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What Dodd-Frank Has Done for Muni Ratings.

WASHINGTON – Federal financial reforms designed to reduce the less favorable treatment by rating agencies of municipal bonds compared to corporate bonds have resulted in higher ratings, fewer downgrades and lower bond yields, according to a just-released research paper.

The paper, titled “The Impact of Dodd-Frank on Credit Ratings and Bond Yields: The Municipal Securities’ Case,” is among those featured at the Brookings Institution’s 7th annual Municipal Finance Conference. The paper’s lead author is Craig Johnson, a professor at Indiana University’s School of Public and Environmental Affairs. His co-authors are Yulianti Abbas and Chantalle LaFontant.

The analysis, which focuses on S&P Global Ratings’ muni ratings from 2004 to 2014, stems from Johnson’s interest in determining whether the Dodd-Frank Act affected munis differently than corporates.

Johnson was starting from some conclusions established by previous work on the corporate market, which found that Dodd-Frank caused credit rating agencies (CRAs) to issue lower ratings in the municipal market.

In academic literature this effect has been termed the “reputational hypothesis,” the idea that tighter regulation will cause credit rating agencies to issue more pessimistic ratings in order to protect their reputations.

Johnson and his fellow researchers found the opposite case or “disciplining hypothesis” to be true in the muni market. The disciplining hypothesis states that rating agencies react to new regulation by trying to improve their methodologies to avoid running afoul of the new rules. That’s the effect new laws and regulations intend to achieve.

Former Congressman Barney Frank, the Massachusetts Democrat for whom Dodd-Frank was partly named, was particularly interested in trying to get rating agencies to represent risk in the muni market the same way they did for corporates, which would result in higher muni ratings.

Muni market participants have griped for years that this has not been the case, as munis have defaulted at lower rates than similarly rated corporate bonds. While Johnson’s study did not analyze the differences in default rates between munis and corporates, he said the question of whether Dodd-Frank was working to level the playing field was central to his work.

“Was this going to put the risk/reward between municipals and other sectors on par?” he asked.

Johnson said his study used S&P ratings because S&P was the only one of the three largest agencies to have not publicly announced a change to its methodology following Dodd-Frank.

Johnson found that the probability a state general obligation bond will be rated higher after Dodd-Frank is 2.7 times greater than before Dodd-Frank. Further, the study revealed that total S&P actions (including rating changes, outlook changes, and watches) decreased by 17.3% and negative actions decreased by about 11.6%. Rating downgrades decreased by 9.51%, while rating upgrades increased by 8.29%.

“Our results provide evidence of greater rating stability after Dodd-Frank and are consistent with the disciplining hypothesis,” the researchers wrote.

The study also looked at bond yields and found that they were lower across all asset classes after Dodd-Frank. It found no change among unrated bonds, suggesting that the ratings were affecting the yields rather than other market forces.

Johnson and his colleagues concluded that their results highlighted “the consequences of the gaping holes in the patchwork system of municipal disclosure.”

Unlike in the more tightly regulated corporate market, he told The Bond Buyer, credit rating agencies may play an outsize role in providing information to municipal investors.

“Even though the municipal market in general, and state government GO bonds in particular, represent a low-risk sector of the fixed income market, CRAs not only certify to the interpretation of publicly available information, but they may also reduce the uncertainty associated with a system lacking complete and timely disclosure,” Johnson wrote.

Johnson, who has his PhD from the State University of New York at Albany, has been researching municipal finance topics for many years. He previously published work on tobacco bonds, government borrowing costs, and the impact of Dodd-Frank on the fiscal management of state and local governments. Before that, he worked as a budget analyst for the state of New York and as a legislative policy analyst at the New York State Assembly.

By Kyle Glazier

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