# OUTLOOK NEGATIVE

How Ratings Agencies Punish Local Governments, Create Huge Profits for Wall Street, and Leave Public Employees and People of Color Holding The Bag


ReFund America Project

ACRE Action Center on Race & The Economy

# Executive Summary

The 2015 film *The Big Short* has a vivid scene of an analyst working for a ratings agency, S&P, evaluating financial products that later turned out to be toxic. The questioner asks the analyst if they've ever given a rating not desired by the banks. The analyst can't answer, and points out that if she gives a worse rating, they'll just go to Moody's.

The three main ratings agencies--Moody's, S&P, and Fitch--exercise an enormous amount of influence over the global economy. Their ratings determine the creditworthiness of major corporations, banks, nearly all bond issuances, cities, states, even sovereign governments. Their authority is enhanced in countless federal and state regulations. Those regulations mandate that banks and insurance companies hold only highly-rated bonds. As a result, a poor rating from any of the ratings agencies can cost any issuer a great deal.

But it costs the public the most. This report delves into the state and local bodies that have borne the brunt of the ratings agencies' two standards: one for the private sector where their profits are higher, and one for the public sector, where the profits are lower. While the private sector consistently gets great ratings--including for the types of securities behind the financial crisis--the public sector, in particular the State of New Jersey, Chicago Public Schools, Jackson, MS, and Newark, NJ--gets left with subpar ratings that significantly increase borrowing costs.

This report exposes the ways in which the ratings agencies use their oligopoly against the public interest, and the tactics that unions, community organizations, cities, counties, and states can use to fight back.

**Key Findings:**

- **Massive inconsistencies between ratings of municipal bonds and private sector bonds continue, six years after Dodd-Frank mandated an across-the-board standardization. In places targeted by ratings agencies, the costs ratchet up massively.**
- **The ratings agencies have launched an unprecedented attack on collectively bargained public pensions and retiree health care.**
- **Racial disparities within the municipal bond market are persistent, with nearly all of the cities and states at the bottom of the ratings scale being majority-minority.**

The consequence of the ongoing bad behavior by the ratings agencies is a deeply skewed market for municipal debt, tilted towards financiers and against the public. [1]

**Glossary of Terms:**

*Municipal bonds*
Municipal bonds are debt securities issued by cities, counties, school districts, public authorities and states.

*Municipal default*
When a municipality misses a debt payment. Municipal defaults are extremely rare.

*Municipal bankruptcy*
When a municipality enters Chapter 9 of the bankruptcy code. Municipal bankruptcies are also exceedingly rare.

*Ratings agency/NRSRO*
There are three agencies that consistently rate both public and private sector debt: Moody's, S&P, and Fitch. They were also the first three ratings agencies granted the "nationally recognized statistical ratings organization" designation when it emerged in 1975 via an SEC rule. As such, they constitute an **oligopoly.** Ratings agencies are supposed to assess the creditworthiness of an issuer, ie, the likelihood of an issuer to default, and then assign a rating. Ratings agencies are usually but not always paid by the issuer to rate a bond. Profits on ratings are considerably higher in the private sector. Moody's is by far the largest rater of public sector debt.

*Bond credit rating*
Moody's, Fitch, and S&P all have slightly different rating systems, but generally they tend to range from Aaa/AAA at the top of the scale to C and then default at the bottom. Ratings determine the cost of servicing debt. Banks, insurance companies, and many pension funds are required to hold certain amounts of low-risk reserves, which must be investment-grade bonds. When bonds are downgraded below investment grade status (Baa3 or BBB- are the lowest investment grade ratings), banks, insurance companies, and many pension funds must sell off those assets, which increase the cost of borrowing significantly more for issuers.

*General obligation (GO) debt*
General obligation is the traditional form of municipal debt, secured at least by the full faith and credit of a municipality. Other forms of non-GO debt include special revenue bonds and pension obligation bonds.

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[1] The issues surrounding ratings agencies have been extensively discussed, largely in the way in which they enabled predatory behavior in the lead-up to the financial crisis. This report is the first treatment that calculates the cost of unfair ratings to targeted municipalities, states, and school districts.

