Understanding Credit Ratings

Credit ratings are an opinion on the ability and willingness of an issuer to meet its financial obligations on time and in full. Ratings serve an important function in capital markets and, as such, are regulated by the Securities Exchange Commission (SEC) through the Office of Credit Ratings. That office currently recognizes ten agencies in the U.S. as Nationally Recognized Statistical Rating Organizations (NRSROs) which assign ratings to various issuers of debt, and can include corporations, municipalities and other issuers. To use rating agency Moody's as a particular example, the credit ratings themselves are "...forward-looking opinions of the relative credit risks of financial obligations..."[1] which are compiled to "...reflect both on the likelihood of a default on contractually promised payments and the expected financial loss suffered in the event of default..." for rated securities. Ratings are not an absolute measure of the probability of default (and loss given default), but are meant to be a measure of the relative risk of default when comparing securities (across multiple issuer types or across securities within a single type). For example, an Aaa rated bond has a lower probability of default relative to a bond rated Aa, regardless of the actual defaults that these two categories may go on to experience.

These credit ratings play a significant role in the investment decisions of capital market participants including institutional investors, mutual funds, pension funds and insurance companies. Many types of investors have legal

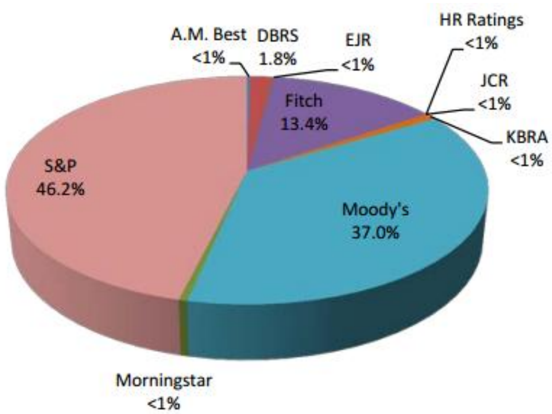
[1] Moody's *Rating Symbols and Definitions,* March 2015.

Greg Kyle

Alex Russell

restrictions on the type of debt they can own, including requirements related to credit quality. The rating agencies themselves maintain that credit ratings should not be relied on to make investment decisions, that they shouldn't be thought of as a statement on suitability, and are not buy, sell, or hold recommendations. However, they do recognize that they are meant to be relied upon as opinions of credit quality.

Although there are ten credit rating agencies that are formally recognized by the SEC as NRSROs, Standard & Poor's, Moody's and Fitch are the three largest and most closely followed by investors. Together, these three firms account for 97% of all ratings issued.



Source: Annual Report on Nationally Recognized Statistical Rating Organizations, U.S. Securities and Exchange Commission, December 2014, p. 10.

The credit ratings issued by these three firms are similar in that the ratings are divided between investment grade and non-investment or speculative grade. However, there are certain distinctions.

Standard & Poor's uses four different letter ratings (AAA, AA, A, BBB) to categorizes its long-term investment grade ratings, with AAA considered the highest available credit rating and BBB considered the lowest investment grade rating. For non-investment or speculative grade ratings, Standard & Poor's uses the letter ratings, BB, B, CCC, CC and C, with C having the highest speculative characteristics. Standard & Poor's also distinguishes some letter ratings with a modifier (plus (+) or minus (-)) indicating the relative ranking or standing within that letter rating category.

In addition to the ratings themselves, Standard & Poor's also assigns rating outlooks and CreditWatches. A ratings outlook "assesses the potential direction of a long-term credit rating over the intermediate term,"[2] taking into account any changes in economic or fundamental conditions of the industry or issuer. In contrast, a CreditWatch highlights the potential direction of a short- or long-term rating, and "focuses on identifiable events and short-term trends that cause ratings to be placed under special surveillance by Standard & Poor's analytical staff."[3]

Similar to Standard & Poor's, Moody's categorizes its long-term, investment-grade ratings into four separate distinctions or letter grades (Aaa, Aa, A, Baa), with Aaa indicating the highest credit quality, and Baa considered the lowest investment grade. Moody's also uses different letter ratings (Ba, B, Caa, Ca, C) to categorize its non-investment grade ratings, with

[2] "Standard & Poor's Rating Definitions", *Standard & Poor's*, September 21, 2007, p. 4.
[3] Ibid

Ba being the least speculative, and C the highest. Some letter grades are further distinguished by a numerical modifier (1, 2, 3) indicating the relative ranking within that generic letter rating classification.

