysts said that was thanks to a surge in issuance of gas prepayment bonds, a sector primarily rated by Moody’s and Fitch.

At the same time, however, S&P was the sole rater on New Jersey’s $3.1 billion refunding of its tobacco securitization bonds earlier this year.

In addition, the other agencies got exposure to large deals where Moody’s didn’t provide a rating.

For instance, Chicago-related issuers and the state of Connecticut didn’t seek a Moody’s rating on several large 2018 sales, the MMA report noted.

“Moody’s loss was Kroll’s gain as the newest agency rated the majority of par associated with these transactions,” the MMA analysts said.

Overall the analysts revealed both an upside and downside in the trend of single-rated transactions.

“Curtailing costs related to borrowing is even more important in the current environment in which expense growth is generally outpacing revenue growth for state and local governments,” they wrote.

Institutions may see less impact, the analyst predicted.

“Fewer ratings means a reduced risk that rating methodology and opinion changes will crop up and undermine pricing,” according to Fabian and Washburn. When this does occur, they said the changes “could be more impactful since there are fewer alternate public opinions.”

“In theory, this reduced rating agency penetration could mean greater investor influence on pricing, although we suspect that this will not be the case in the current market where demand outstrips supply,” they added.

On the downside, the analysts believe there are pitfalls as well.

“Fewer constraints on borrowing reduces fiscal discipline and may encourage ill-advised borrowings for deficits, pensions, OPEBs, and riskier economic development projects versus budget balancing by raising revenues or reducing expenditures.”

For the buyside, MMA said the non-professional investor is the most disadvantaged by the trend toward fewer, higher ratings.

“This group is generally more inclined to place greater weight on ratings and are less likely to handicap the positive effect of issuer-selected opinions,” the analysts wrote.

Rating agencies’ participation in new transactions, whether through single or multiple ratings, is still seen as a vital part of the municipal market, Ciccarone said.

“Independent and credible rating agencies still remain critical players in an active, efficient, and transparent municipal trading market, as well as essential to proper bond pricing.” Ciccarone said. “It’s a challenging environment for rating agencies.”

By Christine Albano

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