## Two Standards, One Rule

**In November 2002,** Moody's published a report[2] that was astounding in its honesty. Moody's admitted that there was little if any justification for its two-tiered system for rating bonds: one standard for cities, counties and states, and another for Wall Street and the corporate world generally. The ratings agency effectively conceded that there was no justification for charging significantly higher credit costs to local governments, costs that researchers would later estimate at over $1 billion annually.[3]

Indeed, Moody's noted that:

> "If municipalities were rated on the corporate scale, Moody's **would likely assign Aaa ratings to the vast majority of general obligation debt issued by fiscally sound, large municipal issuers.** Likewise, Aaa ratings would likely be assigned to the bulk of the senior obligations issued by large, fiscally sound municipal providers of essential services. The rating categories below Aaa would be populated by debt of issuers that (1) were experiencing financial stress or (2) did not have the financial resources or future resources (limited tax base or service area) to withstand some minimum level of financial stress. **Moody's expects that nearly all performing municipal general obligation and essential service revenue bonds would be rated Aa3 or higher if rated on the corporate rating scale."**

Despite the publication of the 2002 report, Moody's failed to change its rating system until 2010, when hundreds of cities received upgrades of 1-2 notches in their credit rating. The changes made by Moody's didn't come about as a result of internal deliberations, but rather because of significant pressure from outside. Dodd-Frank's passage in 2010 mandated that ratings agencies apply the same standards to all issuers of debt, public or private.[4] And the agency had been sued by then-Connecticut Attorney General Richard Blumenthal in 2008,[5] arguing that the two-tier system artificially increased the cost of debt servicing for cities and towns.

But while the ratings upgrades for cities significantly reduced the amount spent to service Wall Street debt, bad behavior by the ratings agencies did not end. The Dodd-Frank rule mandating universal ratings has been conveniently elided by the agencies, as the following case studies show. This is evidenced by the costs of subpar

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[2] 'Special Comment -- Moody's Municipal Bond Rating Scale." Moody's. November 2002.
[3] "Credit Ratings and the Cost of Municipal Financing." Jess Cornaggia, Kimberly Cornaggia, and Ryan D. Israelson. March 21, 2014.
[4] [Americans for Financial Reform SEC Comment Letter on NRSRO Regulation. April 1, 2014.]
[5] "Attorney General Sues Credit Rating Agencies For Illegally Giving Municipalities Lower Ratings, Costing Taxpayers Millions." Connecticut Attorney General's Office Press Release. July 30, 2008.

ratings--a more recent examination from former Moody's analyst Marc Joffe estimates the costs of artificially subpar ratings to public entities as $1.6 billion annually.[6]

One recent example stands out. In August 2016[7], Fitch Ratings, following its competitors, issued a junk bond rating of B+ for Chicago Public Schools general obligation debt. Chicago Public Schools serves over 390,000 students and has nearly 60,000 employees. It is the nation's third-largest school district, and respected analysts have concluded that the likelihood of default is low. Cities, counties, states and school districts rarely if ever default on their bonds, and Illinois, unlike Michigan, has no process for municipal bankruptcy.

In the explanation for the rating, Fitch extensively discusses CPS' pension obligations. But it neglects to mention that Chicago Public Schools has never had a default in the modern era. The explanation doesn't deign to mention at all the actual likelihood of Chicago Public Schools to default.

Four months later, Fitch issued another rating: AAA[8], the highest possible, for a bond of a tranche of residential mortgage-backed securities that do not have backing from the federal government or an affiliated enterprise like Freddie Mac.

It was these kinds of mortgage-backed securities that were at the center of the financial crisis and the assets that were purchased by the federal government's TARP program.

Given that residential mortgage backed securities have a far riskier history--the foundation stone of a credit rating--than Chicago Public Schools, Fitch's rating practices reveal a shocking assault on the children and teachers of Chicago while the worst practices of Wall Street are re-enabled, increasing the likelihood of another financial crisis.

## Private Sector Wipeouts

Moody's, S&P, and Fitch's behavior in the financial crisis was abhorrent. Moody's, S&P and Fitch inflated ratings of risky Wall Street financial products to the highest possible, Aaa, in order to gain business. Holders of some of the Aaa bonds were wiped out. S&P and Moody's have had to pay fines of over $2 billion in response to their

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[6] "Doubly Bound: The Cost of Issuing Municipal Bonds." Marc Joffe, Haas Institute for a Fair and Inclusive Society and the ReFund America Project. 2015.

