The ratings alphabet

Executive summary

- This is the first of two articles prepared for the ACT by Standard & Poor's to help readers understand the underlying principles of the credit ratings process and how these principles may be applied to their particular organisation.

Standard & Poor's ratings represent our opinion of the likelihood that a particular obligor or financial obligation will repay on time owed principal and interest. Put another way, we assess the likelihood, and in some situations the consequences, of default.

Our ratings are not intended to express any opinion of the value, suitability, or merit of an investment beyond its risk of default and, in some cases, the expected recovery in the event of default. Specifically, credit ratings do not address, explicitly or implicitly, whether:

- Investors should buy, sell, or hold rated securities
- A particular rated security is suitable for a particular investor or group of investors
- A security is appropriate for an investor's risk tolerance
- The expected return of a particular investment is adequate compensation for the risk it poses
- The price of a security is appropriate given its credit risk
- The market value of the security will remain stable over time.

NOT INVESTMENT ADVICE In other words, while ratings may be useful for implementing an investment strategy, rating agencies do not intend their analyses to be considered investment advice. Ratings are one of many factors that investors consider when making an investment, and they are one of many factors that influence the market performance of a security.

Our credit ratings evaluate relative creditworthiness, as measured by the capacity to repay debt. They represent an ordinal, as opposed to an absolute, scale. A 'CCC' rating signifies higher default risk than a 'B' rating; a 'B' rating signifies higher default risk than a 'BB' and so on.

The ratings do not assign quantifiable default probabilities. In other words, even though our default and transition studies may indicate that the annual average default rate of 'BBB' structured finance securities between 1987 and 2007 was 0.18%, this does not mean that a 'BBB' rating is a mathematical prediction of a 0.18% default probability. It also follows that we have never claimed that, should a particular set of 'BBB' rated debt suffer a 0.37% default rate, for example, those ratings were somehow wrong or inaccurate.

Because rating scales are relative, default rates fluctuate over time – while default rates are lower for highly rated securities, the specific default rates can vary over time as a result of industry disruptions and economic cycles.

To attach precise expected default rates to any rating category is to imbue the rating process with a degree of scientific accuracy that it could not possibly bear, and which has never been claimed for it.

So why should anyone pay any attention to a Standard & Poor's rating? The reason is that history has shown our opinions to be very good predictors of relative default risk, and that, so far, no other service has been provided outside the rating agencies that is both independent and has such a strong track record.

OUR BUSINESS MODEL One of the most frequently discussed issues in the press over the last year has been our issuer pays business model. When the evaluator is paid by the evaluated, the potential for conflict can arise, which is why S&P has long had in place stringent policies to minimise the prospect of any conflict and maximise the independence of our work.

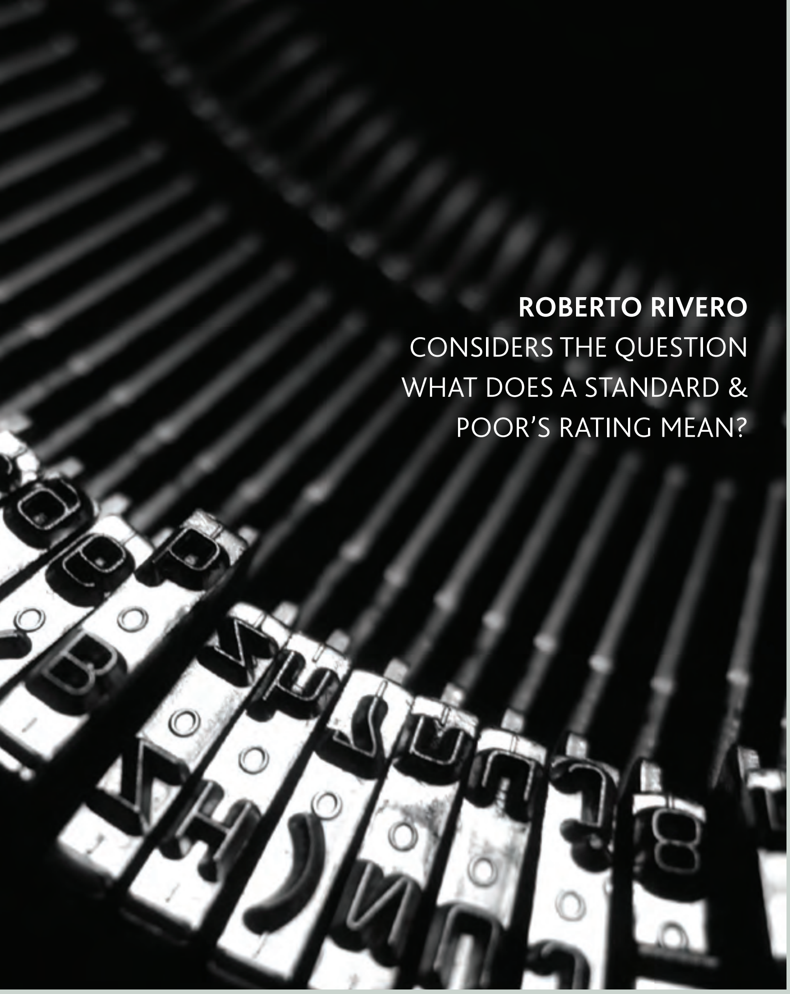
First, our ratings criteria are publicly available and consistently applied. We will refuse, and have refused, to rate transactions that don't meet our criteria.

