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SEC Rating Agency Reforms Positive for Munis.

WASHINGTON – The Securities and Exchange Commission's new credit rating agency reforms seem to make some positive strides for the muni market by creating parity between municipal and corporate bond ratings and increasing rating methodology transparency, sources said.

The rule, adopted on Wednesday by a 3-2 vote, codifies requirements of the Dodd-Frank Act of 2010 that were put in place because of mistrust stemming from credit rating agencies giving high ratings to securities that ended up defaulting and contributing to the financial crisis.

The rules for rating agencies, designated by the SEC as nationally recognized statistical rating organizations, or NRSROs, require them to put in place policies and procedures designed to ensure quality control of the ratings, publish a certificate with every rating that discloses the methodology used and limitations or uncertainties of the score, and apply rating symbols universally for all obligations.

The reforms of most concern to the muni market are effective nine months days after publication in the Federal Register.

Under the new rules, the rating agencies will have to have policies and procedures in place designed to assess the probability than an issuer will default, a positive for munis, which have lower default rates than corporate bonds.

Dustin McDonald, director of the Federal Liaison Center at the Government Finance Officers Association, said issuers had been eager to see munis rated the same way as corporate bonds.

Because muni defaults are extremely rarely relative to corporates, market participants and lawmakers including retired Rep. Barney Frank, D-Mass., pushed for a universal scale. A BNY Mellon analysis published last year showed that three years after being rated A, muni bonds had a default rate of about one in 10,000, versus about 41 out 10,000 A-rated corporate bonds. The NRSROs also will have to publish material changes to their procedures or methodologies, the reason for the change, and the likelihood that the change will cause current ratings to change.

"I would definitely view that as a positive," McDonald said.

Other aspects of the rule are designed to curtail potential conflicts of interest, and forbid rating analysts from participating in sales and marketing activities. The agencies must also perform "look backs" and revise ratings that were improperly influenced by business considerations, such as the prospect of future work for the issuer.

SEC chairman Mary Jo White, who joined with commissioners Kara Stein and Luis Aguilar in approving the rule, said it was necessary to crack down on compensation arrangements or performance review procedures that incentivize analysts to award inflated ratings.

"We must address these channels of influence if we are to prevent the full range of potential conflicts of interest that can lead to deficient credit ratings," she said.

Aguilar said the SEC could go even further by evaluating the “issuer pays” system, which is common in the muni market. Issuers pay the rating agencies a fee in return for getting a rating, which they need in order to effectively market their bonds.

“The commission should consider proposing rules that would more directly address the conflicts that arise when rating agencies are paid by the very issuers of the products they rate,” Aguilar said. “This conflict of interest continues to jeopardize the quality of credit ratings today. If we are to restore integrity to the ratings process, the commission must address this conflict of interest in a meaningful and effective way.”

Commissioners Daniel Gallagher and Michael Piwowar voted against the rule, saying it created a compliance nightmare, particularly the prohibition on marketing activities influencing analysts.

“This new prohibition is solely based on state of mind – there is no requirement that any action be taken,” Gallagher said. “Even if the rating process is effectuated without any abuse, we could theoretically still pursue the analyst unfortunate enough to display evidence that a stray thought related to sales and marketing considerations crossed his or her mind.”

Piwowar sounded similar concerns, and also voiced disagreement with the idea of a universal rating standard for all securities.

“I agree with the concern that credit ratings may be confusing and even downright misleading if they are not applied consistently,” Piwowar said of the rating symbols. “But academic research indicates that trying to achieve perfectly comparable rating scales is not only impractical – it is impossible. Despite any efforts by the credit rating agencies to maintain ratings comparability, the risk profiles of distinct asset classes are significantly different and thus result in varied performance of the instruments.”

Rating agencies, which have waited for the rules for more than four years, expressed a readiness to comply.

“The markets must have clear and consistent rules for credit-rating agencies, and the SEC’s regulatory framework will help ensure investors have confidence in the rating process,” said Daniel Noonan, managing director at Fitch Ratings.

David Wargin, a spokesman for Standard & Poor’s, said his agency is determining what impact the new rule would have.

“We are evaluating the new regulations to determine what changes to our operations may be required,” he said. “We are committed to the highest standards in our ratings activities and complying with the new requirements.”

Moody’s Investors Service declined to respond to a request for comments.

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