[7] Fitch Rates Chicago Board of Education, (IL) ULTGOs 'B+'; Outlook Negative. Fitch Ratings Press Release, August 30, 2016.

[8] "AAA Grades Return for Securities Backed by Riskier Mortgages" Matt Scully, Bloomberg. December 7, 2016.

misbehavior in the financial crisis. That misbehavior was centered on the ratings agencies inflating their credit ratings of complex financial products so as to gain more profits.

The Financial Crisis Inquiry Commission found[9] that 80% of Aaa bondholders of precrisis collateralized debt obligations (CDOs) suffered losses in the aftermath of the financial crisis. 10% of Aaa bondholders of residential mortgage-backed securities (RMBSs) suffered losses in the same time period.

In the corporate world, similar problems emerged. Moody's did not downgrade Lehman Brothers below A1--the fifth-highest, well into investment grade--until July 2008, well after the bank's problems had been publicized. Lehman bondholders ultimately received about 25 cents on the dollar.[10] Moody's did not downgrade Washington Mutual below A2 until the fall of 2007. Washington Mutual bondholders only received about 26 cents on the dollar for their bonds.[11]

**Losses By Holders of Bonds Initially Rated AAA, 2006-2016**

| | |
|---|---|
| CDOs | ~80% |
| RMBSs | ~10% |
| Municipal | 0% |

The degree to which the impairment for Aaa bondholders of Wall Street complex financial transactions contrasts with the municipal bond market is impossible to overstate. In the five-year period leading up to a default, not a single defaulting municipal issuer had a Aaa rating, according to Moody's own research.[12]

To compare to the pre-crisis ratings for financial firms like Lehman or Washington Mutual to a municipal issuer like Detroit also observes significant disparities. Detroit general obligation bondholders had a recovery rate of 41 to 69 cents on the dollar--far above WaMu and Lehman. Yet a year prior to the Detroit bankruptcy, neither classes of

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[9] "Credit Ratings and the Financial Crisis." Financial Crisis Inquiry Commission, Preliminary Staff Report. June 2, 2010.
[10] "Lehman Recovery Seen as Justifying $2 Billion Bankruptcy." Erik Larson, Bloomberg. September 11, 2013.
[11] "Corporate Default and Recovery Rates, 1920-2008." Moody's Investor Service Special Comment. February 2009.
[12] "US Municipal Bond Defaults and Recoveries, 1970-2014." Moody's Investor Service Special Comment. July 24, 2015.

general obligation debt were rated investment grade, in stark contrast to the two banks. [13]

It's also worth looking at the record of the ratings agencies in relation to bond insurance firms. In the leadup to the financial crisis, both Ambac and FGIC were rated Aaa. But by 2010, both had filed for bankruptcy.

## Credit Events

That municipalities would consistently be rated harsher than the private sector, in light of the ratings agencies' behavior during the financial crisis, is galling: it results in increased wealth transfers to Wall Street, at the expense of the municipalities least able to afford it.

But even more so, the stringent burden on municipal issuers doesn't make sense in light of the glaring legal differences governing default and bankruptcy in the public and private sectors.

Defaults outside of bankruptcy are incredibly rare. The following case studies illustrate the consequences that municipalities face when they run afoul of Moody's and S&P, and the consequences that the public encounters as a result.

The following case studies were chosen as examples of cities with low ratings. New Jersey is the second-lowest rated state, while Chicago Public Schools is the lowest-rated school district. Newark and Jackson are both among the lowest rated cities in the nation.

Moody's performs far more municipal ratings than S&P and Fitch, which is why the agency gets significantly more attention in this report.

### State of New Jersey

Total losses to unfair ratings: **$222 million annually**

On March 27, 2017, Moody's further downgraded New Jersey's credit rating, to A3, six notches below Aaa.  The downgrade, which affects $37 billion worth of state debt, is the latest in a long stream of downgrades of the state's debt from ratings agencies.

