Municipal Market Advisors

Response to Moody's Proposal for Global Scale Ratings for all Issuers

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The Trusted Name in Municipal Market Strategy

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RESPONSE

Municipal Market Advisors generally supports Moody's proposal to provide Global Scale Ratings (GSRs) for all municipal issuers, regardless of tax status. However, we believe the following improvements are essential to more permanently resolve the problems the municipal scale has created for issuers, investors, and regulators. These improvements are:

1. GSR assignments should be automatic for any municipal issuer.
2. Moody's should also provide either GSRs—or approximations of GSRs—for all outstanding municipal bond ratings by the end of 2008. This would speed investors' understanding of the new scale and would more quickly reduce our sector's systemic reliance on the bond insurers for pricing and credit quality.
3. The relevance of maintaining the municipal scale at all is debatable; however, its withdrawal would meet strong investor backlash that could undermine Moody's credibility and muffle the net impact of GSRs. Thus we agree with keeping both scales for at least the medium term.
4. That being said, the rating agencies' use of identical rating symbols for both municipal and corporate scales is confusing. This is particularly true for non-specialist retail investors and issuers to whom the municipal scale is most costly. We strongly encourage Moody's and the other rating agencies make substantive changes to the municipal rating scale's lettered system (perhaps to a purely numerical scheme) to make clear its difference from any corporate ratings. Yet any new method of illustrating municipal ratings should also preserve the same number of gradations or notches as at present to minimize difficulties for issuers and investors.
5. Importantly, "municipal scale" ratings should be clarified to contain *only* municipal scale assessments—corporate scale counterparty ratings like bond insurer or bank guaranties should either be moved to the issuer's GSR or converted to a municipal scale assessment. The current, muddy mix included within issuers' "municipal" ratings permits unacceptable ratings scale arbitrage by the insurers and should be changed.
6. To address "cliff risk" concerns (discussed below) associated with a transition to GSRs, Moody's should provide some comfort to investors that the new rating scale will be accompanied by a rigorous rating analyst training program and perhaps enhanced credit surveillance for the future.

BASIS FOR OUR OPINION

We continue to support Moody's leadership in our sector's ultimate transition to rating parity. We also recognize and support the statements and needed actions taken by the State of California and other issuers, the US House Financial Services Committee, and industry participants who have spoken out in favor of change. MMA's perspective remains that the industry as a whole is best served by credit transparency via corporate equivalent ratings, enhanced issuer disclosure, and improved investor access to issuers. Further, any change that reduces our sector's systemic risk to the bond insurers is welcome; an earlier adoption of corporate equivalent ratings for municipals would likely have prevented at least a share of the recent turmoil in the ARS, VRDO, TOB, and fixed rate markets.

Briefly, corporate equivalent ratings for municipal bonds would bring the following benefits or changes:

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BASIS FOR OUR OPINION

1. **Improve credit transparency**. One of Moody's failings in prior discussions of GSRs is the statement that "crossover investors" were historically rare in the municipal sector, and their recent increase now requires apples-to-apples credit comparisons between asset classes. This is true; more than ever, municipals are bought and sold by global banks, hedge funds, and investment houses that weigh their relative risk and reward versus hundreds of alternative instruments. Yet this point still does not go far enough. Individuals—who own 34% of outstanding municipals directly (versus only 8% of corporates) and substantially more via managed accounts—allocate to munis versus stocks, taxable bonds, and other instruments. They base investing decisions on relative income production, safety, and growth potential. Individuals are thus fundamental crossover investors who, without the support or sophistication of institutions, have no ability to look through an opaque municipal rating scale to discern actual default risk.

2. **Better align municipal ratings with regulatory requirements.** Rating parity would help alleviate the current mismatch between the municipal scale's sector-specific focus and regulatory requirements that assume all rating scales show the same thing. The most pressing example is of course money markets' Rule 2a-7 requirement that they purchase only AA or better rated securities, and most munis are simply not eligible for those ratings, regardless of default risk. A switch to GSRs now would give the muni money markets much better flexibility in their investment decisions and reduce the ongoing risk of VRDOs losing their liquidity provider on a bond insurer downgrade. Further, more issuer-based AAA ratings implies better fundamentals for tender option bond programs and thus lower yields and tighter spreads across the curve. Other regulatory mismatch examples include Basel-related regulatory capital requirements, where lower rated assets require more collateralization regardless of actual default risk. And also risk adjusted return standards for bank-type investors, where a AAA-rated bond is accounted as more profitable than an A-rated bond even if the physical returns are identical.

3. **Reduce taxpayers' cost of capital.** In our opinion, the municipal rating scale both exaggerates default risk and heightens valuation risk, limiting the investor base for muni bonds and, perhaps, keeping tax-exempt bond yields unnaturally high. However, more definitively avoidable costs to taxpayers are: 1) bond insurance premiums that, in recent years at least, approximated $2-2.5 billion annually according to S&P; 2) recently high short term funding rates because of the bond insurers' troubles; and 3) onerous rating standards. The last is the converse of the "moral hazard" risk noted below and does not apply to all issuers. We believe that the municipal scale's more conservative criteria may require the overprotection of investors through excessive reserves, higher tax rates, etc., creating undue political and financial pressure on some safe-sector state and local issuers. Easier lending standards for safer issuers could free up extra dollars for much needed capital improvements and social subsidy programs. We also note, however, that a transition to GSRs will reasonably lead to higher disclosure-related costs for issuers since investors' understanding of local credit quality will become more relevant to bond pricing and valuation. Credit analysts' role in the industry would likely grow with GSRs.

