Municipal Market Comments

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from Montage Investments

Moody's Criteria Change Jeopardizes School Bond Ratings in Arkansas and Pennsylvania

On April 10, Moody's released new criteria for how it rates local school bonds that are enhanced by state intercept programs. We discussed the mechanics of these intercept programs in our recent report discussing the types of school bond enhancement programs currently in use (*Municipal Market Comments* dated March 3, 2013). The new criteria raise the possibility that Moody's could withdraw its ratings on state-enhanced local school bonds that do not have an underlying rating already or if Moody's cannot adequately assess the District's stand-alone credit quality. As a result, Moody's has identified approximately 260 local school district issuers in Arkansas and approximately 50 local school district issuers in Pennsylvania whose ratings it has placed "Under Review". Moody's stated that it "will likely withdraw [its] enhanced ratings" on these bonds if it "determines that we do not have sufficient current information to assign a public underlying rating."

If Moody's removes its enhanced ratings for local school bonds, most of them would no longer have a public credit rating. In that case, we would expect that the market for those bonds could significantly weaken, reducing both the number of investors willing to buy them and the market prices offered for them. Ascent has reviewed all of its clients' holdings in enhanced local school bonds subject to the Moody's revision, and we do not anticipate any negative impacts for our clients' holdings. In every case, the obligated district either already has a published rating or has sufficient publicly available financial and operating information for Moody's to assign an underlying rating.

Holders of Arkansas school bonds are likely to be the most significantly impacted by this change. Historically, Arkansas school districts have issued bonds without underlying ratings, relying instead on the credit quality of the state program for market access. These issuers have also typically only used Moody's to rate their issues. Furthermore, Arkansas school districts generally have a poor track record of financial reporting after issuance. Many districts are not timely with their continuing financial disclosure and the quality of the information that is released is often poor. We view enhanced issues from smaller Arkansas local school district as being the most at risk from Moody's action.

As we have discussed previously, Ascent views credit enhancement – whether state school programs, bond insurance or some other structure – as a supplement to the underlying credit of the issuer, not as a substitute for the issuer's own credit. For that reason, we review each bond prior to purchase, "looking through" any enhancement on the bond to determine the underlying credit quality of the obligor. We conduct regular ongoing surveillance of all of our holdings using this same process. The financial crisis and the collapse of the bond insurance industry beginning in 2009 taught many investors a harsh lesson about credit enhancement. Enhanced ratings can be subject to change from a wide variety of factors, including: financial market cycles, changes in corporate strategy, changes in government policy (national, state or local), and changing rating agency criteria. The greater the difference between the perceived credit quality of the enhancement and the underlying credit of the obligor, the greater the risk facing the investor in the event that there is some change that impacts the credit quality or market pricing of that enhancement.

Moody's New Criteria

Moody's new criteria applies directly to five states' programs – Arkansas, Indiana, New York, Pennsylvania and Virginia – that use a post-default intercept mechanism. In this structure, payments from the state are not made to the trustee until the state is notified that a payment has been missed. Moody's new approach effectively caps the state program ratings at two notches below the state's own general obligation (G.O.) rating. So, if a state's G.O. rating is Aa2, the post-default intercept program enhancement rating cannot be higher than A1. It can, however be lower. Rather than simply assign a rating based on the enhancement, Moody's will also evaluate the underlying credit quality of the local district and factor that in to the ultimate rating. Rather than having all issuers equalized by the enhancement program, the new approach will differentiate ratings between stronger districts and weaker districts. Moody's will not "uplift" an underlying issuer's rating by more than three notches. In our example above, where the state program received an A1 rating, a local school district bond in the enhancement program with a stand-alone rating of Baa2 could only receive a program rating of A2 due to its weak underlying credit quality.

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