Better Rating Agency Relations Are Just a Few Steps Away

BY LIZ SWEENEY

Much is at stake for public finance debt issuers that request credit ratings from Wall Street's big credit rating agencies, which include S&P Global Ratings, Moody's, Fitch Ratings, and Kroll Bond Rating Agency. Historically, many public finance issuers avoided credit rating agencies entirely by purchasing bond insurance, a strategy that fell off substantially after the insurers were downgraded during the financial crisis more than a decade ago. Although bond insurance has lately been making a comeback, it still represents a much smaller share of tax-exempt debt issuance than it did before the financial crisis. Similarly, direct placements with banks soared after the financial crisis, when low interest rates and lack of other lending opportunities made it attractive for banks to lend directly to municipalities. But the lower corporate tax rates established in the Tax Cuts and Jobs Act of 2017 have made tax-exempt debt less attractive to banks.

All this means that public finance issuers are finding themselves face to-face with credit rating agencies more often, and it can be a stressful and intimidating experience. Here's the good news: Whether you are a new debt issuer dealing with credit rating agencies for the first time or you have long-standing established relationships with them, there are a few simple ways to maximize your rating agency relations, reduce the anxiety of the rating process, and maybe even get that long-wanted upgrade. Following are 10 suggestions.

10 | It's not all about you.

Ratings can feel like an intensely personal reflection on your organization and its leadership. The strength of management is an explicit factor in nearly every credit rating agency methodology. But there are many rating factors that management has little to no influence over. For example, hospitals face a host of industry risks that they can't control directly, including legislative and policy risks, regulatory changes, reimbursement risk, and developments in clinical care, science, and medical technology. Similarly, local governments have limited influence over their tax base, socioeconomic factors, and the statutory framework that governs which taxes and fees they can assess—and at what levels.

9 | Keep in mind the bigger context.

Crating rating agencies assess creditworthiness in many asset classes and geographies. When they assess your credit risk, they also have an eye on how the risks faced by your organization and your sector compare to many other sectors across the globe. This is called "rating comparability." It's the idea that an A-rated school district in Iowa should have relatively comparable credit risk to an A-rated mortgage pool in Sweden or an A-rated oil company in Canada. Rating comparability is not an easy thing to do, and many market participants feel the rating agencies don't do it very well. Nevertheless, understanding that their methodologies have this bigger context will help you understand their approach to risk assessment, and who knows? You may even impress them in the management meeting with your understanding of the concept.

8 | Understand fixed income has asymmetric risk.

Fixed-income investing is inherently asymmetric. Unlike stockholders, who participate in the upside potential of a company's strategies, bondholders who buy your government's debt will at best get their money back plus interest (ignoring potential secondary market trading gains). And on the downside, they risk everything. This is why credit analysts seem to be inherently negative, or don't seem to be giving you enough "credit" for all your great strategies. It's not that they don't see the upside potential; it's just that downside risk is more important for assessing creditworthiness.

7 | Educate your board.

Rating meetings typically include one or more members of the board or governing body to present your organization's governance structure and practices. Board members of nonprofit and governmental organizations are often rightfully very proud of the organization, and their instinct is to tell the rating agencies about the wonderful work your organization does in the community. While this is important, the credit rating agencies really want to know if your board is capable of providing the oversight and effective challenge of management that is needed for success. Make sure your board is highly educated about what credit rating agencies do, what kind of questions they ask, and how analysts look at risks in your industry. Your board members should be able to provide specific examples of their oversight of management: for example, replacing a chief executive officer or a key official; challenging a strategy; or ordering an internal assessment of certain risks or internal controls. They should be able to demonstrate their understanding of industry risks and how they use that knowledge to oversee management. As a bonus, an educated, effective, and proactive governing body is not just good for rating agency relations, it's good for the organization.

6 | Be prepared to discuss hot-button issues.

All credit rating agencies have published rating methodologies, and their ratings must be determined through application of one or more published methodologies. Your rating presentation materials should therefore focus on the relevant factors in the methodologies. But credit rating agencies can catch you off-guard sometimes with questions that are topical and relevant, but not mentioned in the methodology, such as how you are managing cyber risk or climate change risk. Go beyond the rating methodologies, learn the current hot-button issues, and be prepared to answer questions about them. How can you learn what they are likely to be? Credit rating agencies signal these hot-button issues through regular commentaries and public speaking.

5 | Don't ghost them. Ever.

Rating agency relationships are long-term, committed partnerships—if not always monogamous. There is an expectation, and in some cases a contractual promise, to provide relevant information to them so they can maintain credit ratings that are reflective of current developments. If things start to go badly, such as during or after a governance or management scandal, a high-profile patient safety event, or tax receipts that are significantly below expected, don't try to hide or fix the problem fully before talking to the credit rating agencies. Be proactive. Be transparent about the issue, convey your seriousness about resolving it, and talk to them about what you have done so far and what you still plan to do.

Evading them is likely to backfire in more than one way. First, once they know there's a problem, they must reflect that information in their rating. If you refuse to talk to them, they will still go ahead with whatever information they can get, which may be just a news article, and they may lower the rating. If they have to make assumptions about events or issues, they are likely to be very conservative. It's that asymmetric risk thing. They may even decide that they have insufficient information to maintain the rating, which could result in a rating withdrawal.

4 | Don't be shy— ask for that upgrade!

Credit rating agencies maintain continuous surveillance of their ratings. You might reasonably assume that if your organization warrants a higher rating, an upgrade will just happen in the normal course of the credit rating agency's work—but it doesn't always work that way. Ratings are not particularly granular, and there isn't a bright line between ratings that can be calculated mathematically. There's "wiggle room" around every rating (although rating agencies prefer the phrase "analytic judgment" to "wiggle room"), so for a credit that's doing well, sometimes it's just as reasonable to affirm the rating as it is to upgrade. The big credit rating agencies are keeping track of tens of thousands of municipal ratings. They have resource constraints like any other organization. So, advocate for yourself. Point out your strengths and tie those strengths into their methodologies. Point to comparable organizations that have higher ratings. Ask them to specifically address your points. Sometimes, it works. But even if you don't get the upgrade, you are likely to get something important: detailed feedback on why you aren't being upgraded, and what it would take to get there.

3 | Consider the number of ratings you need.

Every rating comes with a lifetime of commitments. For as long as bonds are outstanding and the debt is rated, you must provide the information the rating agency requests in order to maintain the rating. Information needs and methodologies change over time. Each rating agency asks for different information in slightly different formats. They all have their own surveillance schedules. Analysts turn over. Depending on the sector, debt product, and agency, you may have to pay annual surveillance fees in addition to the upfront rating fee. All this should be weighed carefully against the benefits of each rating. In general, your government will derive the greatest benefit from one rating, and smaller benefits from each additional rating. Work with your financial advisors to

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determine which rating agencies are right for you and how many ratings are really needed for your situation. Many issuers are rethinking whether they really need two or more ratings. To pare back the number of ratings you are carrying, you can make a request in writing to the credit rating agency to withdraw your ratings. Before you do that, though, you should talk to your investors about how important ratings are to them so you won't be surprised by their reactions.

2 | Think like an analyst.

A good way to prepare for meeting with credit rating agencies is to put yourself in their shoes. If you were an analyst, what would you be asking? For example, if your organization is a liberal arts college, you should be able to answer questions about the recent closures of several liberal arts colleges, and why your college differs from those that closed. Another example: Analysts spend a lot of time looking at historic and projected statistics. They may even create their own financial models and forecasts. They try to understand changes in the numbers because it helps to tell the story of your organization and informs their view of your future performance. You can do the same thing by looking at all reported statistics with an analyst's perspective. Any significant deviation from historic trends in revenue, expenses, balance sheet, ratios, the economy, or demand statistics will generate a question from analysts. If you anticipate those questions and come prepared with responses, you'll not only impress the analysts, you'll make their jobs easier (and yours!) by reducing the amount of follow-up work to be done later. Which leads us to our number-one tip:

1 | Give them what they want!

Many issuers find the rating process too long and too iterative (They think: "Every time I give them one piece of information, they ask me for something else."). This can be frustrating, whether you are trying to get to market with a new bond sale or just get through this year's rating surveillance process. It's frustrating for them, too. While you can't control what rating analysts will ask for, and sometimes the answer to one question spawns others, you can reduce the back-and-forth significantly by ensuring that the materials you provide—including rating presentations, continuing disclosure, quarterly financials, budgets, and other information—are tailored to meet their information needs. Many issuer meetings end with the analyst providing a list of a dozen additional pieces of information needed to complete the rating process, many of which were outlined in the methodology. Comb through the credit rating agency methodologies, looking at every factor it assesses, every ratio it calculates, and ask yourself where the agency will get that data. If it isn't in your presentation or disclosure, the analyst will ask you for it. By aligning your materials with credit rating agency needs, not only will you reduce turnaround time and frustration on both sides, you'll also create a favorable impression.

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