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[13] *Ibid.*

The artificial lowering of New Jersey's credit rating by Moody's, S&P and Fitch will cost New Jersey taxpayers **$258 million** annually.[14] That cost exceeds the total annual amount that the state spends on environmental protection by over $30 million[15]

The State of New Jersey has never defaulted on its obligations. A US state has not defaulted on its debt in over 80 years. Yet Moody's decided to downgrade New Jersey to a rating that puts it below the before mentioned rating of Washington Mutual in 2007, well after the bank's problems had been described in the media.

A default by the State of New Jersey is unthinkable. US states cannot go bankrupt. Moody's framed the problem as an issue of high long-term pension obligations.[16] But a rating is supposed to measure the likelihood that public entity will default on its debt, not outstanding obligations that are amortized over 30 years.

Outside of its pension obligations--which have never led to a debt default in the history of the municipal bond market--New Jersey may have fiscal issues. But whether or not those issues indicate a likelihood to default is not evident. From the dataset of US state defaults, Moody's is rating in an environment in which there are no defaults, and as a result, no indication that New Jersey will ever default.

Given both New Jersey as an issuer and its peer group's sterling record for meeting its obligations, Moody's has no excuse but to rate New Jersey's--and all US state's--obligations at Aaa.

## Chicago Public Schools

Total losses to unfair ratings: **$290 million annually, plus $234 million in one-time payments**

This year, the administration of Chicago Public Schools threatened to close schools three weeks early, as a result of a purported cash crunch. This comes on top of years of school closures, and positions left vacant. 80% of Chicago students are eligible for federal meal programs.

[14] This is based on a 0.6% spread between an index of 20-year Aaa-rated municipal bonds and an index of 20-year A-rated municipal bonds. As of March 23, 2017, the Aaa index returned 3.35% and the A index returned 3.97%. Given that some lower interest rates from when the state was rated higher are locked in, this is an estimate of future losses if the current rating persists.

[15] "Fiscal Year 2017 Detailed Budget." State of New Jersey.

[16] Rating Action: Moody's downgrades New Jersey's GO rating to A3; outlook stable." Moody's. March 27, 2017.

In September,[17] Moody's downgraded $5.8 billion worth of Chicago Public Schools debt to B3, fifteen notches below Aaa, and six notches into junk category. The downgraded debt in Chicago will cost the city $290 million annually relative to Aaa debt.[18]

In February, the school district cut $31 million[19] to local schools--money that would help go to provide for additional programming for children, like arts, music, physical education, and field trips--to offset the loss of state aid. But the cost of higher debt service dwarfs **sixfold** the loss of state aid.

That doesn't include other costs to the downgrade. Thanks to complex interest-rate swap deals, Chicago Public Schools was forced to pay out an additional $234 million[20] in swap termination fees. After being sold on the risky swaps--which are supposed to guarantee a fixed-rate to municipal issuers when they make the haphazard decision to issue variable rather than fixed-rate debt--Chicago Public Schools paid the termination fees the swaps contracts mandated when district's credit rating cratered.

The ratings downgrades for Chicago Public Schools were coextensive with ratings downgrades for the City of Chicago, which Moody's justifies in part by saying that "The fiscal stress of Chicago Public Schools (CPS, B3 negative) also poses some long term risks to the city. Sustained fiscal stress at CPS could pressure Chicago's credit profile in various ways, from constraining the city's practical ability to raise revenue for city obligations to raising the city's borrowing costs." The city is currently rated at Ba3, twelve notches below Aaa. The ratings downgrade costs the city approximately **$113 million** annually.[21]

One potential conflict of interest with the city's interest rate swaps has emerged. A total of **$35 million** in swap termination fees were paid to Wells Fargo (among other banks). Interestingly, Wells Fargo and Moody's both share a largest shareholder: Warren Buffett's Berkshire Hathaway. Buffett is notoriously active with his positions in companies. Wells Fargo and Moody's are both among Berkshire Hathaway's largest positions. The timeline, then, is thus: Moody's--Buffett's 11th-largest

