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[10 Years Later: Less-Trusted Rating Agencies Maintain their Central Role]

The municipal market remains skeptical of the rating agencies 10 years after their bad calls on mortgage securities contributed to the worst economic meltdown since the Great Depression.

While S&P Global Ratings, Moody's Investors Service and Fitch Ratings have overhauled their practices since the Great Recession and still provide credit grades on about 92% of municipal bonds, market participants say they don't rely on the agencies as they once did.

"The rating agencies are better than they were before the financial crisis," said Marilyn Cohen, president of Envision Capital Management. "But we use the ratings as suggestions and not the Holy Grail."

RATINGS AND THE FINANCIAL CRISIS

In the years leading up to the Great Recession, the ratings agencies issued profoundly wrong ratings that played a decisive role in creating the recession. Most famous among these were triple-A ratings of mortgage backed securities. When the economy turned sour, large portions of the securities went into default and the lax standards that were used in approving the underlying mortgages became apparent.

"Perhaps more than any other single event, the sudden mass downgrades of" ratings for residential mortgage backed securities and collateralized debt obligations "were the immediate trigger for the financial crisis," an April 2011 Senate report on the origins of the crisis said.

The collapse of these securities had a cascading effect, leading to the collapse of the investment banks Bear Stearns and Lehman Brothers (LBM/2C09).

Lehman was rated A2 by Moody's, A by S&P and A-plus by Fitch when it became the world's biggest bankruptcy ever, in September 2008.

Most of the municipal bond insurers had expanded their offerings to include insuring the mortgage backed securities. The ratings agencies failed to foresee the risk and when the Great Recession hit, seven bond insurers that had pre-recession triple-A ratings collapsed.

Before the Great Recession, the ratings agencies gave the overwhelming majority of municipal issuers investment grades. For the most part, during the Great Recession the issuers showed themselves worthy of their rating. Since the recession, defaults among S&P Global Ratings-rated municipal bonds have been rare and default rates in the sector have remained extremely rare, said S&P spokeswoman April Kabahar.

However, in the last 10 years, in part because as a result of the economic crisis, several major obligors have defaulted. Five of the six biggest municipal bankruptcies in U.S. history have taken place since the Great Recession.

Moody's, S&P and Fitch downgraded Detroit to a speculative rating in January 2009, four and a half years before the city went into bankruptcy.

The agencies didn't give investors as much warning with the much bigger Puerto Rico bankruptcy. All three major agencies downgraded Puerto Rico's general obligation bonds to speculative grades in February 2014. In July 2016 the commonwealth government defaulted on those bonds. Since then most of the island's $74 billion of public sector debt has gone into default.

While Fitch defended its rating change, saying the timing "reflected Fitch's opinion of the issuers' ongoing credit deterioration," some analysts said the rating agencies' performance reinforced doubts.

"Puerto Rico was a travesty," Cohen said. "That was just a giant whitewash. And that is putting it nicely."

MUNICIPAL MARKET ATTITUDES

The agencies' misrating of mortgage backed securities, bond insurers, Puerto Rico and other entities fueled doubts that have lasted to this day.

"We believe the Great Recession has led to much greater skepticism about the rating agencies and greater scrutiny about their business model and rating process," said Triet Nguyen, managing partner at Axios Advisors. Nguyen said history has also made investors more wary of the bond insurers' ratings.

While PNC Municipal Strategist Tom Kozlik said that "generally the rating agencies do a good job" and that their ratings continue to command respect, others said the financial crisis changed that.

"Prior to the credit crisis, Merritt Research saw little interest for most subscribers to pay for general obligation credit data because of the sector's perceived low risk," said Richard Ciccarone, president of Merritt Research Services. "That's certainly not the case today."

LEARNING LESSONS

S&P and Fitch acknowledged learning lessons from the Great Recession and its subsequent impact, while Moody's declined to answer the questions.

"The vast majority of municipal ratings performed very well against the greatest stress any of us have seen in our lifetimes, which is the end-result we would expect from most municipalities to a stress of this magnitude," said Jessalynn Moro, head of U.S. public finance for Fitch Ratings.

"The lessons learned from the market crisis came from the few outliers that endured a Chapter 9 bankruptcy and bucked widely held municipal market conventional wisdom that GO bondholders are secured," Moro said. "Those lessons continue today as we're seeing with the evolution of structures like special revenues and statutory liens that attempt to separate bondholder repayment from operating risk gaining momentum."

S&P spokeswoman April Kabahar said S&P has also learned from the events of 10 years ago. In the aftermath of the downturn, "We've enhanced the integrity and validity of our rating methodologies and models. For example, we've established cross-functional teams of economists and analysts evaluating credit conditions around the world."

Justin Hoogendoorn, head of fixed-income strategy and analytics at Piper Jaffray (PJC), said that, in the aftermath of the Great Recession, “The ratings agencies were ‘forced’ to transition from a mix of qualitative and quantitative ratings to predominantly quantitative models, including the publishing of issuer scorecards following the Great Recession.”

The Great Recession’s impact on the rating agencies stemmed from more than just the agencies’ own voluntary reforms. The U.S. government also responded to the Great Recession’s impact in taking actions on the agencies. The government’s main action was to pass the Wall Street Reform and Consumer Protection Act, better known as the Dodd-Frank Act, in 2010.

Parts of Dodd-Frank addressed municipal bond ratings. Some of its sections, but not all, have been carried out.

