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Has S&P Been Exaggerating Local Governments' Stability?

One analyst says the new way the credit rating agency scores local governments downplays the risk investors are taking and could encourage ratings shopping.

Since last fall, when S&P released new scoring criteria, the agency has been reassessing ratings for thousands of local governments. Generally, and as predicted by S&P itself, the new criteria resulted in more upgrades of governments than downgrades. But a Janney Montgomery Scott analyst pointed out in his July note on the bond market that those changes have not put S&P's ratings more in line with competitors Moody's Investors Service and Fitch Ratings.

In some cases, rather, agencies' ratings scores for the same local governments have diverged even more.

"I do not remember a time when I saw so many credits with not just a one-or-so-notch difference here and there, but multiple-notch differences in some cases," said Tom Kozlik, the analyst who wrote the note. "This is not part of the typical ratings cycle (where sometimes one rating agency is a little higher and vice versa, I suspect). As a result, I expect that rating shopping could be on the rise if the current trend continues."

Ratings shopping, where a government issuer chooses to publish just its highest credit agency rating, came under scrutiny in the aftermath of the financial crisis but the focus from regulators and investors was on the rosy ratings from all credit agencies assigned to mortgage-backed-securities. According to Kozlik, however, investors should bring similar skepticism to S&P's ratings of local governments. "In other words," he wrote, "we do not think that some of S&P's ratings reflect the risk investors are taking."

Jeff Previdi, the S&P managing director for local governments who spearheaded the agency's criteria change, defended the process. He said that the criteria had been heavily tested and had gone through a public comment period. The new criteria scores municipalities in seven categories: management, economy, budgetary flexibility, institutional framework (governance), budgetary performance, liquidity and debt/liabilities. The score for economy counts for 30 percent of the total score; all other categories are given a 10 percent weight.

The intent was to make the process and scoring as transparent as possible, Previdi said. Additionally, he added, the upgrades have tended to outpace downgrades for a very simple reason: Governments are doing better now than when they were last assessed.

"When we are reviewing under the new criteria, we're not working with the same metrics of the old criteria," he said. "It's not done in a vacuum. Over this time we've been in a generally positive environment for local governments — that's informing some of the results you see."

Even so, Kozlik noted in his report that there has been a pattern of governments only publishing an S&P rating. In June, for example, there were a little more than 200 local governments that sold debt competitively. Of those, one-quarter of them only published an S&P rating, according to Kozlik's review. Another 11 governments only published an S&P rating but also had an outstanding Moody's

rating within the past three years (Kozlik dismisses 16 cases where the outstanding Moody's rating is prior to 2011). Like S&P, Moody's has also revamped its ratings criteria in the wake of the financial crisis, however changes have mostly focused on giving pension and other long-term liabilities more weight in the final score. Most local government pension liabilities shot up during the financial crisis and many have still not gained back much – if any – ground. This change has contributed to Moody's issuing more downgrades.

Kozlik also took issue with S&P's assessment that the economy has significantly improved for local governments. Earlier this year, Janney released a report calling for a cautious outlook for local governments based on stagnating revenues that are not keeping pace with demands. "Sure, in some cases a year or two can make a significant difference in municipal credit quality." he said. "I also think that there are too many [cases] for timing to be a key factor in explaining the trend."

He concludes the note by advising investors that own a bond with only an S&P rating, to review the credit themselves and check to see if it also has a Moody's rating. Moody's has been issuing about twice as many downgrades as it has upgrades, "a trend that makes sense to us," Kozlik wrote, "because we are still seeing mostly difficult credit conditions pressure local governments."

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