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[17] "Rating Action: Moody's downgrades Chicago Board of Education, IL's GO to B3; outlook negative." Moody's Investor Service. September 26, 2016.
[18] Based on an estimated 5% spread, which likely understates the cost. Moody's 20-year index reports Aaa bonds at a 3.35% average, while in a February 2016 bond offering, CPS paid 8.5% interest rates. See "CPS borrows $725 million at extraordinarily high interest rate." Heather Gillers, *Chicago Tribune.* February 3, 2016. Given that some lower interest rates from when the school district was rated higher are locked in, this is an estimate of future losses if the current rating persists.
[19] "Former CPS Leader Calls Out Cuts to Low-Income, Minority Schools." Nick Bloomberg, WTTW. February 27, 2017.
[20] "Turned Around: How The Swaps That Were Supposed To Save Illinois Turned Toxic." Saqib Bhatti and Carrie Sloan, ReFund America Project. January 2016.
[21] Based on a 2.3 percent spread, as estimated by Bloomberg. "Chicago Returns to Municipal Market After Record Tax Hike." Elizabeth Campbell, Bloomberg. January 12, 2016.

position--downgrades Chicago's bond rating into junk status. In turn, the city must pay out millions in termination fees to Wells Fargo, Buffett's second-largest[22] position.[23]

Chicago Public Schools hasn't defaulted on a debt obligation since 1943. With the debt rated into junk territory, far fewer investors--in particular, banks and insurance companies--can hold the debt, driving up the costs even more. In February 2016, a $725 million general obligation issuance by CPS carried an 8.5% yield, compared to a Aaa average yield of 3.35%. The 2016 issuance alone will cost Chicago schoolchildren over $35 million annually.

The September 2016 ratings downgrade followed a string of other downgrades. And beyond the high interest rates, Wall Street walked to the bank in two other ways as well.

In its statement reviewing the decision to lower CPS' credit, Moody's noted that the new rating **"incorporates... elevated debt service expenses that include interest rates of up to 9% on GO bonds."** Such a statement from Moody's typifies the classical definition of the term "chutzpah", given that it was Moody's own actions that caused the skyrocketing debt service costs.

While the Governor of Illinois has called for authorizing legislation to allow Chicago Public Schools to declare bankruptcy, such legislation is not in place. The overwhelming Democratic control of the state's legislature makes the likelihood of impairment as a result of bankruptcy a near impossibility. Additionally, missed debt payments are also highly unlikely given that Chicago has unlimited sovereign ability to raise property taxes, and that "Chicago homeowners... pay far less in property taxes than the vast majority of their suburban neighbors," according to the Chicago Tribune.[24] Chicago's ability to raise property taxes distinguishes it from the hundreds of localities subject to a tax cap, which include cities, counties, and school districts in California, Massachusetts, New York, Oregon, Colorado, and many municipalities outside of Chicago in Illinois.[25]

As noted above with the Wells Fargo example, the rating downgrade did not happen in a vacuum. But some of the forces were notably forward about their intentions. In a

[22] "CNBC Berkshire Hathaway Portfolio Tracker." Data pulled May 8, 2017.
[23] In a recent study, researchers from Rutgers and Emory found that Moody's gave statistically significant higher ratings to companies owned or invested in by Berkshire Hathaway, including to Wells Fargo. See: "Does it matter who own's Moody's?" Simi Kedia, Shivaram Rajgopal and Xing Zhou. March 23, 2015.
[24] "Even with Emanuel hike, city homeowner property tax rates still below suburbs." Hal Dardick, *Chicago Tribune*. November 13, 2015.
[25] "Tax Caps in Other States: Lessons for New York." Hector Chang and Christine Wen. Creative Responses to Fiscal Stress Project, Cornell University. December 2014.

2013 speech, the head of the Civic Committee of the Commercial Club of Chicago--the roundtable of the city's business elite--admitted that some of his members had contacted the ratings agencies and urged them to lower ratings as a way to pressure the state to deal with pension costs, calling the ratings agencies "enablers."[26] After that speech, ratings downgrades have been ubiquitous for Chicago and Chicago Public Schools.

**Newark, New Jersey**

Total losses to unfair ratings: **$10 million annually**

Shadowy Wall Street actors spent millions to attack incumbent Mayor Ras Baraka in the contentious 2014 election.[27] Less than a year later, Moody's announced a ratings action that would send millions of dollars out the door to Wall Street. On May 15, 2015, Moody's lowered the rating for $374 million of Newark's general obligation debt to Baa3, just one notch into investment grade. The ratings downgrade will cost the city $10 million annually in additional debt service costs relative to Aaa debt.[28] That exceeds the total the city spends on health care for the indigent, environmental health, and economic and housing development by over $3 million annually.