“One of Dodd-Frank’s original intents was to increase transparency about the rating process and force regulated financial institutions to reduce their reliance on agency ratings,” Nguyen said. “Banks in particular have been required to come up with their own internal risk assessment process to supplement agency ratings.

“Dodd Frank was also supposed to encourage greater competition by equalizing the playing field for smaller” ratings agency players, Nguyen continued. This hasn’t happened for several reasons, he said.

“S&P Global Ratings takes its regulatory obligations across our global operations very seriously,” Kabahar, the spokeswoman, said.

Other parts of Dodd-Frank Act relevant to munis haven’t been carried out. The Dodd-Frank law required the Securities and Exchange Commission to create a rule to make the ratings agencies liable for their ratings the same way accounting firms or security analysts are legally liable for their reports. The commission hasn’t done this yet.

“This requirement was misguided, in our opinion,” Nguyen said. “Agency ratings should be recognized for what they are, just an investment opinion, hopefully an informed one.”

The Dodd-Frank law also required the SEC to recommend an alternative to the “issuer pays” business model for the rating agencies, which observers have said provides an incentive to the agencies to grant high ratings. If the commission couldn’t come up with a superior model, it required the commission to create a board to randomly assign credit rating assignments among the rating agencies. It hasn’t done either of these things.

The SEC held a roundtable discussion in May 2013 on this general topic, but it hasn’t taken action on the issues the panel raised.

“Having the issuer pay for the rating remains a fundamental flaw in the rating agency business model, as it creates a built-in conflict of interest,” Nguyen said. “However, as many of the recent upstarts found out, getting the buy side to pay for ratings is also difficult.”

Finally, Dodd-Frank said that a rule should go into effect requiring rating agencies to adopt procedures designed so credit ratings weigh default risk “in a manner that is consistent” for all rated obligors and securities.

The SEC adopted Rule 17g-8(b) on Aug. 27, 2014, that essentially required this.

From 2010 to 2014 both Moody’s (MCO) and S&P engaged in recalibrations or applied new criteria to U.S. public finance, leading to broadly higher ratings for munis connected with these actions. On average the changes were subtle.

S&P's changes in 2013 and 2014 to the local government rating criteria led to an average increase in ratings of about 0.1 notch across all municipal credits.

In 2010 Moody's (MCO) recalibrated some of its municipal issuer ratings to address the category's comparative lack of risk at different rating levels. In categories closest to government, like general obligation and public water and sewer utility bonds, it raised ratings about one notch in the Aa category, two in the A category, and about three in the Baa category. Speculative grade ratings were left unchanged. For non-utility enterprise, public university, mass transit and a few other categories, Moody's (MCO) raised the ratings by one notch around the Aa and A categories. It left ratings unchanged for several other categories like nonprofits and public electric power utility bonds.

Both agencies' upgrade movement took place within a stronger tide of downgrades.

If the ratings agencies were to use historical defaults as a guide, in order to make the ratings denote equal risk in munis as in corporate bonds, all ratings of BBB-minus or above would have to be converted to AAA. Speculative grade municipal bonds would also have to be drastically upgraded. This would leave the municipal ratings with little differentiation and thus little value for those focusing on munis.

While the SEC hasn't enforced the measure yet with regard to munis, on Aug. 28 the commission did find that Moody's had broken the SEC rule with regards to a different financial instrument, combination notes, which are collateralized loan obligations backed by corporate loans.

The SEC ordered Moody's to pay a $1.25 million fine and to "complete a comprehensive review of its policies, procedures, and internal controls that relate to the findings in this order in consultation with the Office of Credit Ratings" within 180 days. It also ordered the ratings agency to submit a report within 240 days describing its new policies for adhering to the SEC rule.

A Moody's (MCO) spokesman said: "We are pleased to have resolved these legacy matters, which reach back to 2010. Moody's Investors Service regularly reviews and refines its policies and procedures and is committed to maintaining strong controls around models used in the rating process."

EVALUATING CREDIT TODAY

The Great Recession led market participants to think about issuer credit differently. "The meltdown of monoline insurers resulting from losses in the subprime mortgage backed securities arena forced investors to look harder at the underlying credit of a municipality leading up to the crisis," said Justin Hoogendorn, head of fixed income strategy at Piper Jaffray (PJC).

"One tendency when looking at these separate Great Recession events was to describe them, at the time, as 'idiosyncratic,' " said Douglas Benton, who was an analyst at Moody's at the time and is now municipal credit manager for Cavanal Hill Investment Management. "However, an idiosyncratic list is an oxymoron. I believe we learned a lot about contagion risk that we as market participants hadn't fully appreciated."

The financial crisis and municipal bankruptcies in Vallejo, California and Detroit prompted investors to undertake more credit analysis themselves, said Michael Zezas, Morgan Stanley's (MS) chief U.S. public policy strategist and municipal strategist. "Once the bond insurers lost their high ratings and reminders that GOs could default started to pile up, it became clear that munis had credit risk that needed to be measured by the security holder, rather than simply rely on a third party."

Muni investors will continue to do more credit research than they did before the Financial Crisis, Zezas said. However, “for better or worse, ratings will be a common denominator for many investors trying to measure risk in a market with too many securities to follow.”

Richard Williamson contributed to this story.

Next: After the fall, remaining insurers fight for relevance

By Robert Slavin

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