In addition to letter grades or ratings, Moody's also provides "non-rating signals, such as rating outlooks and the Watchlist."[4] Ratings outlooks are "an opinion regarding the likely direction of an issuer's rating over the medium term."[5] The Watchlist "highlights issuers (or debt obligations) whose rating is formally on review…"[6] for a possible rating change in the short-term.

Fitch also categorizes its long-term corporate investment grade ratings into four separate letter ratings (AAA, AA, A, BBB) with AAA considered the highest available credit quality and BBB considered the lowest investment grade quality. Fitch also uses the modifiers (+) and (-) to "denote relative status within the major rating categories"[7] for most of its letter rating categories (see Exhibit 3). Similar to Moody's and Standard & Poor's, Fitch also provides rating outlooks and watches for corporate issuers. Rating outlooks reflect trends and "indicate the direction a rating is likely to move over a one- to two-year period,"[8] while rating watches indicate "a heightened probability of a rating change"[9] and are typically event-driven. Fitch notes that an outlook change does "not imply that a rating change is inevitable."[10]

In addition to providing an opinion on the creditworthiness of a particular issuer, credit ratings also provide an assessment or estimate of the probability that the issuer could experience a default event. Moody's has compiled detailed statistics on corporate defaults by letter grade since 1920. Based on the data, Moody's has calculated the probability that a given issuer could experience a default event in a given year. For example, for an A-rated issuer, the probability that such an entity could experience a default event in a given year is just 0.096%, or less than 1/10 of 1%[11]. It is important to note that Moody's defines a default event as encompassing events that are far less extreme than bankruptcy.[12] Standard & Poor's and Fitch have also compiled statistics on corporate defaults by letter grade, and the findings are similar to Moody's, with the single-

4 "Understanding Moody's Corporate Bond Ratings And Rating Process", *Moody's*, May 2002, p. 6.
5 "Moody's Rating Symbols and Definitions", *Moody's*, May 2009, p. 52.
6 "Understanding Moody's Corporate Bond Ratings And Rating Process", *Moody's*, May 2002, p. 7.
7 "Definitions of Ratings and Other Scales", *Fitch*, March 2009, p. 9.
8 Ibid, p. 43.

9 Ibid.
10 Ibid.
11 "Corporate Default and Recovery Rates, 1920-20013", *Moody's*, February 2014, p. 31.
12 "Moody's definition of default includes three types of credit events:

1. A missed or delayed disbursement of interest and/or principal;
2. Bankruptcy, administration, legal receivership, or other legal blocks (perhaps by regulators) to the timely payment of interest and/or principal; or
3. A distressed exchange occurs where: (i) the issuer offers debt holders a new security or package of securities that amount to a diminished financial obligation (such as preferred or common stock, or debt with a lower coupon or par amount, lower seniority, or longer maturity); or (ii) the exchange had the apparent purpose of helping the borrower avoid default."

See, Ibid, p. 54.

year default rate for A-rated issuers being 0.06% and 0.08% respectively. [13,14]

As stated previously, one of the key reasons that credit ratings are relied on in the marketplace is that they provide investors and other capital market participants with an assessment of a firm's creditworthiness and the probability of a default event (including its most extreme form, bankruptcy). Historically, credit ratings have proven to be effective predictors of default events. In a Moody's analysis of 1,900 corporate issuers who have defaulted during the period 1983-2013, those entities which eventually defaulted held a B1 rating (non-investment grade), on average, five years prior to the default event[15]. The credit ratings then continued to deteriorate over the period leading up to default.

All three major rating agencies compile reports such as those referenced above, which show the performance of their ratings against experienced defaults within the major categories of debt issuers that they rate (corporate, municipal, sovereign, structured finance, etc.). These reports tend to support the conclusion that all three are doing an adequate job in measuring the credit quality of different issuers over time. Such periodic reports are made available on each agency's website.

[13] "2013 Annual Global Corporate Default Study And Rating Transitions", *Standard & Poor's*, March 19, 2014, p. 10.
[14] "Fitch Ratings Global Corporate Finance 2013 Transition and Default Study", *Fitch*, March 17, 2014, p. 10
[15] "Corporate Default and Recovery Rates, 1920-2013", *Moody's*, February 2014, p. 10-11.

About The Bates Group LLC

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Bates Group, LLC | 5005 SW Meadows Road, Suite 300 | Lake Oswego OR 97035 | Tel: 503.670.7772

http://BatesResearchGroup.com | research@BatesGroupLLC.com

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