

# Changing Credit Rating Practices: What It Means for Government Issuers

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3:50 - 5:30 p.m.

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# Issuer's and the New Ratings World

- A. Recalibration/Global Scale: What to Be Aware of?
- B. What Does This New World Mean for Issuers
- C. Recalibration and Fiscal Policy
- D. New Rating Dynamic and Issuer Presentations
- E. Rating Changes and Disclosure Issues

# Recalibration: What to Be Aware of?

- Ratings Recalibration by Moody's and Fitch
- Moody's Investors Service
  - “Beginning in April 2010, Moody's plans to recalibrate its long-term U.S. municipal ratings to its global scale. The global scale is used to rate sovereign, sub-sovereign, financial institution, project finance, structured finance and corporate obligations. This recalibration will enhance the comparability of ratings across the Moody's-rated universe. “
  - “Our benchmarking analysis of municipal credits against global scale ratings ...will result in an upward shift for most state and local government long-term municipal ratings by up to three notches.”

## Moody's also says:

- **“Market participants should not view the recalibration of municipal ratings as rating upgrades, but rather as a recalibration of the ratings to a different rating scale.”**
- **“This recalibration does not reflect an improvement in credit quality or a change in our credit opinion for rated municipal debt issuers.”**

# Are the changes merely cosmetic?

*“Going into it there was an expectation that it wouldn’t have an effect, but memories are short,” the Los Angeles trader said.*

(Bond Buyer 4/27/2010)

## Rating agency upgrades several Anchorage bond ratings

*Change in rating likely to reduce the cost of Anchorage's debt*

ANCHORAGE- Last week, a global rating agency upgraded several of the Municipality of Anchorage's (MOA) bond ratings. After a thorough review, Fitch Ratings announced that the MOA's General Obligation bond rating would be recalibrated upward. Prior to the recalibration, the MOA enjoyed an AA credit rating on its bonds. After the recalibration the MOA's credit rating is AA+. The improvement in the rating is likely to **have a positive effect** on the pricing of the Municipality of Anchorage's debt, particularly when **issuing Build America Bonds**.

Rating agency upgrades several Anchorage bond ratings

*Change in rating likely to reduce the cost of Anchorage's debt*

"We are pleased to have received a **positive** adjustment to our credit rating," said Lucinda Mahoney, chief financial officer for the city. "This will likely have a **positive impact** on the pricing of our debt in the taxable marketplace when selling Build America Bonds, mostly **because many of these investors have not historically purchased our debt** due to tax exempt nature of the bonds."

(Alaska Business Monthly)

## Beach gets top grades from bond-rating agencies

“Fitch Ratings and Moody's Investors Service were the latest to give Virginia Beach the highest possible rating, AAA, this week...Fitch's rating change is in large part because of a recalibration the agency has done on municipal bonds nationwide...’**The potential is quite good for savings,**’ said Patricia Phillips, the city's finance director.”

*(HamptonRoads.com)*

## DASNY Recalibration Revise

*“The Dormitory Authority of the State of New York last week revised a previously approved financing because staff expected that credit rating recalibrations **obviated the need for mortgage insurance.**” (Bond Buyer)*

# Confused? Try This--

From Redding, Connecticut:

## *Moody's raises Town's Bond Rating*

*The town's bond rating **has been raised** by Moody's Investors Service, from Aa2 to Aa1, the result of the rating company's recalibration to a global scale.*

*The town's bond rating **was downgraded** from Aa1 to Aa2 by Moody's last December.*

*"They lowered our previous rating with the intention of looking at it on a global scale, **so now we're back to where we should be,**" said Mr. Alvarez.*

# Confused? Try This--

## *Moody's raises Town's Bond Rating (Continued)*

*When the town got the Aa2 rating, he said, Moody's had indicated **it was temporary** until it did a whole recalibration.*

*At Tuesday's finance board meeting, Town Treasurer Peg O'Donnell agreed that Moody's had recalibrated the town's bond rating but said Moody's Web site states **the new ratings are not a rerating**, but a calibration.*

*Mr. Alvarez said Moody's called it a downgrade when the town went from Aa2 to Aa1. **"You can't have it both ways,"** he said.*

## **Down, Then Up** (within 24 days!)

“Back on April 6, Fitch Ratings downgraded Nashville GOs to AA-minus because of the potential strain of the convention center. On April 30, with its ratings recalibration, the agency raised the rating to AA with a stable outlook.” (Bond Buyer)

# So what does it mean?

- Will it lower borrowing costs?
  - Higher rating = Lower interest cost
  - Access to Build America Bonds
  - No Need for Insurance
  - Higher Demand
    - Some Muni-bond funds only invest in high grade paper
  - More Advance refundings
- Will it lead to the commoditization of Municipal Bonds?
  - More ratings in the “AA” level
  - Bond structure becomes more important than credit distinctions
    - Different coupons; maturities; calls.

# Rethinking Fiscal Policies and Issuer Presentations

- Rethinking fiscal policies
- Rethinking your rating presentation

# Rating Changes and Disclosure Issues

- Issuers with continuing disclosure undertakings under SEC 15c2-12 may require filing of a material event notice.
- Check with your Bond or Disclosure Counsel.
- If rating change is determined to be material, notice should be filed promptly with MSRB's Electronic Municipal Market Access (EMMA) system.
- For new debt issued after 12/1/2010 issuers will be required to file notice with EMMA not more than 10 business days after a rating change, regardless of whether that change was material.

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# **Changing Credit Rating Practices: The Road to “Recalibration” – and Beyond**

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GFOA Annual Conference  
June 7, 2010

Paul Rosenstiel  
De La Rosa & Co.

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# Genesis of “Recalibration”

- Disparity between corporate and municipal default rates of securities with the same rating
  - Fitch and Moody’s have studied and reported on the differences for a decade
  - Moody’s 2002 study of 1970 – 2000 determined that
    - Of 26,718 non-healthcare issuers Moody’s rated, only 8 defaulted
    - Default rate for Aaa-rated corporate bonds was 16 times the default rate of all rated muni bonds

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# The “Recalibration” Debate

- Issuers advocating for reform argue that a rating should only reflect the likelihood an issuer will do what it promises to bondholders it will do: pay debt service on time and in full
- Raises questions of what a rating means
  - Should it reflect only the likelihood of default?
  - If not, what should a rating measure?
  - Should municipal and corporate ratings measure the same thing?
  - Who should the ratings serve?
  - Do we need legislation or regulation to oversee muni ratings?
- Recalibration was an important ***first*** step for issuers
- Basis for upward shifts in ratings is not apparent or transparent so as to hold agencies accountable in the future
- The debate should – and will – continue.

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# Early Actions by Rating Agencies

- 1999 Fitch study comparing corporate and muni default rates led to upgrades in 2000 of about one quarter of GO ratings and one half of water/sewer ratings
- Moody's published a comparative analysis of muni and corporate ratings in 2002
- Beginning in 2003, Moody's made Corporate Equivalent Ratings available for taxable muni bonds sold abroad and muni swaps

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# Early Actions by Rating Agencies

- This was extended to all taxable munis, starting in 2007, and now called Global Scale Ratings
  - “In recent years, the lines separating the U.S. municipal market from other global markets have become increasingly blurred as growing numbers of "crossover" buyers invest in municipal bonds for various reasons.”
- Also “mapped” muni ratings to GSR explaining:
  - “Unlike Moody's global ratings scale, which measure "expected loss" (default probability times loss given default), Moody's long-term municipal ratings measure the intrinsic ability and willingness of an entity to pay its debt service. In the investment grade categories, the municipal rating measures distance to distress – how likely an entity is to reach such a weakened financial condition that extraordinary support is needed in order to avert default. This extraordinary support typically is provided by another entity, usually a higher level of government, or by means of voter-enacted additions to governmental powers.”
  - A1 state GOs mapped to a Aaa GSR – a 4 notch difference
  - Aa3 local GOs, water/sewer, state lease and special tax bonds mapped to a Aaa GSR

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# Bond Insurer Woes Accelerate Change

- Bond insurers began to show vulnerability in late 2007
- Issuers without underlying AA ratings faced severe problems on their insured VRDBs due to SEC Rule 2(a)-7 rules
- William Ackman of Pershing Square Capital Management began highlighting credit problems at the bond insurers because of mortgage exposure and the dual standard of the rating agencies that explains why issuers “are forced to purchase bond insurance in order to enhance their credit ratings.”

