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A Bond Rating Means Many Relationships

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As someone who has been at a bond rating agency for close to 20 years, I am still not surprised when I am asked, "What is a bond rating?" There has been, and still remains, some mystery around what exactly a bond rating is, how it works, and how one should engage with a host of new constituents involved in the process. This article focuses on three important aspects: what a rating is, and what it isn't; the ways a board can best participate; and how to manage the multiple relationships involved.

What a Rating Is, and What It Isn't

Let's clarify this right at the outset. A bond rating is a rating agency's opinion of your organization's ability to repay borrowed debt on time and in full. It's a measure of risk that investors (those individuals or firms that buy your bonds) use as a part of their risk/reward decisions as to whether they want to buy your bonds, what they may want to pay for them, and whether they keep them or sell them at a later date.

A bond rating is not a recommendation to buy or sell a particular bond. A bond rating, no matter how personal it may feel, is also not a personal judgement against any one person or persons—it's an *organizational* assessment. A bond rating is often thought to be a judgement on clinical quality, and no, that is not quite right either. While it is true that quality and financial success are highly correlated, a bond rating is ultimately based on your financial ability to repay that debt, not clinical outcomes.

Lastly, a bond rating is sometimes viewed as being dependent on size and scale. Again, there is a correlation with size and scale and higher ratings, but it all ultimately comes down to perceived risk of repayment. Less risk equals a higher rating; higher risk equals a lower rating. Size and scale can be important rating factors, but they do not, *a priori*, determine the rating.

Why a Rating Is Important to Bondholders

One of the first relationships involved in a rating is that of the bondholder. Bondholders take a disproportionate amount of risk when they loan money to a hospital or health system. From their perspective, *at best*, they get their money back plus a little interest. At worst, they lose it all in a bankruptcy or default situation. Unlike *share*holders who own a piece of a company, *bond*holders are merely loaning money for a period of time; they have no equity

Key Board Takeaways

- **Know what a rating is and isn't.** Bond ratings are measures of relative risk, assessing the ability of your organization to repay debt both on time and in full. Bond ratings are intended for investors, to enable them to make informed risk/reward decisions. Bond ratings are not personal referendums on you as an individual or a governance team.
- **Stay informed.** There is typically board-level representation at rating agency meetings. Stay educated on criteria, rating agency specific hot-topic issues, and current organizational performance—particularly if there has been an unexpected change from budgeted levels. Be prepared to articulate the board's expectations and level of oversight.
- **Manage your many relationships.** The board should stay in touch with the rating agencies, both directly when there is an anticipated CEO or other C-level change, but also indirectly by board-level oversight of the leadership team's communication with rating agencies. Keep them informed. Keep your bondholders informed. Rating agencies and bondholders generally do not like surprises, and will, in the absence of direct and honest communication, begin to assume the worst.

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stake to fall back on in a distressed situation. As such, bondholders are keenly interested in what a rating agency has to say as a neutral third party about perceived risk. They are also very interested in a steady flow of information from the hospital or health system in which they have invested.

What Should I Do Going Forward?

Staying in touch and managing all your relationships is the best thing you can do. Beyond the rating agencies and bondholders, there is also the way your board manages *your* leadership teams and how *they* manage and communicate with both the rating agencies and the bondholders. Both rating agencies and bondholders will ask for and expect a continuous flow of information. Rating agencies need this to keep the rating up to date and accurate, and bondholders continuously evaluate their position and risk threshold.

Bondholders and rating analysts like transparency—they do not like surprises. Reading about something in the newspaper or on the Internet versus hearing it ahead of time from your organization does not help build a strong relationship. Rather, it creates an unfortunate opportunity for a knee-jerk reaction and potentially sets a stage of mistrust. Encourage your management teams to keep the lines of communication open, and to respond when contacted. Anything less than open, transparent, and honest discussion will generally lead to mistrust. Longer-term lack of communication can lead to the withdrawal of a rating, or bondholders refusing to loan money to your organization in the future.

What Is My Role as a Board Member?

Rating agencies prefer to have some level of board representation at rating agency meetings, certainly if it is a new rating, if it is a particularly challenging point in time for the organization, or if there is significant strategy to discuss (i.e., a potential large-scale merger or acquisition). The best way the board can participate is by being informed. A rating analyst and your bondholders will want to know how involved the board is in management's day-to-day work (at the appropriate level of oversight). Similarly, if a board member is attending the meeting or hosting an investor call, there will be an assumption that the board member is fully engaged in the organization and able to discuss it at length. You will get asked about any issues, and your rating analyst and bondholders will want to get your perspective. Bondholders and rating agencies will want to know about any pending CEO or C-level changes coming up specifically, and succession planning more generally. If your organization just had a particularly bad quarter financially, you should expect your rating analyst and bondholders will want to know what happened and how the organization is going to respond.

Summary

Obtaining and maintaining a bond rating should not seem a daunting prospect if you put yourself in the shoes of the bondholder. There is a natural and reasonable need for regular information to be shared with both bondholders and rating agencies to build and maintain transparency between the various parties. Your role as a board member is to stay informed, stay involved, and work with your management team to ensure that all constituents in the bond rating process are informed.

The Governance Institute thanks Kevin Holloran, Senior Director, U.S. Public Finance, Fitch Ratings, for contributing this article. He can be reached at kevin.holloran@fitchratings.com.