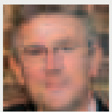
Ask the experts:

Fighting rating fatigue

Rating agencies have announced a series of changes to methodologies recently, but are they moving the goalposts too often?



Philip Brown, Group Treasurer at Tate & Lyle

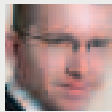
At one level the simple answer to this question is, yes, the rating agencies have moved the goalposts in assessing credit risk. However, the question implies that the agencies determine which risks are relevant for the market and how those risks should be assessed. It also implies that the agencies are sometimes unreasonable in making changes to their methodologies and credit metrics.

You have to consider the underlying reasons for the changes to rating methodologies and credit metrics. The agencies do not actively determine risk but reflect the market's assessment of credit risk. It could be argued that the primary role of the rating agencies is to improve the dissemination of information and the efficient functioning of debt capital markets. In effect, the agencies lower the cost to the market of making informed credit decisions.

The agencies are also responding to broader changes in the underlying economic environment and market attitudes to risk. In the UK, there has been a gradual transfer of risk from employee to employer so that the defined benefit pensions promise is now more like a debt obligation. To reflect this, rating agencies have amended methodologies and credit metrics and included pension deficits in their calculations of net debt.

The agencies also change methodologies and credit metrics to reflect an increasingly complex economic environment, such as greater competitive threats due to globalisation. It makes the treasurer's job more difficult but to blame the agencies would be to confuse cause and effect.

Treasurers should maintain an effective relationship with the agencies and the debt capital markets, to better understand the changing attitudes to risk. It should be a dialogue because the assessment of risk is so complex. Treasurers should be willing to challenge changes in the rating agencies methodologies to ensure there is a clear understanding of the assessment and communication of credit risk.



Richard Hunter, Head of Credit Policy EMEA at Fitch Ratings

Rating agencies always perform a balancing act in revising their methodologies. On the one hand, we aim to improve the quality and analytical quality of our ratings by incorporating new considerations. On the other, a rating system that constantly changed to meet different definitions would obscure changes driven by the rated company rather than by the agency's criteria.

In creating new scales as well as new methodologies, the agencies are also generally aware of the potential for ratings fatigue among users. One of the main practical benefits of the existing primary rating scale, the AAA long-term scale, is its ability to condense a lot of information into a very concise indicator of credit quality. Fitch therefore only adds new scales where they make a major contribution to clarity in communicating our analysis.

Typically, most methodology changes refine existing criteria for a narrow spectrum of rating without resulting in major rating changes. Where rating changes are implied by a change in criteria, Fitch also generally respects a 'momentum' argument in considering individual rating changes. An issuer high in its category and on course to be upgraded will not be downgraded based on a rating criteria change only to be upgraded based on fundamentals shortly after.

New scales provide extra information and don't require major rating changes, although changes are occasionally necessary when a new primary scale is introduced or an existing scale is recalibrated. When Fitch introduced its recovery rating scale in 2005, ratings were affected for 325 issuers (under 10% of relevant coverage) and instrument ratings changed on a further $120bn of high-yield obligations (again, a minority of ratings). Differences in the short-term default experience were noticeable for only two rating categories, in each case at the second decimal place, indicating just how much it takes to move the ultimate goalposts.

Eric de Bodard, Chief Credit Officer for EMEA at Moody's

I would acknowledge that Moody's has put out a number of methodology changes but in the long run these are for the better because they make ratings more transparent, easier to replicate and more consistent.

We are striving to improve the rating quality as the market evolves. This is partly in response to new financial instruments and partly to the changing needs of market participants. Two significant initiatives illustrate all those objectives. About 15 months ago we introduced a new approach to rating government-related issuers to bring more transparency to our final ratings. More recently, we launched our loss-given default (LGD) methodology. The LGD change arose because we identified that the market wanted more recovery information.

In many instances we are not fundamentally changing our methodologies, but trying to provide a clearer picture. Good examples are our industry methodologies – for instance, consumer goods and pharmaceuticals. In such documents we identify key rating factors and use rating grids to provide a mapping to a rating outcome. Many market participants are interested in knowing how we arrive at our rating factors in order to replicate what we do. These are not changes, merely spelling out more clearly how we arrive at our final ratings.

We communicate changes clearly. Our use of requests for comments signals to the market the changes we are proposing. We take market comments very seriously and adjust our methodology in light of the feedback we receive.

This type of communication is in addition to our normal dialogue with the market. All of this adds up to us being more proactive in seeking communication with the market. This year we probably will issue three or four such requests for comments. That does not represent an unusual amount.

The key point is that we are committed to communicating with the market. We do not want to surprise market participants if at all possible.