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# Bond Insurer Woes Accelerate Change

- Municipal Market Advisors publishes a report in January 2008 reviewing the forces for and against rating changes and concludes “With at least \$2B of annual taxpayer savings possible, we urge issuers to act.”
- Fortune published an article in February 2008 saying
  - “What the municipal bond market needs most is not an injection of capital into the bond insurance companies. What it needs is an injection of common sense into its credit rating system. The simple truth is that the overwhelming majority of tax-exempt bonds issued by states and cities deserve a triple-A credit rating without any bond insurance, given their historically minuscule default rates.”

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# Issuers Call for Change

- 15 major issuers, led by California State Treasurer Bill Lockyer and including 10 other state treasurers, wrote in March to the rating agencies asking for “new rating standards for U.S. municipal debt”
  - Ratings bear little relationship to default risk
  - Muni issuers are held to a higher standard than corporations
  - Muni ratings provide inaccurate information to investors about the risk of their investment
  - Muni ratings impose unnecessary costs on issuers in terms of interest rates, bond insurance costs and VRDB costs (due to SEC Rule 2(a)-7)
  - “The State of California, with a global scale rating from Moody’s of Aaa, nonetheless paid \$102 million from 2003-07 to buy triple- A bond insurance on its general obligation bonds.”
- The letter was featured in a front page New York Times article

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# Washington Focuses Attention

- A week later, Rep. Barney Frank convened a hearing of the House Financial Services Committee about muni ratings
  - Frank passed out a 30-year Moody's default study and said "Under General Obligation, there it is. Number of Issuers: 14,775. Number of Defaults: 0. Despite that, there has been pressure on issuers to buy insurance."

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# Investor Perspective

- The debate highlighted the question of what investors want from ratings
- Retail and institutional investors may have different uses for ratings
- Historical retail interest in insured bonds suggests they want a rating system that focuses on the safety of their investment
- But institutional investors argued for the importance of the “granularity” of the muni rating scale

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# National Federation of Municipal Analysts

- NFMA, representing credit analysts from institutional investors (and the rating agencies) responded in May
  - “The NFMA finds it troubling that such advocacy is being driven by a relatively small group of state, local and national political officials, issuers and non-traditional niche investors who seek to seize on the recent turmoil in order to push for broad scale rating upgrades.”
- Though not taking a position, they raised reasons to go slow
  - Poor muni disclosure
  - Rating agencies’ failures to anticipate defaults in mortgage securities
  - Turmoil in the economy – is this the right time to raise ratings?
  - Effect that current rating system has in enforcing fiscal discipline

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# Moody's and Fitch Respond

- In March 2008, Moody's announced that, beginning in May 2008, it would begin assigning a GSR for any muni issue, at the issuer's request, in addition to the traditional muni rating
- Requesting comments from market participants, they received 150 and reported in June 2008 that the market wanted only one rating that should be:
  - Broadly consistent with other global ratings
  - But "continue to provide reasonable differentiation" among muni credits and "go beyond expected loss" in what they measure
- In September 2008, Moody's announced the transition of all muni ratings to a single global scale in October. On average, state and local GO bonds would get a two notch upgrade.
  - This was less than the mapping they had released in 2007

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# Moody's and Fitch Respond

- Fitch announced in July 2008 it would recalibrate to a single scale that would bring the average rating on GOs and water/sewer bonds up GO ratings up one notch
  - Fitch announcement followed four roundtables with issuers and investors
  - Recalibration would increase percentage of GO ratings AA or better from 58% to 86%
- S&P insisted, as it has all along, that it has always had one scale, despite significant differences in corporate and muni default rates for the same rating