Second, our ratings are always made by committees, never by individual analysts. This process is designed to maximise the amount of expertise and experience brought to bear in issuing a rating, and minimise the influence any one person can have on a rating.

Third, we maintain a strict separation between the analytical side of the business and any commercial activities. Analysts are not involved in negotiating fees or other commercial transactions. Nor do our analysts have a financial incentive to skew their reviews in favour of the companies they research, because their compensation is not determined by the fees that S&P earns on the basis of their work, nor is a client's fee affected by the rating they gain. In addition, our analysts are not allowed to own, or trade in, any securities they rate.

Fourth, the very openness of the process acts as a check against any potential conflict. Our ratings, and all of the analysis that goes into them, can be scrutinised by anyone who wants to examine them, for any reason: investors, regulators, journalists, institutions and individuals, experts and lay persons, professionals and amateurs alike. Any bias in our ratings would be readily detectable.

Fifth and most important, our reputation for honesty and integrity is our most valuable asset. It is our company's lifeblood. If the market perceived that the opinions of S&P or any other rating agency were



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compromised by the influence of issuers or some other conflict of interest, the agency's reputation (and thus its bottom line) would inevitably suffer to a far greater degree than any benefits that come from the fees from specific issuers.

So while the potential for conflict exists, we believe the issue to be well-managed and, over the past years, many market participants and regulators have echoed these sentiments.

The issuer pays model is the only one that enables us to make our ratings widely available to the market and public, free of charge, in real time. Today, anyone anywhere in the world can access and evaluate our ratings. The volume and easy accessibility of this information creates a level playing field and a common basis for analysing risk.

We believe the issuer pays model is the one that best supports the efficient operation and transparency of the global credit markets.

The acid test of our work and the value we bring, of course, remains our track record – that is, the historic correlation between our ratings and defaults. And despite the recent performance of many subprime-related securities, the long-term track record of our ratings as opinions of relative default risk remains excellent. Since 1978, the cumulative default rate for triple A rated structured securities is about 0.16 per cent; for investment grade securities it is about 1.5 per cent; and for speculative grade securities it is about 6 per cent.

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In next month's article we look at the recent performance of our ratings in more detail and the lessons that we have learnt in the last year. In addition we shall draw some distinctions between our approaches to corporate and structured ratings.

Box 1: Criteria and Process

Our credit ratings are arrived at according to strict criteria and after following a rigorous process. Together, these are intended to promote

- objectivity
- credibility
- transparency and
- comparability.

To assess the creditworthiness of an issuer, we concentrate on evidence of the issuer's ability and willingness to repay its obligations in a timely manner. To form that opinion, agency analysts weigh a range of business and financial information. For example, we may evaluate a borrower's historical and projected financial performance and current financial condition, including revenues, cash flow, assets and liabilities.

Business risks include industry risk, competitive position, diversification, management, and strategy. Our analysts also consider how similar businesses or entities are faring under current market conditions and are expected to perform under future conditions.

We also assess counterparty risk; the potential that a party to a credit agreement may not be able to fulfill its obligations.

In rating an individual debt security on its likelihood of default, we take into account:

- Unique legal structure
- Terms and conditions of the debt issue
- Relative position with regard to issuer's other debts and priority of repayment of the issue in the event of default
- Existence of external support or credit enhancements, which are protections such as letters of credit, guarantees, insurance, and collateral, that may limit the potential risks of the debt issue.

The Rating Committee

After reviewing the relevant information, the lead analyst takes the transaction to a rating committee. Committees are comprised of S&P personnel who bring to bear particular credit experience or other expertise relevant to the rating. The qualitative judgments of committee members at all stages of the process are an integral part of the rating process as they provide for consideration of issuer, asset and transaction specific factors, as well as changes in the market and environment. Personnel responsible for fee negotiations and other business-related activities are not permitted to vote in ratings committees and vice versa.

Once a rating is determined by the rating committee, S&P notifies the issuer and disseminates the rating to the public for free by, among other ways, posting it on our website. Along with the rating, we frequently publish a short narrative rationale authored by the lead analyst. The purpose of this rationale is to inform the public of the basis for S&P's analysis and enhance transparency to the marketplace.

After a rating has been issued, S&P monitors or "surveils" the rating to review developments that could alter the original rating. The surveillance process seeks to identify those issues that should be reviewed for either an upgrade or a downgrade because of unexpected performance or changes in the environment. Analysts review performance data periodically during the course of the transaction, and as appropriate present that analysis to a rating committee for review of whether to take a rating action. The rating committee then decides whether a rating change is warranted. When changes are made to public ratings, a press release is disseminated.

Additional information about our procedures and all our criteria are available on our website, **www.standardandpoors.com**