Ratings Agencies Diverge on Post-Default Approaches.

Kroll Bond Rating Agency last week weighed in on post-default ratings, a subject of increasing interest in the municipal industry.

Four of the five biggest municipal bankruptcies in United States history have taken place in the last four years. And the Puerto Rico Electric Power Authority will almost certainly create the greatest municipal default in U.S. history within the next few months.

Kroll noted the "changing landscape" in its Oct. 2 report, "Shouldn't Defaulting on Debt Have Rating Consequences."

While predicting defaults will remain low, the rating service said, "we do expect there will be a higher default rate going forward with substantially lower recoveries than has been experienced historically."

When an issuer defaults the agencies lower its rating, though not necessarily to the lowest grade. Kroll, like Moody's Investors Service would take into account recovery prospects. So even if the issuer has already defaulted, they may give the issuer something better than their lowest ratings based on prospects for a strong recovery on the debt.

Fitch Ratings and Standard & Poor's do not take into account recovery expectations in determining their lowest ratings.

The ratings agencies also vary in how they treat defaulted issuers in the years following defaults. Moody's and Fitch are flexible. S&P and Kroll take more systematic approaches.

Moody's doesn't have a general policy on how it deals with issuers in the years after default because the situation of credits vary so greatly, said Moody's spokesman David Jacobson.

At Fitch, "We consider the credit fundamentals of the issuer as it emerges, the restructured financial profile and the degree to which the forces triggering bankruptcy have been addressed," said Jessalynn Moro, head of U.S. local government ratings. "If the credit fundamentals leading to an issuer's default are unchanged post-default, the rating will remain low, in non-investment grade territory," she said in an email. "Conversely, if an issuer is able to restructure its revenue, expenditure and/or debt profile in a way that makes default less likely in the future, Fitch's rating will reflect those new fundamentals."

Kroll said it "will generally view a decision by a municipal issuer to default on its debt as the basis for assignment of a non-investment grade rating for an extended period of time. KBRA will take this rating approach both for general obligation and non-general obligations debt which has been placed into default." Adoption of a plan to repay bondholders in full may mitigate Kroll 's position. "KBRA will not take this long term position of assigning a non-investment grade rating in a situation where a municipality has been through a Chapter 9 bankruptcy but has not defaulted on its debt, although KBRA may assign a non-investment grade rating during the bankruptcy process," the report added.

“It is KBRA’s view that the decision to default on a municipal debt payment reflects an essential unwillingness to pay its obligations on the part of the municipal issuer,” Kroll said. “In KBRA’s view, the decision to upgrade a credit to investment grade post-default would be based on successful implementation of a long term plan to maintain fiscally balanced operations and pay its obligations as well as fund the ongoing operations of the local government.”

Before considering an upgrade, KBRA would need to see evidence of “significant progress towards these goals over an extended period of time.”

S&P explained its position on defaulted issuers in a September 2013 report on U.S. local government general obligation ratings:

“While the issuer credit rating of a local government would fall to ‘D’ or ‘SD’ following a default on an actual debt obligation, the payment prospects for other GO debt may remain stronger (such as when the default results from insufficient funds for limited-tax GO debt and other GO debt enjoys an unlimited-tax pledge),” wrote S&P analyst Jeffrey Previdi and eight others. “Consistent with our criteria for appropriation-backed obligations, a failure to pay a capital lease obligation also caps the GO rating.”

S&P didn’t immediately respond to a request for details on how it treats ratings of defaulted obligations in the years that follow a default.

THE BOND BUYER

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