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KBRA Releases Comment – Municipal Default History: Rating Ceilings Do Not Hold Up

A rating ceiling is an upward limit on a bond rating based on its linkage to the rating of the underlying municipality's general obligation credit. This linkage is based on the view that there is a high likelihood that, should the underlying credit enter bankruptcy or a restructuring process, all of the issuer's obligations will be drawn into that process. In KBRA's view, this approach is problematic because the prospect of bankruptcy among most municipal credits is highly unlikely and for some—like states—legally impossible. KBRA believes that, due to the low default rate in the municipal market, arbitrary rating ceilings distort risk.

Municipal defaults are very rare, with S&P and Moody's pegging municipal bond default rates at a fraction—about 1/20th and one-tenth, respectively—of the default rate for corporate bonds. At the same time, ratings issued by legacy rating agencies have a checkered record of anticipating municipal defaults. Even speculative-grade municipal ratings show low default rates, which suggest inadequate correlation and further undermines the rationale for rating ceilings.

KBRA believes that rating ceilings provide a false sense of comfort. A case in point are those which mandate the ratings of special revenue bonds must remain within a prescribed range relative to the underlying general obligation rating. This implies a level of precision in municipal credit ratings that is not supported by their history. These ceilings also needlessly limit the rating for many credits, regardless of the additional protections that may be provided. Furthermore, these limitations are a particularly poor fit for states, which cannot file for bankruptcy.

- Municipal Default History: Rating Ceilings Do Not Hold Up
- Rating Ceilings Subvert Fundamental Municipal Credit Analysis

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