Municipal Market Comments

Ascent Investment Partners

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S&P Criteria Changes Could Trigger a Wave of Upgrades

S&P has proposed a methodology change in the way it rates general credit ratings (general obligation pledges or issuer credit ratings) of local government issuers in the United States. The change would affect issuers that are not states and are not special purpose districts, and would include: cities, counties, towns, villages, townships, and boroughs and other local governments. The change specifically excludes states and state agency ratings and ratings on special purpose districts such as school districts, park districts, special taxing districts and other such issuers.

The purpose of S&P's proposed methodology change is to introduce into U.S. local issuer ratings "use of the same major elements as [S&P's] criteria for rating local and regional governments outside the U.S. Specifically, the proposed criteria assign ratings based on the assessment of the government's institutional framework, economy, management, budgetary flexibility, budgetary performance, liquidity, and debt and contingent liability scores." In practice, S&P's proposed new methodology is designed to introduce more transparency into the ratings process.

S&P issued its proposed methodology criteria and requested comments from market participants by early June. S&P intends to incorporate feedback from market participants into its final criteria. Our expectation would be that there would be no finalization of the new criteria until late 2012 at the earliest. Therefore, we would not expect to see any rating changes from the final revised local government rating criteria until at least early 2013, and possibly considerably longer.

Impacts of the Methodology Change

S&P's initial testing of its proposed methodology suggests that 32% of outstanding local government ratings would increase as a result of the new approach. Approximately 65% of ratings would remain the same, while roughly 3% of ratings would decrease. S&P estimates that rating changes (up or down) would generally be one notch (e.g., an upgrade to AA- from A+). S&P states that it maintains ratings for more than 3,800 governments that would be affected by the new methodology, suggesting that at implementation S&P would upgrade more than 1,200 local issuers' G.O. ratings.

The impacts of the proposed changes would reach farther than just local government G.O. ratings. S&P also rates thousands of additional issues that are secured by appropriation pledges or credit support agreements of various types from local issuers. These include structures such as lease revenue bonds, certificates of participation (COPs), debt service reserve guarantees, special assessment support agreements, and many other individual structures. Any changes to a local issuer's general credit ratings would be expected to also affect other bonds secured by payments from that issuer. For example, City A with a G.O. rating of AA- might have lease revenue bonds outstanding that are rated A+ based on the City A's pledge to appropriate payments annually. It might also have issued COPs for a project that are rated A based on the structure of the transaction and the city appropriated funds that flow through to make debt service payments. Absent any changes to the way S&P rates the relationships between local issuers and their appropriation obligations, we would expect that an upgrade of City A's general credit rating under the new criteria to AA from AA- would also raise the ratings on the lease revenue bonds and on the COPs, to AA- and A+, respectively. Therefore, the potential universe of rating changes resulting from the new methodology could be many multiples of the approximately 1,300 issuers that S&P expects would be upgraded or downgraded.

We have begun to review the details of S&P proposed criteria changes, and we will continue to monitor and comment on the impacts we expect for municipal investors.

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