RESERVE BANK

OF NEW ZEALAND

# Explaining

# Credit Ratings

## What is a credit rating?

A credit rating is an independent opinion of the capability and willingness of a financial institution to repay its debts – in other words, its financial strength or creditworthiness.

Credit ratings are issued by independent rating agencies, such as the internationally recognised Standard & Poor's, Fitch Ratings and Moody's Investors Services. The rating is usually calculated as the likelihood of a failure occurring over a given period and is expressed as an alphabetical rating, with the higher rating e.g. 'AAA', being superior (having a lower chance of default) to a lower rating e.g. 'C' (a higher risk of default).

Rating agencies look at a range of financial measures when they assess an organisation's financial strength, as well as external industry-related issues and the quality of management and internal processes.

## What credit ratings can and cannot do

Credit ratings give investors an indication of a financial institution's relative strength, the likelihood that it will default and fail to repay investors. The rating helps investors assess whether the risk of investing is balanced by the rate of return on an investment.

Ratings are not a guarantee that an institution will be safe in the future. Indeed even an 'AAA' rated bank has an approximately 1 in 600 chance of default over a five year period. Although ratings are periodically revised, they are designed to provide a medium-term view of an institution's financial strength. They do not respond to specific events or market volatility.

Recent rapid downgrades in credit ratings given by the agencies to the financial instruments at the heart of the recent 'credit crunch' have called the value of ratings into question. However, there is a distinction between the ratings given to highly complex, abstract and new 'financial instruments', and those given to established and tangible financial institutions such as banks. These latter ratings relate to relatively simple obligations, such as straight-forward deposits and loans, and have been used by the ratings agencies for decades.

## Comparing credit ratings

Different ratings systems are broadly comparable. For instance, an 'AA' rating from Standard & Poor's and Fitch and an 'Aa' rating from Moody's all imply that the chance of the rated organisation defaulting is approximately one in 300 over the next five years.

Table 1

Standardised rating scale

<table>
<tr><th></th><th>Description</th><th>S&P Scale</th><th>Moody's Scale</th><th>Fitch Scale</th><th>Approx. probability of default over 5 years*</th></tr>
<tr><td rowspan="4">Capacity to make timely payment</td><td>Extremely Strong</td><td>AAA</td><td>Aaa</td><td>AAA</td><td>1 in 600</td></tr>
<tr><td>Very Strong</td><td>AA</td><td>Aa</td><td>AA</td><td>1 in 300</td></tr>
<tr><td>Strong</td><td>A</td><td>A</td><td>A</td><td>1 in 150</td></tr>
<tr><td>Adequate</td><td>BBB</td><td>Baa</td><td>BBB</td><td>1 in 30</td></tr>
<tr><td rowspan="5">Vulnerability to non-payment</td><td>Less Vulnerable</td><td>BB</td><td>Ba</td><td>BB</td><td>1 in 10</td></tr>
<tr><td>More Vulnerable</td><td>B</td><td>B</td><td>B</td><td>1 in 5</td></tr>
<tr><td>Currently Vulnerable</td><td>CCC</td><td rowspan="2">Caa</td><td>CCC</td><td rowspan="2">1 in 2</td></tr>
<tr><td>Currently Highly Vulnerable</td><td>CC</td><td>CC</td></tr>
<tr><td>Default</td><td>D</td><td>C</td><td>D</td><td></td></tr>
</table>

* The approximate, median likelihood that an investor will not receive repayment on a five-year investment on time and in full based upon historical default rates published by each agency.

## Credit ratings as investment advice

Credit ratings are useful indicators of risk for investors, but they are not a sole guide and have limitations which are important to bear in mind. The virtue of ratings lies in their availability, their ability to convey a simple measure of risk, and the way they enable investors to easily compare alternative opportunities. That said, they are not a panacea. Prudent investors should always consider their own personal circumstances, their willingness to take risks or otherwise, available investment strategies, and prevailing market conditions.

The Reserve Bank supports the use of ratings by individual investors as a tool to help make more informed investment decisions.

## Further information

Doug Widdowson and Andy Wood, 'A User's Guide to Credit Ratings', Reserve Bank of New Zealand *Bulletin*, Vol. 71, No. 3, September 2008.