Credit Rating Process

A credit rating assesses a borrower´s ability to meet financial obligations.

A credit rating represents a risk evaluation by a Credit Rating Agency (CRA) based on qualitative and quantitative information provided by the debtor as well as such from public and non-public sources. A credit rating is instrument-specific, assessing an obligator's ability to make good on specific debt obligations, per terms of the agreement: It refers to whether both, payments of the principal as well as interest are expected to be met in a timely manner. - Each CRA uses its own credit rating matrix for measuring the standing of a debt issue, whereby ratings are distinguished between investment grade (solid standing: AAA down to BBB minus) and non-investment, speculative grade (high risk standing: BB plus down to C or D). Each rating is further divided into notches (plus / flat / minus), whilst the outlook of the credit rating may be judged positive / stable / negative.

The distinction between investment grade and non-investment grade is significant: Whilst the default spread in pricing fixed income securities rises only slightly with each drop of a notch within the investment grade category, hikes per notch are considerably steeper, once a bond is rated non-investment grade. This is not least as most pension funds are only allowed to invest in investment grade-rated structures: As these funds combine the vast majority of global assets under management, non-investment grade-rated issuers have far less choice in approaching investor candidates and – hence – pricing power significantly deteriorates.

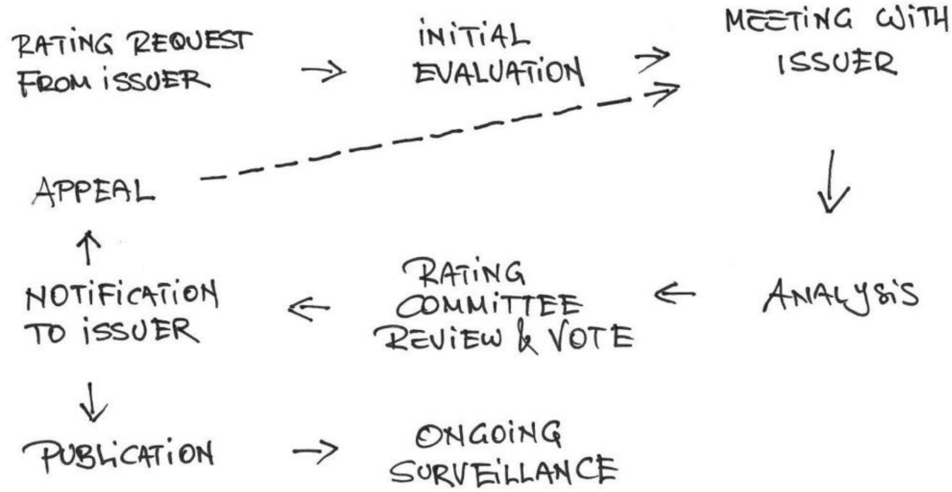
A sovereign credit rating refers to a sovereign entity, such as a national government. It is a risk indicator when investing in a country, and used by investors when considering an opportunity in a particular jurisdiction, also assessing political risk. - Corporate credit ratings can address either a firm's financial instruments or the firm itself. - As a matter of fact, the highest rating a bond can have is dictated by the rating of the country where the issuer is domiciled. The respective country rating is therefore also referred to as the sovereign ceiling (or: cap).

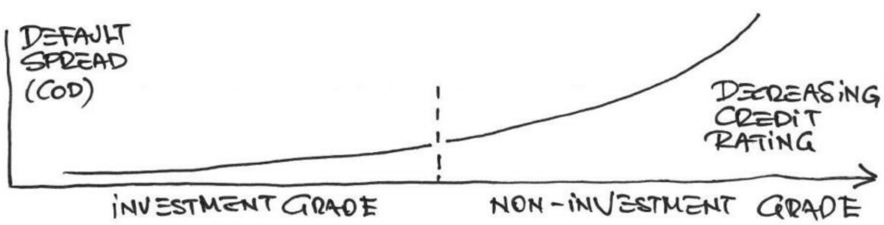
A rating expresses the likelihood the rated party will go into default within a given time: A time horizon of one year or less is considered short-term, else long-term. In the past institutional investors preferred to consider long-term ratings. Nowadays, short-term ratings seem more commonly used.

In regards to corporate ratings, CRAs broadly base their assessment along the lines of the "Camel Model" (as per capital structure, assets´ revenue earning capacity and quality, management quality, earnings trends and stability, liquidity and effectiveness of working capital management). These parameters are forming the foundation for determining the creditworthiness of an issuer, and subsequently for the rating of a specific debt instrument.

In most cases, a rating process is initiated upon an issuer´s request (i.e. solicited rating - unsolicited ratings do also exist, though) and for the rating of a particular instrument. Therefore, it is also the issuer paying the CRA for services provided. - Upon this, the CRA expert team interacts with the firm: It acquires relevant data to fully understand as well as to be in a position to quantitatively and qualitatively assess the issuer´s historical performance, financial policies, business risk profile, competitive position and similar. Then, the expert team presents its findings in the credit rating report internally to the rating committee (where the issuer is not permitted to participate). Subsequently, the decision of the rating is shared with the issuer. The issuer may appeal the decision and be heard, whereby additional material may be provided, based on which the committee may amend the rating. Typically, rejected ratings are not disclosed and complete confidentiality maintained. Else, once the issuer accepts the rating, it is made public. – If the issuer decided to use the rating, CRAs are obliged to monitor the accepted ratings over the life of the instrument. Therefore, the CRA surveils ratings on an ongoing basis, with reference to recent political, economic and financial developments and industry trends which may lead to (upward / downward / no) changes in a rating.

The most prominent CRAs are Standard & Poor´s (S&P) and Moody´s. Together, they account for approximately 80 per cent of all credit ratings and related revenues. This is not least due to the fact that in the United States any bond has to be reviewed by at least two accredited CRAs prior to approaching the public markets. In Europe, such is not required: Nevertheless, also there bonds are frequently rated (at least with one CRA) to strengthen perception and investor confidence.





S&P	MOODY'S	S&P	MOODY'S	
AAA	Aaa	BB+	Ba1	
AA+	Aa1	BB	Ba2	
AA	Aa2	BB-	Ba3	
AA-	Aa3	B+	B1	
A+	A1	B	B2	
A	A2	B-	B3	
A-	A3	CCC+	Caa1	
BBB+	Baa1	CCC	Caa2	
BBB	Baa2	CCC-	Caa3	
BBB-	Baa3	CC	Ca	DEFAULT IMMINENT
		C		
		D	C	DEFAULT

For more concepts click on: