National Federation of Municipal Analysts

POSITION ON UNDERLYING RATINGS OF MUNICIPAL BOND ISSUERS

The National Federation of Municipal Analysts (the "NFMA"), chartered in 1983, is a not-for-profit association formed with the goals of promoting professionalism in municipal credit analysis and providing an informed perspective in the formulation of legal and regulatory matters relating to the municipal finance industry. NFMA membership includes over 1,000 members, primarily research analysts, who evaluate credit and other risks of municipal securities. These individuals represent, among others, mutual funds, insurance companies, broker/dealers, bond insurers, and rating agencies.

Within the last year, the financial strength of some monoline bond insurers has been called into question as a result of their guarantees of real estate-related debt obligations. Several bond insurers have been downgraded, some significantly, leading to widespread concern over the value of bond insurance.

As a result, municipal bond market participants (investors, bond underwriters, and others) are devoting increased attention to the “underlying” credit quality of a bond, i.e. the credit quality of the bond issuer, as indicated by its rating, rather than that of the insurer.

Unfortunately, there are many bond issues that have no underlying rating - they were sold with an insured rating only. The rating agencies have adopted a variety of approaches to the ratings of insured bonds with no underlying rating, including, in some cases, withdrawing the rating associated with the downgraded insurer so that the bonds may lose one or all ratings.

In addition, issuers, investors, and other market participants have become increasingly concerned with the underlying credit quality of bonds guaranteed by insurers that have retained their AAA ratings, especially those that are on review for a downgrade or carry negative outlook. Without underlying ratings, market participants are unable to get a clear understanding of the credit risks such bonds offer.

Many individual investors in the municipal bond market have traditionally purchased insured bonds and may not have the skills to analyze municipal credits. As a result, these investors own or may be offered bonds which they have difficulty valuing. This scenario is especially troubling for municipal bond investors in view of the present economic slowdown and increasingly frequent headlines regarding state and local budget shortfalls.

An ancillary effect of the present dislocation in the municipal bond market and the inability of some market participants to judge credit quality has resulted in widening credit spreads, which has lead to increased borrowing costs for state and local governments that need to immediately finance public projects.

Public bond ratings have always played an essential role in assessing credit risk and helping the market price municipal bonds. NFMA believes that issuers can act in their own best interests as well as those of their bondholders and other market participants if they request underlying ratings on their bonds that a) have been downgraded due to an insurer downgrade or b) have become unrated due to an insurer downgrade. Also, because some issuers may have sold insured debt with no underlying rating and also sold uninsured debt with an underlying rating, the NFMA also encourages bond issuers to ensure that all of their parity debt carries the same underlying rating.
While the general credit quality of the municipal bond market is very high, concern over the financial guarantors has clouded the municipal bond market. Widespread use of underlying ratings would help restore an orderly market and the efficient financing of critical public projects.