# A common language



## Executive summary

- In the last issue of The Treasurer, we looked at what a rating means (and does not mean) and how our business model works. In this article we examine the actions that Standard & Poor's is taking in light of events of the past 18 months.


S&P uses the same rating scale across all types of debt: structured finance, corporate and government. It provides a common language for evaluating and comparing creditworthiness across all major sectors and subsectors, and is accepted by the vast majority of market participants. Our focus is on developing, maintaining and, if necessary, adjusting ratings criteria to achieve reasonably consistent credit opinions across sectors and regions.

**ASSESSING COMPARABILITY** Ratings are opinions of relative creditworthiness, defined as the probability of an issuer defaulting. They represent a comparative rather than an absolute scale; a CCC rating signifies higher default risk than a B rating, a B rating more default risk than a BB rating, and so on. A AA CDO rating therefore has a similar default probability to a AA corporate bond rating, even if the market characteristics of the security (e.g. their liquidity) may be very different.

Although observing and comparing average historical default rates over long periods is one way of evaluating rating performance and the comparability of ratings across sectors, individual ratings have never been meant to be precise measures of default probability.

So what does history show? The exhaustive studies we publish showing correlation over time between ratings and defaults shows that S&P's ratings in aggregate have been excellent indicators of relative default risk. High ratings are associated with low default rates and low ratings are associated with high default risk.

That is the case with structured finance ratings as well as corporate and government ratings. Since 1978, the average five-year default rate for investment-grade structured securities is around 1% and for speculative-grade structured securities it is around 15%. For corporate bonds, default rates for the same period are 1% and 17% respectively; in other words, they are broadly comparable.

Some have questioned, in particular, whether a AAA rating for a structured bond is the same as a AAA rating for a corporate bond. In fact, AAA ratings have historically had very low default rates and are broadly comparable as opinions of default risk across asset classes. Although the market valuation of many AAA-structured securities has fallen heavily – reflecting the evaporation of their market liquidity – very few (less than 0.2% rated by S&P since 1978) have defaulted. Of more than 3,000 US residential mortgage-backed securities originally rated AAA by S&P since 2005, only two have defaulted to date – and almost 90% are still rated AAA. By comparison, the cumulative average five-year default rate for corporate bonds rated AAA by S&P since 1981 is around 0.3%.

AAA ratings can and do change, both in the corporate and structured bond markets (there are, for instance, now no corporate issuers in Europe rated AAA by S&P), and they can and do default. However, it remains the case that they default much more rarely than securities that were originally rated lower.

**RATINGS STABILITY** While we aim for reasonably comparable default rates for equivalent ratings across different sectors, the frequency of rating changes during the life of a security can be more variable. For instance, around 20% (by value of original issuance) of US subprime-related securities issued since 2005 have been downgraded by S&P. Given the recent market volatility, we are currently assessing feedback

**Table 1:** Structured finance securities: weighted average five-year rating transition

| | AAA | AA | A | BBB | BB | B | CCC |
|---|---|---|---|---|---|---|---|
| AAA | 97.85 | 1.37 | 0.28 | 0.14 | 0.11 | 0.1 | 0.09 |
| AA | 25.69 | 67.84 | 3.89 | 0.73 | 0.3 | 0.47 | 0.48 |
| A | 14.26 | 11.17 | 65.91 | 4.83 | 0.93 | 0.59 | 0.73 |
| BBB | 8.36 | 10.15 | 10.89 | 56.03 | 3.53 | 2.32 | 2.76 |
| BB | 2.58 | 5.59 | 7.96 | 15.82 | 49.53 | 4.8 | 3.58 |
| B | 0.82 | 0.69 | 2.67 | 7.63 | 13.34 | 49.72 | 6.34 |
| CCC | 0 | 0.39 | 1.18 | 0 | 0.2 | 2.76 | 37.60 |

*Source: S&P 2007 Global Structured Finance Default Study*

**ROBERTO RIVERO** FROM STANDARD & POOR'S RATINGS SERVICES TAKES A LOOK AT THE BENEFITS OF A COMMON RATINGS BENCHMARK.

on a proposal to incorporate credit stability (in addition to ultimate default risk) in our rating opinions.

