
[Misrated Muni Market Hoists $1.8 Billion Annual Tab on Taxpayers.](#)

U.S. states and localities still aren't getting the respect they deserve in fixed-income markets five years after Congress mandated that municipal debt be graded on a level playing field with company borrowings.

So says a study co-authored by Marc Joffe, principal consultant with Public Sector Credit Solutions in Walnut Creek, California, which estimates the misgrading adds about $1.8 billion a year to the cost of state and local-government debt. While rating companies have revised thousands of issuers higher, many grades still don't reflect municipal bonds' low default rates, said Joffe, a former Moody's Investors Service analyst.

"Taxpayers are the losers," said Joffe, whose study will be published as soon as August by the Haas Institute for a Fair and Inclusive Society, a policy center at the University of California at Berkeley. "This results in a transfer from taxpayers to municipal bondholders."

The Dodd-Frank Act, being phased in with new rules that take effect Monday, is designed to change that by requiring credit grades to reflect the risk of default while also expanding the Securities and Exchange Commission's ability to police the assessments.

Adjustments Made

Standard & Poor's adjusted its ratings "to a common set of stress scenarios and definitions" to make ratings across asset classes comparable, according to a statement from Alex Ortolani, a spokesman in New York. Moody's said in a June 8 press release that it has taken the steps to comply with the act.

"Fitch Ratings is prepared to implement a number of policy and procedural changes in response to new and amended SEC rules which take effect on June 15," Daniel Noonan, a spokesman, said in an e-mailed statement.

Historically, ratings haven't reflected the safety of local debt: Munis graded single-A defaulted at less than one-third the rate of like-ranked corporate debt over the 30 years through 2010, according to a study published last month by researchers at Rice University, American University and Georgetown University. Two-dozen municipal bonds out of 22,000 securities in Concord, Massachusetts-based Municipal Market Analytics Inc.'s database are in default.

2008 Pressure

"Default statistics show that muni ratings are too low, so anything short of AAA is not going to reflect default risk," said Matt Fabian, partner at Municipal Market Analytics. The new standard will lead to upgrades, he predicts.

Municipal issuers led by former California Treasurer Bill Lockyer began pressing rating companies in 2007 to show investors how they'd be assessed on a corporate scale. The localities said the system at the time raised borrowing costs because ratings didn't fairly reflect low default rates.

In 2010, Moody's and Fitch, both based in New York, revised their muni ratings to a standard used for corporations: default risk. Previously, municipal grades were based on various financial metrics. S&P also began revising rankings. In the year through September 2014 it raised at least 1,600 general obligations.

The difference between yields on double-A and single-A munis underscores the potential cost savings from an upgrade. An index of double-A munis has a yield to maturity of 3.13 percent, compared with 3.8 percent for single-A, Bank of America Merrill Lynch index data show.

Enforcement Actions

The Haas Institute's estimate of the $1.8 billion yearly tab is based on the extra interest expense and the cost of buying bond insurance to raise ratings, according to Joffe, who says he's an independent researcher and has developed a model for local-government credit scoring.

Congress passed Dodd-Frank in 2010 to prevent a repeat of the near-collapse of financial institutions during the recession. Besides requiring more disclosure of ratings criteria and default data, the act stipulates credit grades be applied "in a manner that is consistent for all types of securities."

Under the rules that take effect Monday, the SEC will be able to bring enforcement actions to ensure that the companies consistently evaluate debt fairly across asset classes.

The agency had no further comment beyond the rule, according to Kevin Callahan, a spokesman.

'Acid Test'

States and cities still have doubts about whether rating companies have gone far enough.
"I am skeptical about whether changes in the scale will lead to that" fair assessment of municipal default risk, said Jonas Biery, debt manager for the city of Portland. "You don't really see it doing anything for municipal credit."

The academic study showing the disparity in defaults between single-A munis and like-rated corporate debt has relevance for California, which is graded A+ by Fitch and S&P, and one level higher by Moody's.
The state, which has never defaulted and is the biggest issuer of municipal debt, is still rated on par or lower than companies with a higher risk of default, Catalina Martinez, spokeswoman for state Treasurer John Chiang, said in an e-mail.

In early March, California sold general obligations maturing in March 2025 at a 2.38 percent yield, while similarly rated Franklin Resources Inc. issued senior unsecured notes later that month that were due in 10 years and fetched 2.87 percent.

"The acid test for whether the federal law has been successfully implemented will be in whether ratings track with default rates," Martinez said.

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