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# So Close! – Change Put on Hold

- September 2008 saw tremendous financial market turmoil – Lehman Bros, AIG, Fannie/Freddie
- Moody's and Fitch both announce it is not the right time to move forward
- In March 2009, Moody's recalibrates 26 outstanding GSR ratings, adjusting all *down* one to three notches
- Over the subsequent year and a half, economic and market developments affected the perspective on recalibration
  - Severe fiscal distress, but still few defaults
  - BABs and more crossover buyers who want to buy higher ratings and aren't familiar with the muni rating scale
  - Strong retail demand for munis, but shortage of highest-rated bonds they prefer because of the reduced presence of the bond insurers

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# Moody's Recalibrates

- Moody's announced in March of this year that it would move forward recalibrating bonds of 18,000 issuers
  - Began in April when 34 states were assigned a higher rating
  - Regardless of sector, similarly rated securities are "intended to have similar average loss rates over long periods of time."
  - "This recalibration does not reflect an improvement in credit quality or a change in our credit opinion for rated municipal debt issuers."
  - But: new ratings are to reflect expected loss, which is primarily risk of default for higher-rated bonds, rather than the previous standard of "distance to distress"
  - And: "certain [credit] factors are likely to receive greater emphasis going forward as we shift our focus from rank-ordering credit risk within the municipal sector, to evaluating default and loss characteristics relative to similarly-rated credits in other global sectors."

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# Fitch Recalibrates

- A week after Moody's, Fitch said it too would recalibrate
  - GO ratings A+ to AA+ to get one notch upgrade
  - GO ratings BBB- to A to get two notch upgrade
- “Credit ratings provide Fitch’s opinion on the relative ability of an entity to meet financial commitments.”
- Goal:
  - “the aspiration is for Fitch’s ratings to demonstrate broadly comparable levels of default patterns over long periods.”

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# Fitch Recalibrates

- Default history is not necessarily a good guide
  - “a sector or issuer that has demonstrated a no- or low-default history or even limited negative ratings migration is not immune from the possibility of prospective worsening in credit risk just based on that past performance, nor is it guaranteed a given rating level going forward based solely on past performance.”
- Not an upgrade
  - “The recalibration of certain public finance ratings should not be interpreted as an improvement in the credit quality of those securities. Rather, they are adjustments to denote a comparable level of credit risk as ratings in other sectors.”

# What Did Recalibration Do?

- General Obligation and Utility bonds recalibrated higher than other municipal credits
  - Lower rated issuers in these sectors benefited more

**Upward Shift in Ratings (Number of Notches)**

Moody's		Fitch	
Current Rating	GO; Water/Sewer; Distribution Only Utilities; MUDs	Current Rating	GO; Water/Sewer; Public Power (Distribution Only)
Aaa	0	AAA	0
Aa1	0-1	AA+	1
Aa2	1	AA	1
Aa3	1	AA-	1
A1	2	A+	1
A2	2	A	2
A3	2	A-	2
Baa1	3	BBB+	2
Baa2	3	BBB	2
Baa3	2-3	BBB-	2
Below	0	Below	Case by Case

# Moody's Recalibrates Less Than Original GSR

- GSR “mapping” in March 2007 was the same as the CER “mapping” in June 2006
  - Includes local GO, Water/Sewer, State Revolving Fund, State Lease Obligation, FHA Insured
- GSR recalibration in March 2010 was considerably less
  - Includes GO, Water/Sewer, Distribution only Utilities, Municipal Utility Districts

Upward Shift in Ratings (Number of Notches)

	Jun-06	Mar-07	Mar-10
Current Rating	Corporate Equivalent Rating	Global Scale Rating	Global Scale Rating
Aaa	0	0	0
Aa1	1	1	0-1
Aa2	2	2	1
Aa3	3	3	1
A1	3	3	2
A2	4	4	2
A3	5	5	2
Baa1	5	5	3
Baa2	5	5	3
Baa3	6	6	2-3
B3-Ba1	6	6	0
Caa3-Caa1	7	7	0

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# Rating Reform Legislation - Senate

- SEC must require each NRSRO to have policies and procedures that “assess the probability that an issuer of a security or money market instrument will default” and apply rating symbols “in a manner that is consistent for all types of securities and money market instruments for which the symbol is used” but doesn’t explicitly require that ratings be based on this assessment.
- But NRSROs will not be prohibited “from using distinct sets of symbols to denote credit ratings for different types of securities or money market instruments.”

