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S&P Defends Higher Municipal Credit Ratings.

Over the last year, the credit agency upgraded 41 percent of local governments' ratings, drawing skepticism from some.

As rating agencies, following the financial crisis, have sought to maintain their credibility, the divergence between the ratings that those agencies have doled out to governments has increased. Over the last year the number of issuers that have one rating from Moody's Investors Service and a different one from Standard & Poor's (so-called split ratings) has increased to nearly half, or 46 percent of all investment-grade rated municipal bonds.

Much of the focus has been on S&P, which over the past year has upgraded about 1,600 local governments' ratings as it has applied its new scoring criteria. An upgrade means those governments will likely get a more favorable interest rate on their bond sales than they did in the past, ultimately helping that government save money on borrowing costs. S&P's shift toward higher ratings have drawn skepticism from some observers. But the agency's analysts this week said the higher level of upgrades are simply because after they took a peek under the hood, the local government sector is doing better than analysts initially thought.

Of the roughly 4,000 local governments S&P re-evaluated over the past year, 41 percent received a ratings upgrade, 55 percent received the same rating and 4 percent received a downgrade. S&P initially predicted a more negative picture before it started its reviews – analysts figured only one out of every three governments would get an upgrade while 10 percent would be downgraded. The unpredicted level of upgrades was largely due to the fact that initial predictions were based on old financial and economic data and didn't include any of the more subjective components of S&P's scoring criteria, said analyst Chris Krahe.

"Management is a key piece," Krahe said in a webcast presentation regarding the conclusion of the ratings re-evaluations. "We had conversations with management teams and those discussions bring about insights about plans they have, expectations for future years, [and so on]. That's a very key part of the qualitative analysis we took into account…that was not part of the initial predictions."

Better information also played a role, he added. Many of the unpredicted upgrades were due to things like getting new audited information or updated economic figures.

The ratings criteria had been tested and went through a public comment period in the year before S&P began using it to re-evaluate its government ratings. 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. Key changes in the scoring criteria included giving more weight to the local economy score and adding more factors to the management score to take into account performance under financial stress.

Meanwhile, counterpart Moody's is issuing more downgrades than upgrades and it's leading some to question S&P's tack. In July, a Janney Montgomery Scott issued a fiery note that wondered whether the divergence in ratings would lead to governments only publishing their best rating, a practice known as ratings shopping.

“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,” Tom Kozlik, the analyst who wrote the note, told Governing at the time. “This is not part of the typical ratings cycle, where sometimes one rating agency is a little higher and vice versa.”

Struggling governments have certainly grabbed the headlines but S&P this week reiterated its view that the local government sector as a whole is “strong and stable” with a historically low default rate. Therefore, the agency’s ratings reflect that strength. The ratings upgrades generally resulted in a percentage shift from government credits that S&P had previously rated in the single-A category moving up into the double-A category. (The triple-A category, the highest rating, also saw an increase in the number of governments that S&P qualified for that tier.) The portion of governments S&P rated at triple-B or lower (junk status) stayed the same.

“We don’t want to appear unaware that there are pockets of stress that could occur, said analyst Lisa Schroeer. “But we wanted this framework to be written in a way that doesn’t penalize the entire sector.”

Others agree. “As an asset class, municipals have an extremely low default experience, higher ratings are better supported by the data,” said the Aug. 25 issue of Municipal Market Advisors’ weekly research brief (emphasis included). The brief added that S&P’s approach to scoring governments’ credit is more forward-looking than Moody’s, which accounts for some of the divergence between the two.

Now that S&P has reevaluated its local credits, it plans on using the new data it has to issue more reports that look at broader themes and trends in local government.

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