4. **Reduce rating volatility**. Because: 1) most investment grade, safe sector muni bonds would carry GSRs of either AA or AAA; and 2) municipal default risk is driven more by structure than by month-to-month financial condition, municipal rating volatility should fall with GSRs. Again, reduced rating risk, and thus event-driven valuation risks, should improve investor demand for municipal paper.

5. **Limit systemic risk from the bond insurers**. The apparently easier standards for getting a corporate scale Aaa versus a municipal scale Aaa has permitted widespread rating scale arbitrage by the bond insurers and massive industry exposure to these companies. A transition to GSRs should reasonably lead to much lower insured penetration in municipals and help prevent similar collapses as seen in the first quarter. We do see an ongoing role for the insurers after corporate equivalent ratings, albeit a more limited one that is focused on risky sector credits, project finance, and securitization.

6. **Better compare muni bonds across sectors.** Another problem with the municipal scale is its internal inconsistency. Single project, unenhanced apartment buildings can carry ratings as high or higher than some state GOs; water revenue bonds are sometimes rated below tax increment finance districts. We assume that, using the same criteria for all muni bonds (i.e., risk of default and loss given default) would, for the first time, regularize ratings of all muni issuers versus each other.

Noteworthy

The municipal rating scale exacerbates issuers' and individual investors' lack of specialization and limits sector transparency

RISKS IN A CHANGE OF RATING POLICY

While we strongly believe that GSRs are overdue, we also agree with some institutional buyers that there is value in the municipal scale. And, as a data company ourselves, we believe it would be heedless to discard any historical information. Below, we have cataloged a list of reasons for retaining the municipal scale and our opinions on the relevance of each.

1. **Munis ratings need granularity**. Muni bonds have thousands of issuers, highly individual credit and structural features, poor disclosure, and weak and often biased communication between borrowers and investors. As with structured finance, (where ratings are an essential shorthand for the majority of investors not sophisticated enough to model the underlying assets themselves) the municipal industry's heterogeneity forces large holders to outsource some or all of their credit work to the raters. That service is devalued by rating compression. This is a credible reason for maintaining the municipal scale, but not a good one for not ALSO mapping munis onto a less detailed, but more accurate GSR system. We also point out that the transition to GSRs would improve top line rating granularity in a market now flooded with insured AAAs.
2. **The buyers need a more conservative scale.** This argument goes that our sector's majority holders—individuals—are long-term holders better served by more "careful" ratings. This might be a valid reason to maintain the muni scale, if in fact the rating agencies also view it as a longer-term assessment than are GSRs. They don't; note the persistent, cyclical change in muni ratings based on cash/budget fluctuations and the long-term secular upgrade trends at all companies.
3. **Higher ratings create a moral hazard**. Here, the idea is that more generous rating conditions would induce issuers to trim pledged security, putting bondholders at risk. We agree that GSRs will allow some issuers, in particular safe sector credits, to reduce collateral without notable financial penalty. However, in theory at least, corporate scale ratings should be much more important to primary and secondary transaction pricing, and issuers should face much higher penalties for lower ratings than is now the case. For example, the spread penalty for falling from a GSR of AA to A may be seen as tantamount to falling from a muni scale AA to BBB. Further, risky sector credits most at risk from moral hazard-related security dilution, would, according to Moody's GSR/Muni scale map, not see as much inflation from muni to GSR ratings.
4. **Higher ratings increase "cliff risk**". At issue are valid investor fears that the rating agencies do not remain current enough on each issuer's credit quality to give investors sufficient warning of a crisis or collapse. A transition to GSRs amplifies these fears by raising the stakes of a rating "miss". In a similar way, a tightrope is scarier at 20ft above the ground than at 10ft. To address these concerns, the rating agencies should make some effort to ensure an improved level of review for each credit, acknowledging the changed analytic context for institutional investors.
5. **The current system is not broken**. It is.
6. **Munis are already on the corporate scale**. They're not.
7. **Munis are riskier than the statistics imply.** This follows: 1) the nation has just had a long economic expansion with abnormally few defaults; and 2) munis carry less predictable but highly potent political risk. Both points may be true; however: 1) corporate issuers are emerging from the same economic period and are headed into the same hypothetical dark days yet have a substantially higher rating baseline than their muni peers. Should munis begin to show more default risk as an asset class, we agree they would then warrant lower ratings. But not until. And 2) we argue that, while corporations are generally not run by purely political leadership, they also face a much more complicated capital structure, where equity and debt investors' interests are often at odds and where a company's existence can be actively shorted in a public exchange. In the past, this exposure to conflicting investors has greatly disrupted the predictive power of corporate ratings.

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