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# Rating Reform Legislation - House

- SEC must require each NRSRO to have policies and procedures that “assess the risk that investors in securities and money market instruments may not receive payment in accordance with the terms of such securities and instruments” but doesn’t explicitly require that ratings be based on this assessment.
- Nothing prohibits an NRSRO from
  - “considering credit factors that are unique to municipal securities.”
  - “establishing ratings that are complementary to the ratings [assessing default] and that are created to measure a discrete aspect of the security’s or instrument’s risk.”

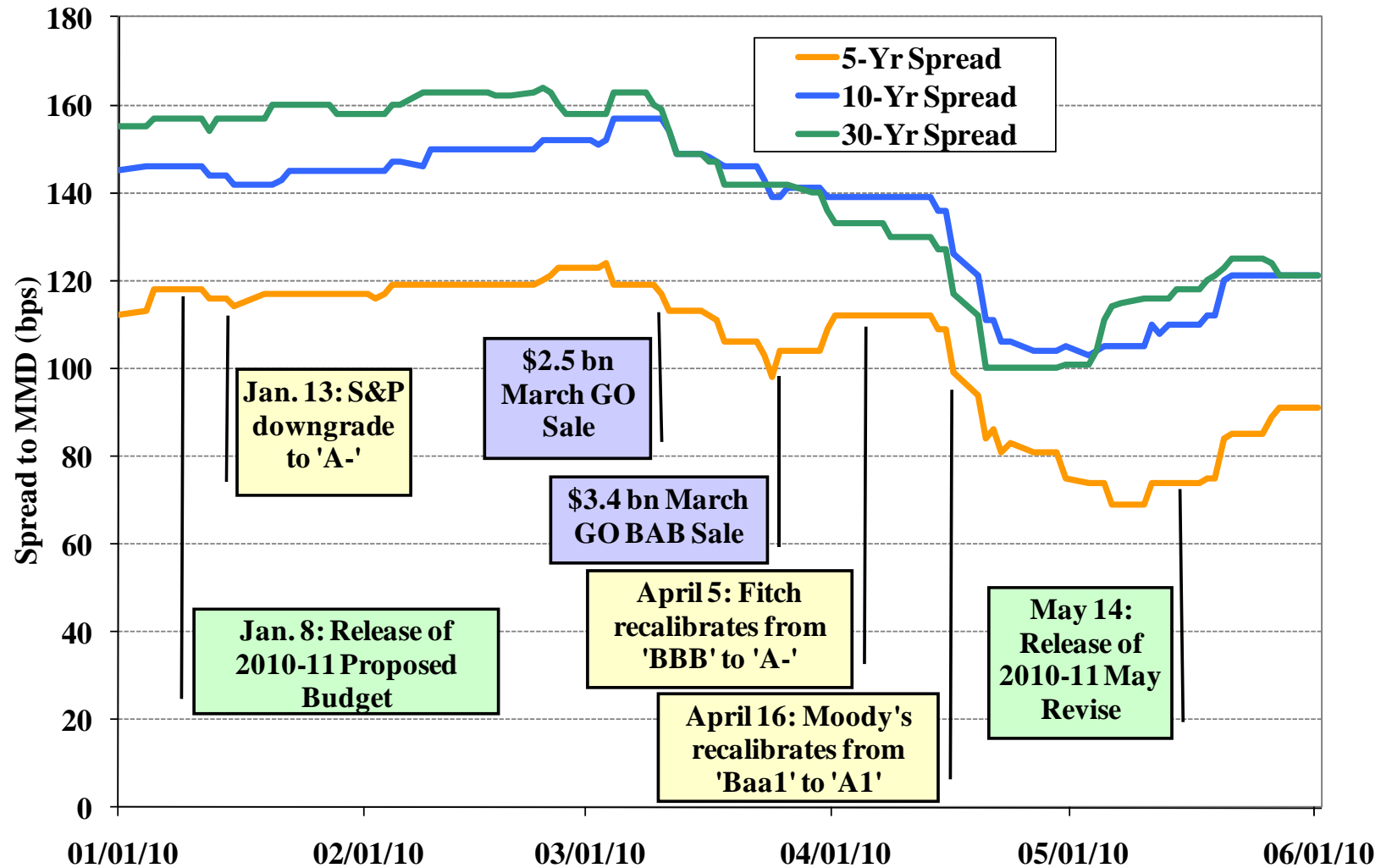
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# Will Recalibration Reduce Issuers' Costs?

