Credit Rating Basics for Municipal Bond Investors

When contemplating the purchase of a municipal bond, there are many important factors an investor should consider. One such factor is the credit rating of the issuer and of the specific bond being issued. A municipal bond's credit rating is one indicator of the credit quality of an issuer and may be assessed by any or all of Fitch Ratings, Kroll Bond Rating Agency, Moody's Investors Service, Inc. and Standard & Poor's. Generally, a credit rating is the "grade" a rating agency assigns to a bond to indicate the potential risk of default by the bond's issuer and, in some cases, takes into consideration the potential loss to investors in the event of default. Not all bonds are rated. The absence of a rating for a bond from any of the rating agencies does not necessarily indicate that the bond is any less or more creditworthy than other municipal bonds.

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Investors should ask their broker, dealer or municipal securities dealer (collectively, "financial professional") for guidance on evaluating a municipal bond before making a purchase. Under the rules of the Municipal Securities Rulemaking Board (MSRB), financial professionals have certain duties to clients when purchasing or selling municipal bonds on an investor's behalf. For example, MSRB Rule G-19 requires a financial professional to have a reasonable basis to believe a recommended transaction or investment strategy involving a municipal bond is suitable for the particular customer,[1] and MSRB Rule G-47 requires financial professionals to disclose all material information about a municipal bond at or prior to the time of the sale or purchase.[2] The required time-of-trade disclosures include providing material information about the credit rating or lack thereof, credit rating changes, and credit risk of the municipal bond.

Be an informed investor by understanding the basics of credit ratings and available free resources about credit ratings. It is also helpful to know what questions to ask a financial professional when deciding whether to purchase a particular municipal bond. This document provides an overview of basic considerations regarding an issuer's credit status, as well as questions to ask a financial professional about municipal bond credit ratings to support making an informed investment decision.

What is a Credit Rating and What Does it Mean?

A credit rating is the evaluation or assessment that a rating agency assigns to a bond to indicate the likelihood that the issuer will repay the bond, as well as the potential for loss to investors in the event of default by the issuer. Credit ratings are not absolute measures of the probability of default, but express the rating agency's

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relative opinion about the creditworthiness of an issuer or the credit quality of a specific bond issue. When a rating agency reviews the creditworthiness of an issuer, the rating agency is evaluating the issuer's ability to meet its operational and financial obligations. When a rating agency evaluates the credit quality of a specific bond issue, it typically examines the security and amount of revenues pledged to repay principal and interest on the bonds and considers the issuer's willingness and ability to make those payments when due.

Generally, a rating agency assesses the credit risk of a municipal bond at a point in time. The rating agency's assessment, among other factors, may include:

- An evaluation of the issuer's financial condition, including the review of financial statements for evaluating the strength of its operations and financial management of revenues and expenses;
- The amount of debt and other longer-term liabilities of the issuer that may impact the same sources of revenues that support payment of the bonds;
- The source of funds for repayment of the principal and interest on the bonds;
- Any statutory limits or caps on the issuer's ability to raise revenues;
- Any economic or other trends that may impact revenues available to pay the principal and interest on the bonds;
- Whether or not the bonds are non-recourse, meaning that if the issuer fails to pay debt service on the bonds, the bondholder does not have a claim on the underlying revenue source or the issuer;
- The purpose of the financing, whether it is for an essential governmental purpose or financing a specific project; and
- The strength or weakness of the local economy and the potential impact on the financial position of the issuer.

Rating agencies also monitor the financial condition of issuers and track the underlying credit characteristics of a municipal bond until its maturity. As changes occur, a rating agency may alter (either positively or negatively) a rating it has issued. In other words, if the credit quality of an issuer deteriorates or improves, the municipal bond may be downgraded or upgraded, and this may affect the price of the bond in the secondary market.

Are Credit Ratings Required?

An issuer is not required to obtain a credit rating, but obtaining a credit rating typically enhances the marketability of the bonds. The issuer may seek a rating from one or more or all the rating agencies for a specific bond issuance. The issuer's decision to seek a credit rating may be based upon an evaluation of the potential increased benefit to the marketability of the bonds by having one or multiple rating agencies assign a credit rating to the bonds.

In some cases, an issuance of municipal bonds may not be rated. In these circumstances, in addition to asking your financial professional questions about the creditworthiness of the issuer, it is important to review the issuer's official statement and continuing disclosures, which may provide further insight into the credit quality of the bond and the issuer.

Moody's	Standard & Poor's	Fitch Ratings	Kroll	Description
Aaa	AAA	AAA	AAA	Best Quality
Aa1 Aa2 Aa3	AA+ AA AA-	AA+ AA AA-	AA+ AA AA-	High Quality
A1 A2 A3	A+ A A-	A+ A A-	A+ A A-	Upper Medium Grade
Baa1 Baa2 Baa3	BBB+ BBB BBB-	BBB+ BBB BBB-	BBB+ BBB BBB-	Investment Grade
Ba B Caa Ca C	BB B CCC CC C	BB B CCC CC C	BB B CCC CC C D (default)	Speculative

Each rating agency evaluates credit risk based on its own standards, applies its own ratings methodology, and weighs the various factors in its methodology.

Who Provides Credit Ratings?

Rating agencies that evaluate municipal bonds include Fitch Ratings, Kroll Bond Rating Agency, Moody's Investors Service, Inc., and Standard & Poor's. Each rating agency evaluates credit risk based on its own standards, applies its own ratings methodology, and weighs the various factors in its methodology. Each rating agency has specific definitions of its ratings, and a unique process for determining a credit rating on a municipal bond.[3] Each rating agency produces a ratings scale, symbols and definitions to express credit risks. Generally, rating agencies use a scale of letters and/or numbers, and these symbols are defined by the credit rating agency issuing the rating.