Moody's had also downgraded Newark the year before, to Baa1. In part due to Moody's actions, Mayor Baraka requested state aid, which in turn forced the city to submit its budget for approval to a state board, which forced the Mayor to take more out of public employees' paychecks for their health care. The state board's review process was praised by Moody's, but did not lead to an upgrade. Instead, it led to a rare two-notch downgrade the following May.

The ratings agency openly admits that the city's high poverty levels factored into its rating: an open-shut definition of redlining, inflicted on people on the receiving end of Wall Street-driven economic inequality.

Given that poverty levels have no correlation with default in states without a history of municipal defaults or bankruptcy, what the rating reveals is instead a tax on poverty, a tax on historically marginalized populations.

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[26] "Chicago CEO Club, With Rahm and Pritzkers on Board, Pushed for Chicago Bond Downgrade, Whacking Local Investors and Pension-Holders." Yves Smith, Naked Capitalism. July 26, 2013.

[27] "Newark mayor's race: pro-Jeffries independent expenditure group shows donations of $1.3 million, Wall Street ties in ELEC report." Mark Bonamo, *Observer.* April 21, 2014.

[28] Based on a 2.7% estimated annual spread. The 20-year Moody's AAA index returned 3.35% as of March 23, 2017, and a 20-year index of New Jersey Baa3 bonds returned 6.05%, again according to Bloomberg Terminal research. Given that some lower interest rates from when the city was rated higher are locked in, this is an estimate of future losses if the current rating persists.

No New Jersey city has defaulted on its debt since World War II, and given the state's expansive role in municipal oversight, it is extremely unlikely that any will do so, unless compelled by the state.[29]

**City of Jackson, Mississippi**
Total losses to unfair ratings: **$2.8 million annually**

In Jackson, Mississippi, the approximate spread between the cost to service debt at Aaa--a rating that accurately reflects Jackson's extended credit history and the lack of state bankruptcy law--and the current ratings, at Baa2 for Jackson's $124 million in general obligation debt and A3 for its $228 million in water and sewer debt--are significant. The total cost to Jackson for subpar ratings on an annual basis is estimated to cost the city approximately $1.6 million in additional debt service costs on the water/sewer debt, and approximately $1.2 million in additional debt service costs annually on general obligation debt, for a total of $2.8 million annually in surplus debt service costs.[30]

Jackson has not had a municipal default since 1933, and there are no provisions for municipal bankruptcy in Mississippi. Moody's notes that the general obligation debt is "secured by an annual ad valorem tax, levied against all taxable property in the city without legal limitation as to rate or amount." In the case of the water/sewer debt, the bonds are "secured by the system's net revenues."[31]

While Jackson has seen depletion in its reserves, the question is if that leads to default. And Jackson faces enormous needs. An extra $2.8 million annually out of Jackson is not something that the city can afford. The city desperately needs substantial improvements to its infrastructure, and there has been rampant austerity over the past few years, including furloughs to city employees.

Moody's two-tier rating system--one for the private sector, the other for the public sector--has the result of demanding austerity out of those municipalities that can least afford it.

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[29] For more, see "STRICT FISCAL OVERSIGHT KEEPS NEW JERSEY CITIES OUT OF BANKRUPTCY" Mark Magyar, NJ Spotlight. July 22, 2013.

[30] Data pulled from a Bloomberg Terminal as of March 23, 2017. General obligation calculations are based on a 0.98% spread between the cost of Aaa municipal bonds and Baa3 municipal bonds. While there are not indices that track Baa2 municipal bonds specifically, the difference between the Moody's 20 year Aaa bond index and the Moody's 20 year Baa average was 0.98%. There are three Baa notches, Baa1, Baa2, and Baa3 (the lowest. Hence the estimate at $1.2 million for GO debt. The water/sewer debt was based on a 0.7% spread. The difference between the Moody's Aaa and Moody's A 20 year indices was 0.62%, but A3 is the lowest notch of A debt, thus a 0.7% estimate. Given that some lower interest rates from when the city was rated higher are locked in, this is an estimate of future losses if the current rating persists.