Under the proposal, when assigning and monitoring ratings, we will consider whether we believe an issuer or security has a high chance of experiencing unusually large adverse changes in credit quality under conditions of moderate stress (for example, recessions of moderate severity, such as the European recession of 1991). In these cases we would assign a lower rating than we would have otherwise.

The proposed change would have very little, if any, effect on corporate and government ratings (except where issuers have ratings-based triggers in their obligations or are engaged in high-volatility business activities). It would have a bigger impact in certain areas of structured finance, such as CDOs of asset-backed securities.

As a rating agency, we do not structure securities or advise banks on how they should be structured. Bankers explain their structures to us and we explain how they would be rated under our public criteria. The IOSCO code of conduct for rating agencies expressly prohibits ratings agencies from providing consulting or advisory services, and we fully support that prohibition. Our role is not to advise issuers, it is to provide an opinion about default risk. That is the case in the structured finance market as much as in the corporate bond world.

**Table 2:** Corporate bonds: global average five-year transition rates

| | AAA | AA | A | BBB | BB | B | CCC/C |
|---|---|---|---|---|---|---|---|
| AAA | 53.95 | 23.71 | 4.93 | 1.02 | 0.13 | 0.13 | 0.03 |
| AA | 1.73 | 51.6 | 23.56 | 4.18 | 0.63 | 0.37 | 0.04 |
| A | 0.11 | 5.83 | 53.09 | 15.41 | 2.52 | 0.99 | 0.18 |
| BBB | 0.05 | 0.81 | 10.7 | 46.72 | 8.56 | 3.02 | 0.48 |
| BB | 0.02 | 0.14 | 1.56 | 12.16 | 27.76 | 11.09 | 1.58 |
| B | 0.03 | 0.06 | 0.54 | 2.08 | 10.53 | 20.51 | 2.84 |
| CCC/C | 0 | 0 | 0.25 | 1.1 | 3.39 | 10.17 | 3.73 |

*Source: S&P 2007 Global Corporate Default Study*

**Box 1:** Highlights of S&P's new actions

In February, S&P announced a broad set of initiatives in four areas to strengthen its ratings operations and to better serve global capital markets. Given here are brief descriptions of some of the actions that S&P is undertaking. Details of all 27 individual measures are available at **www.spnewactions.com/**

**Enhancing governance**

New measures build on existing policies and protections and further strengthen the integrity of the ratings process to ensure its independence, make the effectiveness of our governance even more transparent, and maintain investor confidence. The measures include:

- establishing an Office of the Ombudsman to address concerns related to potential conflicts of interest and to analytical and governance processes across S&P's businesses; and
- periodically conducting and publishing an independent review of S&P Ratings' compliance and governance processes.

**Strengthening analytics**

The new actions ensure that our ratings models, processes and analytical talent continue to be of the highest quality, and that S&P remains fully equipped to rate complex financial structures with increasing transparency with regard to assumptions. The new measures include:

- complementing traditional credit ratings analysis by highlighting non-default risk factors such as liquidity, volatility and correlation;
- adding surveillance capabilities, including tools, models and data sets, so S&P can better monitor the performance of collateral pools over time; and
- increasing annual analyst training requirements, enhancing training programmes, and establishing an analyst certification programme.

**Increasing transparency of information**

S&P's initiatives here provide market participants with greater transparency about the ratings process and greater clarity about the risks that could cause a change in ratings assumptions. They include:

- putting what-if scenario analysis in rating reports to explain key rating assumptions and the potential impact on the rating of unexpected events so investors can better assess an issue's risk profile;
- working with issuers and investors to improve disclosure of information on collateral supporting structured securities; and
- requesting greater minimum portfolio disclosure criteria of issuers of certain structured securities.

**Educating the public**

Extensive programmes will help market participants better understand what a credit rating is – and is not. The measures include:

- creating a Credit Ratings User Manual and Investor Guidelines to promote understanding of our ratings and their role in the financial markets;
- establishing an Advisory Council with independent membership; and
- broadening distribution of analysis and opinions via the web and other media.

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