Credit ratings : opinions on credit quality

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In this article, Shahla Motadel describes the role and nature of credit ratings and the methodology adopted by the agencies that produce them. The article outlines the current use of ratings for regulatory purposes in New Zealand and briefly reviews the past reliability of ratings.

I Introduction

When someone relies on a "promise to pay", the creditworthiness of those making the promise is of utmost importance to the person expecting payment. Credit ratings provide an independent and objective way of judging credit quality and the risk of default.

This article looks at the importance of credit ratings in today's financial markets environment and what the ratings signify. In doing so, it explains the role of ratings and the symbols, definitions and methodology used by two of the leading credit rating agencies.

II The role of credit ratings

Credit ratings play an increasingly important role in today's financial decision making. With the liberalisation and globalisation of international financial markets, a wide variety of financial products with differing risk characteristics and complexity has developed. While investment opportunities have grown, however, so have the uncertainties and potential risks.

A major risk is the credit risk, or the risk of default or delay in meeting obligations. This may vary from extremely safe to highly risky or speculative.

A combination of in-depth analysis and expert judgement is needed to gauge adequately the credit quality inherent in various investment options, not only at the time an investment decision is being made, but also over the life of the investment. For the individual, the assessment and monitoring are both costly and difficult, demanding time, expertise and information, all of which may not be readily available. These tasks become almost impossible for consistent credit quality assessments of investment alternatives globally.

Specialist credit rating agencies have evolved to meet this need. Rating agencies rate institutions and countries around the world. They may also rate specific obligations (for example bank deposits, commercial paper, senior and subordinated debt). A credit rating signals the company's overall ability to repay its obligations while the ratings on specific obligations address the company's ability to service particular types of commitments. Thus, a company or country may be assigned different ratings for different types of obligations.

The credit ratings issued by the agencies provide informed opinions about the creditworthiness of the borrower or instrument concerned, on a comparative basis and on a global scale. The ratings given reflect the rating agency's expectation of the future ability of the obligor to meet its commitment on time and in full. They do not, however, purport to forecast securities' prices or earnings, nor are they intended as recommendations to sell, buy or hold certain securities. Ratings are essentially one element for investors to consider, whether they are investing in debt or equity of a particular institution, or investing in debt securities of a particular country.[1]

Ratings are also an important indicator of financial soundness for other parties, particularly creditors and consumers of financial services and products. Borrowers too typically need ratings if they wish to access international financial markets to raise funds.

III Use of ratings for regulatory compliance

Credit ratings feature in a number of regulatory regimes around the world. The US supervisory authorities, for instance, use ratings for setting capital requirements and bank asset quality thresholds. In New Zealand, credit ratings have regulatory recognition in both the insurance and banking industries.

Under the Insurance Companies (Ratings and Inspections) Act 1994, New Zealand insurance companies providing disaster or general insurance must obtain, register and disclose a current claims paying ability rating from a rating agency approved by the Registrar of Companies.[2]

1 Other factors in financial decisions may include market risk (comprising interest rate risk and foreign exchange risk), liquidity risk, and concentration risk (geographical, sectoral, or to a group of related parties) and, of course, expected return.

2 Two international rating agencies, Standard & Poor's (Australia) and A.M. Best Company (United States) have been approved by the Registrar for a three year period ending 20 July 1998.

The rating of the claims paying ability of insurers aims to raise the awareness of insurance customers to the financial strength of the companies they are relying on for payment of future claims.

The Reserve Bank's new disclosure regime for registered banks also uses ratings. Under the new disclosure requirements, which came into force in January this year,[3] each bank must state in its quarterly disclosure statement whether or not it has a credit rating for its long-term (ie 12 months or more) senior unsecured New Zealand dollar debt. If a bank does have a rating, it must disclose the rating, the name of the rating agency and a description of the ratings scale used, together with any qualification and recent changes to the rating. The purpose of this requirement, and the disclosure requirements overall, is to increase transparency in the financial markets, offering depositors/creditors and investors an informed credit quality judgement on which they can differentiate banks and monitor conditions on an ongoing basis. Given the competitive nature of the banking industry, ratings disclosure can also be a self-imposed control device for banks to pursue prudent banking practices.

IV Rating agencies and symbols used

The number of rating agencies has grown rapidly in recent years. Some agencies specialise in particular geographical regions or market sectors. Two of the major international rating agencies and leading bank rating agencies are the US-based Moody's Investors Service and Standard & Poor's Corporation.[4]

Typically, rating agencies use a combination of letters and numbers to convey their credit quality opinions. In the case of Standard & Poor's and Moody's, ratings fall into two categories: investment grade and speculative grade. There are short-term and long-term ratings that correspond to these two categories. Table 1 shows the symbols used by the two agencies and a brief description of how to interpret these. The ratings and definitions of the two agencies are very similar but not necessarily equivalent. Indeed, due to differences in assessments, the agencies do not always agree in their credit quality opinions. Divergencies of opinion, however, tend to be relatively small.

In addition to the letter-based ratings for which the agencies are known, they also provide full assessment reports and a range of commentaries and research which are available to their clients.

V Rating agencies' methodology

Credit ratings are opinions which are based on a combination of quantitative analysis and expert judgement. For their assessment, rating agencies use publicly available financial and non-financial information, together with private information obtained during regular discussions with representatives of the company or country being rated. The first-hand knowledge gained through their discussions is often not otherwise generally accessible by investors.