[31] The revenues, that is, from a system that every resident and business in the City of Jackson--and many outside--depend on a daily basis.

## "More of a Drain"

All the entities identified in this report have above-average compositions of people of color. New Jersey is one of the most diverse states. Jackson and Newark are both majority-black, while the children served by Chicago Public Schools are just 10% white.

This is not an accident. It's worth recalling a racially coded "welfare queen" statement about Detroit from Brenton W. Harries, a former President and chief executive of Standard and Poor's in a 1993 interview. Harries argued that **"[Detroit's] particular mix of population requires more welfare payments, more housing. They're more of a drain as opposed to being more a contributor."**[32]

Harries failed to note that funding for welfare and housing overwhelmingly comes from federal and state governments, which limits the import of that data towards an assessment of a city's likelihood of default. The same is true with Moody's decisions to include poverty and median household income in its ratings methodology for public sector debt. Moody's makes no claim of a correlation between low MHI and a likelihood to default. But it's in the ratings methodology anyways. It's a 21st century form of redlining: you have too many poor people, so you must pay more to Wall Street. The fact that these cities are disproportionately people of color, and disproportionately bear the brunt of a ratings system gone haywire, is incidental, according to Moody's, S&P, and Fitch.

But the public knows better. The ratings agencies' misconduct in the leadup to the financial crisis was too great to excuse misconduct and racism as a source of their decision-making when it comes to public sector ratings.

Redlining was explicitly banned by Congress in 1968 via the Fair Housing Act, so too was credit discrimination by the Equal Credit Opportunity Act in 1975. For a variety of reasons, these laws have never been applied to the ratings agencies. But this should change. Given the limited space of states and municipalities with subpar ratings, the fact that almost all of them are cities with high populations of people of color suggest a clear case of racially discriminatory policies. [33]

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[32] From "Debt, Governmentality, and the Neoliberal City." Christopher Foerster-Smith, April 2015. Additionally, it's worth noting that in retrospect, the Detroit Free Press rated then-Mayor Coleman Young's stewardship of the city's finances as excellent, finding that Young consistently worked to keep deficits down. For more, see "How Detroit went broke: The answers may surprise you — and don't blame Coleman Young." Nathan Bomey and John Gallagher, Detroit Free Press. September 15, 2013.
[33] For more on this subject, see "Municipal Bond Ratings and Citizens' Rights." John Yinger, American Economic Law Review. October 20, 2009.

## Are Pension Obligations A Reliable Indicator of Fiscal Stress?

A thread running throughout this report is that the ratings agencies have targeted municipalities for a variety of reasons, among them pension and retiree health care funding.

This is a new endeavor. Only in 2013 did Moody's formally include pension funding in their ratings methodology for the public sector.[34] And in the rationale for the ratings change, Moody's makes no claim as to the actual import of the data to the likelihood of a default. Instead, Moody's presents its changes in a circular manner: rising pension obligations had driven Moody's own debt downgrades, so it has now decided to formally include the pension data, as presented by Moody's, in its formal analysis. And rather than using a discount rate to assess pension obligations that reflects industry standards (around 6.5% to 7.5% assumed rate of return)--Moody's instead used the significantly-lower 5-year corporate bond rate (around 3%) to assess liabilities.

The effect of Moody's numbers-play is a significant inflation of the cost of pension obligations.[35] The result is mass hysteria around pension obligations.[36]

Coincidentally, the formal addition of pension funding issues came as Enron billionaire John Arnold launched his nationwide assault on defined-benefit pensions.[37] In 2012, Arnold granted $5 million[38] to the Pew Research Centers to fund an advanced research and communications strategy that emphasized the unsustainability of defined-benefit pensions--and by implication making the case for transitions to 401(k)-style plans that offer far less comprehensive benefits at retirement. Prior to the Arnold grant to Pew, public pension obligations had a limited presence in the national discourse. Since the grant, news articles have been written across the country making the case that pension benefits are unsustainable.

