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Municipal Bond Ratings Simplified: Part 2

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Bond ratings begin with a request from the issuer. The issuer must pay a fee to obtain a rating. That is why ratings are not automatic. In addition, if an issuer sells more bonds without a rating, the rating will generally be withdrawn.

The rating process is strong, but not perfect. When I was Chief Municipal Rating Officer at S&P, rating teams had two people assigned, with one senior person assigned to the rating. Only senior analysts with experience can vote; the junior analyst may make recommendations, but their vote doesn't count.

Rating committees may be as small as 3 senior analysts, but for large controversial issues, committees could expand to 12 or more senior analysts. The rating fee also depends on the amount of bonds being rated. The fee could be as small as $2,500, but for larger issues can be higher than $100,000. Positive ratings generally result in lower interest costs to the issuer.

Each rating company sets standards for ratings, through the company's criteria committees. These criteria have been strengthened since the debacle of 2008, when hundreds of billions of "AAA" rated bonds were suddenly downgraded to junk-bond status. But because of recalibration of municipal ratings since 2010, many ratings municipal bond ratings have been raised to reflect the low incidence of default (and rightfully so).

Let me make something perfectly clear, since I have been asked this question many times: the rating companies do not consult with each other before they determine a rating. That is a fact. But members of a rating committee may be influenced by another company's rating rationale. That is pure human nature.

The next installment will explain "Rating Outlooks" and "Rating Watches".

About the Author

RICHARD P. LARKIN, Stoever Glass & Co., Inc.

Richard Larkin, a recognized 40 year industry veteran, has joined SG & Co. as Director of Municipal Credit Analysis. Mr. Larkin began his career in credit rating analysis at Standard & Poor's in 1975. After rising through the ranks in various analytical and management positions, Dick left S&P as its Chief Municipal Rating Officer, responsible for municipal rating policy, practices, governance and criteria. In 1998, Mr. Larkin joined Fitch Ratings as Chairman of its Public Finance Criteria Committee.

"Dick will be a unique resource to Stoever Glass' municipal clients. His knowledge in specific issues and areas of the municipal bond industry will aid our representatives and their clients in making educated decisions, in a sector where this type of research is unique," said Roland Stoever of Stoever Glass.