- This is the goal – higher ratings will reduce borrowing costs or reduce the need for bond insurance
- The actual impact will depend on how investors react to new ratings
- Some institutional investors have said they're still going to value bonds on the old muni scale
- But will they be able to?
  - Newer crossover (BABs) buyers aren't familiar with the old scale and higher ratings should increase the demand for BABs
  - Retail isn't attuned to the difference and will find higher-rated bonds more attractive
  - Issuers will sell to those who will buy at the lowest interest rate and that is the investors who will accept pricing based on the new ratings
  - Over time, the new rating scale will probably dictate pricing

# Evidence from State of California

CA GO Spreads to AAA MMD  
(1/1/2010 to Present)



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# Now – Is Muni Risk Understated?

➤ **Warren Buffett** (June 2, 2010)

- I don't think **Moody's** or Standard & Poor's or I can come up with anything terribly insightful about the question of state and municipal finance five or 10 years from now except for the fact there will be a terrible problem.

➤ **SEC Chair Mary Shapiro** (May 7, 2010)

- There were 136 defaults on municipal securities in 2008, in an aggregate amount in excess of \$7.5 billion. While most of these defaults involved conduit issuers in the health care sector, rather than general obligation municipal bonds, these defaults cannot be ignored.

➤ **NY Times interview with S&P President Deven Sharma** (June 5, 2010)

- Q: One of the major complaints of the rating agencies is that you practice a kind of “ratings inflation” in some politically delicate bonds – for instance, the general obligation bonds in California or the sovereign debts of powerful nations.
- A: We downgraded California 18 months ago, even though Bill Lockyer lashed out against us. Ratings are opinions on relative risk. All we are saying [is] that if you look at Rhode Island and look at California, which one is closer to the prospect of default – that is all it means.

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# The Meaning of Ratings Remains Unclear

- If they are meant primarily to reflect default risk, why isn't there equivalency instead of recalibration?
- If the criteria for the ratings are different (more reflective of default risk), why aren't they a new evaluation of credit risk and a rating upgrade, rather than a recalibration?
- If ratings are now supposed to primarily measure default risk, do we still need 10 separate ratings to signify the relative likelihood of something happening that almost never happens?
- With rating criteria still qualitative, will the ongoing debate result in ratings creeping back to where they were pre-calibration?



# Changing Credit Rating Practices

Amy R. Laskey, Managing Director

GFOA Annual Conference

June 7, 2010



## Rating Recalibration – Key Issues

- Meaning of ratings
  - Default
  - Stability
  - Recovery
- Purpose of Recalibration
  - Increased comparability of credit risk with other sectors
  - Recalibration is not at an indication of improved credit quality



## Background of Recalibration Process

- > Part of continuous effort to ensure comparability of Fitch's opinion on relative ability of entities in all sectors to meet financial commitments.
- > Recalibration effort is not unique -
  - > Fitch conducted inaugural study of municipal defaults in 1999
  - > Sector rating revisions have been made in other sectors – Banks, CDOs, RMBS, Non-Investment Grade Corporates