Factors assessed in the quantitative analysis include capital adequacy, asset quality, earnings performance and cash flow adequacy, liquidity and the extent of vulnerability of these factors to external shocks. Qualitative analysis focuses on management quality and the operating environment, assessing such factors as business policies and plans, its industry risks, and the threats posed by competitors domestically and globally.

While they look at historical financial information, the rating agencies adopt a forward looking approach, focusing on information which has predictive power to reveal tendencies for the future, typically over a medium-term period of 2 to 5 years.

Institutions or instruments are assessed on a stand alone basis, complemented with any credit support factors which may be accessible if and when financial assistance is needed. These include explicit or implicit guarantees, other parent or shareholder support, and access to credit facilities and capital markets.

A further factor is the credit rating of the country in which the institution is based. As a general rule, the credit rating of any borrower or issuer cannot be higher than the rating of its sovereign (or home) government. This "sovereign ceiling" concept reflects the wide range of powers and resources of governments that make their credit standing superior to corporate issuers and banks domiciled in the same country.[5]

Once a rating is assigned, the agency monitors it on an ongoing basis. The changing nature of today's financial

3 See the RBNZ *Bulletin*, March 1996, pages 21 to 29 for further details of the new registered banks disclosure regime.

4 Other international agencies include, among others, IBCA Ltd, Duff & Phelps Credit Rating Co; Fitch Investors Service, and Thomson BankWatch.

5 New Zealand's Government domestic debt has a long-term rating of Aaa/AAA, while its foreign currency debt is rated as Aa1/AA+. [A country's domestic currency rating is generally higher than its foreign currency rating. This is because a government's ability to service its domestic debt is likely to be stronger than its capacity to service foreign debt.]

Table 1

Credit ratings - symbols and abridged definitions

Long-term ratings[6]

Moody's	S&P's	Definition
Investment grade:		
Aaa	AAA	Highest rating and quality
Aa	AA	Highest quality; very strong capacity to meet financial commitments.
A	A	Favourable quality but may be susceptible to impair ment in the future.
Baa	BBB	Medium quality with adequate capacity but suscepti ble to adverse conditions.
Speculative grade:		
Ba	BB	Moderate quality but subject to ongoing uncertainty and exposures to adverse conditions.
B	B	Current payment capacity but ongoing assurance may be small.
Caa	CCC	Poor standing, may be in default.
Ca	CC	Lowest ratings; highly speculative,
C	C	showing strong default indications.
	D	In bankruptcy or default.

Short-term ratings[7]

Moody's	S&P's	Definition
Prime-1	A-1+	Superior ability for repayment of short (P-1) term debt obligations.
P-2	A-1	Strong ability for timely repayment.
P-3	A-2 A-3	Adequate repayment ability but vulnerable to changed conditions.
Not Prime	B-1 B-2 C-1	Speculative capacity for timely repayment.
-	D-1	In default.

6 Ratings on senior debt obligations with maturity greater than 1 year. The use of 1, 2 or 3 (for Moody's ratings, eg, Aa1, Aa2, Aa3) or the addition of a plus or minus sign (for Standard & Poor's, eg, AA+, AA, AA-) shows relative credit standing within the major rating categories.

7 Ratings on obligations with maturity up to 1 year.

markets demands continuous surveillance of financial health and timely reporting of developments. This is important if investors, creditors and consumers, are to be adequately informed.

To respond to the financial market's demand for immediate credit quality warning, the rating agencies have developed ways of advising of possible changes in advance: "CreditWatch" in the case of Standard & Poor's and "Watchlist" for Moody's. With these lists the agencies alert financial markets to an emerging situation which could materially impact, positively or negatively, on the financial position and credit quality of the name concerned. A full review and rating update will subsequently confirm or clarify the position. Changes in credit ratings, however, may occur without prior notice, or without the institutions or countries being first placed on credit watch by the agencies.

VI Historical reliability of ratings

Studies on the default history of rated issuers help provide an objective measure of the accuracy of rating agencies' assessments and also help quantify the relative risk of default. The various studies clearly show that the risk of default rises with lower rating categories, particularly those in the speculative grades. A recent study by Moody's, for example, covering the last 58 years, shows that of the 560 issuers which had Moody's ratings at the time they defaulted, all but three (0.5 percent) had speculative grade ratings when they defaulted, while 90 percent had single B or lower ratings. None had Aaa or Aa ratings.

The same study showed that the default rate since 1970 for companies rated single A or above by Moody's was less than 0.1 percent on average one year after the A (or better) rating was assigned and still less than 2 percent ten years after the original A rating. The default rates for speculative grades, in contrast, was around 4 percent on average after one year (over 7 percent for single B or lower rated issuers) and 27 percent after ten years.

Overall, the default data and studies to date suggest ratings provide a reasonable ordering of relative credit risks and the risk of default, but are less reliable in an absolute sense.

VII Conclusion

Credit ratings provide an independent and specialist assessment of relative credit quality. The demand for independent credit rating opinions has emerged from a wide range of participants of the international financial markets. Investors and creditors, who are relying on a future payment promise, and borrowers, who wish to raise funds, all have an interest in rating agencies' opinions. Ratings may also be required for regulatory compliance reasons. Credit ratings or views on credit quality, however, should be seen as one, albeit important, element in any financial decision.

Users of credit ratings should also bear in mind that the business of credit analysis is inherently subjective and therefore imprecise. Credit ratings are judgements, affected by, amongst other things, the quality of information provided to the agencies. Furthermore, the credit performance of a rated company or country can be influenced by a number of factors, some of which may be outside its control. The possibility of surprise therefore always exists.

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