Moody's actions happened to perfectly coincide with the Arnold-financed uptick in concern about pension obligations. And Moody's has also not hesitated to intervene in state-level battles over pension reform, arguing that the Illinois Supreme Court's

[34] "Adjustments to US State and Local Government Reported Pension Data." Moody's Investor Service Cross Sector Ratings Methodology. 2013. And "Announcement: Moody's announces new approach to analyzing state, local government pensions; 29 local governments placed under review." Press Release. April 17, 2013.
[35] "Moody's flawed estimate on public pension liabilities." Cate Long, Reuters. June 28, 2013.
[36] For more, see "The real threat to pensions is Wall Street." Matthew Cunningham-Cook, Al Jazeera America. December 11, 2014.
[37] For more, see "The Plot Against Pensions." David Sirota, Institute for America's Future. September 2013.
[38] "John Arnold: The Most Hated Man in Pensionland." Liz Farmer, *Governing.* April 2017.

rejection of pension cuts was "credit negative" in July 2014,[39] warning that a New Jersey Supreme Court decision in favor of workers demanding their contractually and constitutionally-mandated cost of living adjustments would "negatively affect [New Jersey's] credit profile."[40] While Moody's has also intervened in some cases over taxes, it has been far more taciturn to punish cities and states for a failure to tax than for a failure to address pension obligations.[41] Indeed, despite rampant evidence of out of control interest-rate swap payments--many of which are unnecessary, given a willingness on the part of banks to negotiate when threatened with legal action--Moody's has never spoken up.

The same goes with corporate subsidies. There was silence from the ratings agencies when *The Record* found that corporate subsidies under Governor Christie had exploded to $7.4 billion from 2010 to 2016[42]--despite the fact that unlike the pension cost of living adjustments at issue in the court case, corporate subsidies are not an earned contractual obligation.

## Next Steps

The goal of this report is to demonstrate that the ratings agencies 1) apply two different standards for public and private sector debt, costing cities, states and school districts millions, 2) engage in redlining-type practices that disproportionately affect communities of color, and 3) have included pension obligations in their rating analysis with no evidence that such obligations increase the likelihood to default.

Given that their existence is predicated on the NRSRO authorization from the SEC, credit rating agencies have a public interest obligation to ensure that their policies do not disproportionately force cities and states to pay higher debt service costs *just because they are cities and states.*

This is the reason why the ratings agencies settled with the State of Connecticut, and then Moody's engaged in mass upgrading of public sector debt--saving cities, counties, states and school districts $1 billion annually.

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[39] "Moody's says court ruling is negative for Illinois pension reform." Reuters, July 11, 2014.
[40] Moody's: Pension case poses risk for N.J.'s credit rating." Andrew Seidman, Philly.com. January 21, 2016.
[41] See Kansas' credit rating of Aa2--two notches below Aaa, compared to A2 for New Jersey, six notches below Aaa, and Baa2 for the Illinois, eight notches below Aaa. For more on Kansas' fiscal difficulties, see "What Trump Can Learn From Kansas' Tax Troubles." Kyle Pomerlau, Scott Drenkard, and John Buhl, Politico. May 4, 2017.
[42] "Lawmakers ignoring $7.4B boom in 'corporate welfare,' experts say." Salvador Rizzo, NorthJersey.com. December 18, 2016.

And a double standard for public sector issuers is also illegal. Dodd-Frank mandated a universal standard. This report makes it clear that that mandate has not been reached.

With a former Goldman Sachs attorney now leading the SEC, change from the federal government is not likely. Cities, counties, and state attorneys general must follow Connecticut's lead and take action against the ratings agencies to hold them accountable for the gross financial injustices described here.

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**Methodologies**

The estimates in this report of losses due to unfair ratings come from estimates of spreads between bonds depending on their credit rating, pulled from a Bloomberg Terminal on March 23, 2017. The spread was then plugged into the amount of debt affected, according to Moody's.  Given that some lower interest rates from when the state was rated higher are locked in, this is an estimate of future losses if the current rating persists.

**Note on Puerto Rico**

The largest municipal debt crisis in the country right now is in Puerto Rico, where the actions of the ratings agencies have not been helpful--both in the leadup to the crisis to now. However, the island's special legal status significantly differentiates it from the rest of the bond market and as such I did not include it in the report. There are other aspects that differentiate the situation in Puerto Rico as well. For more on this, see please see the ReFund America Project's series on Puerto Rico's debt.

[43] Of course, acknowledgments do not imply the full endorsement of this report by the acknowledged.