## Key Considerations in Municipal Ratings Uplift

- > Favorable credit characteristics
- > Low overall default experience
- > Existing rating distribution
- > Outlook for credit quality with special emphasis on current environment and long-term factors
  - > Prolonged recession
  - > Continued weakness of the housing market, and more recent declines in commercial real estate
  - > Delayed impact of real estate declines on governmental revenues
  - > Increased Pension and OPEB funding requirements



## Ratings Affected by April 2010 Recalibration:

- > Approximately 2,100 out of 3,600 Fitch-rated US public finance ratings, on a securities basis (140,000 out of 191,000 on a CUSIP basis).
- > State and local government tax-supported debt and water/sewer, public higher education, and public power (distribution-only) revenue bonds are being recalibrated upward by one-to-two notches.
- > Sectors not affected include public power generating systems, nonprofit healthcare, private higher education, tax-exempt housing, transportation, and state revolving funds.



## Impact of Rating Recalibration

- > Broad-based upward rating adjustments subject to certain constraints
- > Upward revisions for tax-supported, water/sewer, public power (distribution only) and public higher education bonds
  - > Typically 2 notches for 'BBB-' to 'A' ratings
  - > Typically 1 notch for 'A+' to 'AA+' ratings
  - > 1 notch for special tax bonds
- > Below investment grade credits were reviewed on a case-by-case basis
- > With few exceptions, Rating Outlook and Watch designations were maintained



## Final Recalibration Map

<b>Current Rating</b>	<b>GO, Water Sewer, Public Power (distribution-only)</b>	<b>Special Tax</b>	<b>Public Higher Education</b>
AAA	AAA	AAA	AAA
AA+	AAA	AAA	AA+
AA	AA+	AA+	AA
AA-	AA	AA	AA
A+	AA-	AA-	AA-
A	AA-	A+	A+
A-	A+	A	A
BBB+	A	A-	A-
BBB	A-	BBB+	BBB+
BBB-	BBB+	BBB	BBB
Below BBB-	case by case	case by case	case by case



## Impact on Affected US Public Finance Rating Sectors (%)<sup>1</sup>

	AAA	AA	A	BBB	BIG <sup>2</sup>
<b>Pre-Recalibration</b>	6	46	40	7	1
<b>Current</b>	15	67	15	2	1

> Based on number of issuers.

(1) includes tax-supported and essential service enterprise ratings only

(2) below investment grade



## General Guidelines for Rating Levels Post-Recalibration

- > Fitch continues to review four major rating factors
  - Debt
  - Management
  - Financial Operations
  - Economy
  
- > We evaluate the following elements, which cut across the four factors above
  - Stability
  - Sustainability
  - Flexibility



## **‘AA’ is Now the Average GO Rating**

- For an average rating, Fitch has moderate concerns about one of the three elements (stability, sustainability, flexibility)
- Multiple options exist to address potential budgetary or economic constraints, although they may be challenging to implement
- Long-term economic prospects are sound, even if recessionary weakness is apparent
- Debt structure allows for additional issuance sufficient to address capital needs
- Management is fairly proactive about identifying problems early



## Ratings above 'AA'

- > Strength in at least two of the three elements (stability, sustainability, flexibility) with no more than modest weakness in the third
- > Limited if any concerns about the types of issues that often lead to credit deterioration (e.g. political impasse, unrealistic budgeting, increased leverage, rapid decline of an industry on which tax revenue is dependent, delayed financial reporting)
- > Management uses tools such as multi-year financial forecasting, long-term capital planning, regular interim reporting



## Ratings Below 'AA-'

- > Moderate to higher concerns about two of the three elements (stability, sustainability, flexibility)
- > 'A' category indicates potential for meaningful, non-transitory improvement in at least one category, where lower ratings indicate that solutions, to the extent they exist, are non-recurring
- > Some had weak management and/or financial performance historically which has since been largely corrected but concerns about their institutionalization linger



## Ratings on EMMA

- > Fitch expects soon to have its public finance ratings displayed on the MSRB-EMMA website
- > Information will be in read-only format



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