A typical credit rating scale, as shown in the table, has a top rating of 'AAA' and may have a lowest rating of 'D' (indicating default). Some credit rating agency's scales distinguish between investment and non-investment grade ratings (*i.e.*, "speculative" or "high yield") and draw a distinction between the 'BBB' and 'BB' rating categories. Ratings that are 'BBB-' or higher are investment grade and ratings that are lower than 'BBB-' are non-investment grade.

How are Credit Ratings Determined?

Generally, rating agencies assess specific credit factors during the credit rating process. Typically, the process begins with an evaluation of the creditworthiness of the issuer before assessing the credit quality of a specific bond issue. Generally, rating agencies assess specific credit factors during the credit rating process. Rating agency considerations generally include the economic characteristics of the issuer, the issuer's total amount of debt and other liabilities outstanding, and the overall financial performance of the issuer. Evaluation of the issuer's overall financial performance may include a review of its operations and administration,

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A rating agency's surveillance of a previously rated issuer or bond issue may result in an adjustment to the credit rating or outlook of an issuer.

revenue forecasts, operating budgets, available reserves and liquidity to meet expenditures. The existence of, or potential for, any structural financial issues may also be a consideration. Assessment by the rating agencies of the credit quality of a specific debt issue may include: the terms and conditions of the debt security and legal structure; the relative seniority of the bond issue as compared with the issuer's other debt issuances and the priority of payment in event of default; and the existence of external support or credit enhancements, such as a letter of credit, guarantee, insurance, or collateral associated with a specific bond issue that offsets potential credit risk.

Do Credit Ratings Change?

Ratings of an issuer and/or the issuer's outstanding bonds can change over time. The reasons that a credit rating agency may change a rating vary but may be broadly related to overall shifts in the economy or involve more focused circumstances that impact a specific sector or industry. Generally, rating agencies track issuers' activities related to previously rated bond issuances that may impact the credit risks previously expressed. A rating agency's surveillance of a previously rated issuer or bond issue may result in an adjustment to the credit rating or outlook of an issuer. Typically, these adjustments to the credit rating or outlook of an issuer signify an agency's view of a higher or lower level of credit risk based upon changes in circumstances over time that alter the underlying assumptions of the original credit assessment.

Questions to Ask Your Financial Professional about Credit Ratings When Buying a Municipal Bond

1. Does the municipal bond have any credit enhancement or other type of guarantee backing the repayment of the principal and interest on the bonds?
2. What events or circumstances could impact the likelihood of the issuer's repayment of the bonds in full and on schedule for the duration of the municipal bond?
3. What are some of the likely risks that could impact credit quality of the bonds over time?
4. What are some of the factors that may lead to a downgrade of an issuer's credit rating?
5. Will changes in an issuer's credit rating impact municipal bonds purchased with the intent to be held to maturity?
6. What happens to bonds if an issuer's credit rating is downgraded?
7. If a default occurs, how might that impact an investment in municipal bonds?
8. How will the financial advisor monitor the bonds and communicate information regarding any changes to the issuer's financial condition?
9. What resources are available and accessible to the investor for monitoring the bonds?

Where can Credit Ratings and Other Relevant Information be Found?

The MSRB's Electronic Municipal Market Access website (EMMA) receives real-time credit rating information for all municipal securities that have ratings assigned by Fitch Ratings, Kroll Bond Rating Agency, Moody's Investors Service, Inc. and Standard & Poor's on EMMA. This free resource is available to obtain credit ratings related to existing or potential municipal bond investments and can support an investor in making an informed investment decision. Credit ratings and other relevant reports and information about the municipal market are also available by subscription from the rating agencies and by direct access to the rating agencies' websites.

Current credit ratings and often the respective rating agencies' reports may also be available on an issuer's website. Additionally, some issuers maintain investor relations pages on their websites, where an investor may find information related to the issuer's current and historical financial performance, as well as other reports describing the issuer's management and operations, strategic initiatives and other information.

ALSO SEE ADDITIONAL EMMA® RESOURCES

- Explore the EMMA Website
- EMMA 101: An Overview for Municipal Bond Investors
- Using EMMA's Map-Based Search
- Using MyEMMA® Alerts

[1] This summary does not describe all applicable provisions of MSRB rules and interpretations, nor does it include all exceptions from general MSRB requirements. The MSRB may amend any such rules or interpretations, or may adopt additional rules or interpretations, from time to time. The complete text of specific rules and interpretations, and related definitions, is available at http://msrb.org/Rules-and-Interpretations/MSRB-Rules.aspx.

MSRB Rule G-19: *Suitability of Recommendations and Transactions* requires a broker, dealer or municipal securities dealer to have a reasonable basis to believe that a recommended investment involving a municipal bond is suitable for the investor, based upon information obtained through reasonable diligence of the financial professional to ascertain the investor's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the in connection with a recommendation.

[2] MSRB Rule G-47: *Time-of-Trade Disclosure* requires each broker, dealer or municipal securities dealer to disclose all material information known about a municipal bond orally or in writing, at or prior to the time of trade when conducting a sale to a customer or purchase from a customer of a municipal bond, whether unsolicited or recommended, and whether in a primary offering or secondary market transaction and reasonably accessible to the market. Information is considered to be material if there is a substantial likelihood that the information would be considered important or significant by a reasonable investor in making an investment decision.

[3] The credit rating agencies mentioned are registered with the Securities and Exchange Commission. For more information see: https://www.sec.gov/ocr/ocr-learn-nrsros.html

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