Criteria Report
Exposure Draft

Proposed Revision to Short-Term Rating Scales

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Questions for Respondents

- Do you use short-term ratings primarily for counterparty use (issuer rating) or for instrument analysis (instrument ratings)?
- Do you agree that investment grade short-term ratings should be based on "sustainable liquidity" (i.e., exclusive of temporary fluctuations in liquidity balances) and that non-investment-grade ratings should be based on "actual expected liquidity" over the following 13 months?
- In assigning short-term instrument ratings, do you support the "expected loss approach" (in which instrument ratings are mapped to their pari passu long-term issue rating and thus reflect an element of recovery given default), or would you prefer short-term instruments and issuer ratings to be identical and thus only reflect default and liquidity risk?
- Do you support the existing limitation of 'F'-level ratings to investment-grade issuers only? Or do you believe that a 'BB+' rated issuer, which would currently be rated 'B' under Fitch's short-term rating scale, can demonstrate liquidity and market access consistent with 'F3' issuers?
- Would you support an 'F4' category for strongly liquid speculative-grade names which do not possess sustainable liquidity consistent with an investment-grade long-term or short-term rating?

Please forward comments and responses to richard.hunter@fitchratings.com by November 24, 2006.

Overview

Fitch Ratings is planning to extend the introduction of Issuer Default Ratings ("IDRs") on the short-term rating scale – i.e., Short-Term Issuer Default Ratings or "ST IDRs" –to complement its previous introduction of IDRs on the long-term scale. A limited number of ST-IDRs have been introduced already, but before assigning further ST IDRs, the agency is soliciting input from the marketplace on the priorities that ratings users place on the short-term rating scale in the course of their work. Fitch wishes to incorporate market feedback on short-term rating usage relating to both issuers and their instruments.

The current proposal is to assign separate short-term issuer and instrument ratings, and formalise the incorporation of recovery given default expectations in the short-term ratings of instruments. An ST IDR would be assigned to all issuers to which Fitch has also assigned short-term instrument ratings. In addition, the agency will continue to selectively assign ST IDRs to those issuers which do not have any rated short-term instruments when an ST IDR would nevertheless prove useful to the marketplace.

Current Approach to Short-Term Ratings in Corporate Finance

Current Short-Term Ratings

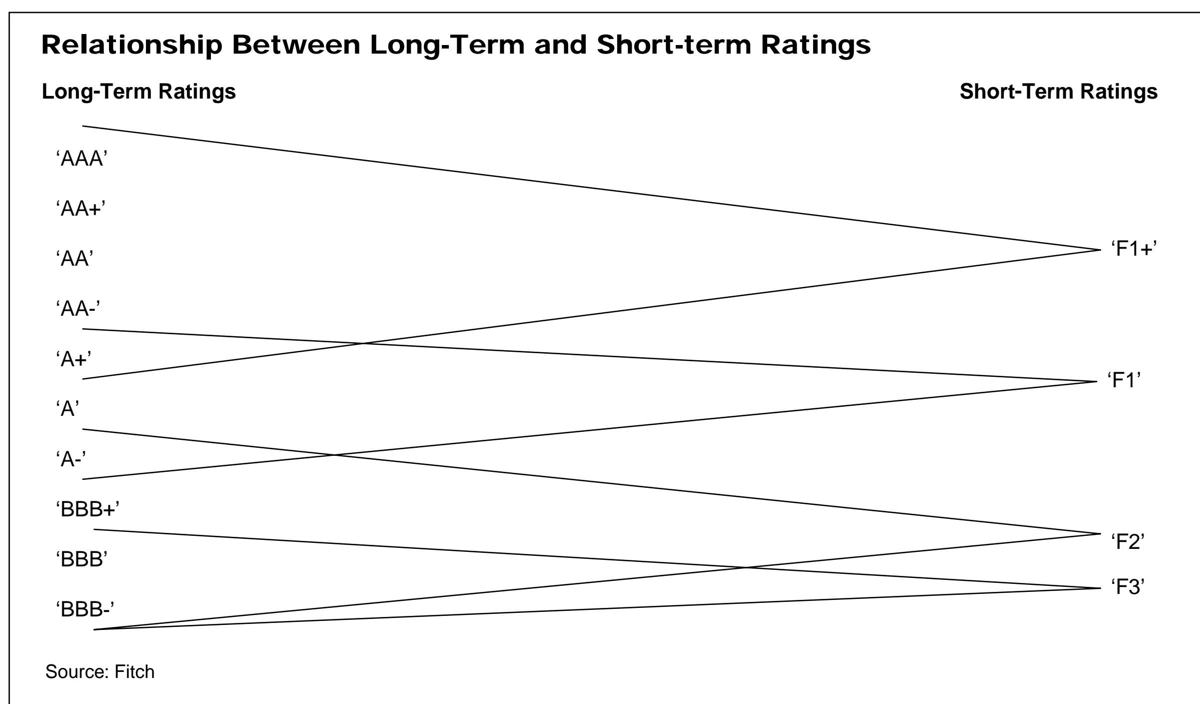
Currently, Fitch assigns short-term ratings to a large number of corporate finance issuers and obligations. Issuers may either have a short-term issuer rating on its own, or both short-term issuer and obligation ratings, or simply short-term obligation ratings. The ratings have thus been used both by counterparties and by other ratings users to monitor exposures on a short-term basis, and to assess specifically short-term individual obligations (for example, against investor guidelines).

Short-term ratings are also assigned to asset-backed commercial paper and a limited number of other structured finance products, which remain outside the scope of this consultation paper, as the IDR concept is not one relevant to structured finance ratings.

Relationship Between Short-Term and Long-Term Ratings

While there are a large number of discrete factors which drive short-term ratings, a linkage has existed between short-term and long-term ratings that ensures the two scales do not intuitively contradict each other for a given issuer. This linkage is outlined in Chart 1, and displays a certain asymmetry, namely:

a. higher relative short-term default risk implies an elevated risk of default in the near-term which cannot be separated from the long-term default assessment; but
b. lower relative short-term default risk, perhaps through factors which lend the issuer's profile temporary support, may coexist with higher medium- or longer-term default risk.



The time horizon of the short-term rating extends to 13 months. However, for investment-grade ratings, this does not relate to the 13 months immediately following a given date. Instead, it relates to the intrinsic or sustainable liquidity profile of the rated entity that would be expected to endure for the next several years. Thus, this approach places less emphasis on features of the liquidity profile which may be regarded as temporary, such as high cash balances which would not be expected to be maintained, or a high degree of contractual certainty on revenues/cash flows for the next 12 months which will then roll off with a lower likelihood of replacement.

As a result, it is possible that this sustainable liquidity profile on which the short-term rating is based could depart from the actual, stronger (albeit temporary) liquidity profile of an issuer over the following 13 months. As a result, investment-grade short-term ratings are designed to be more stable over time since they will link to the issuer's sustainable liquidity profile, and will not reflect the volatility associated with increases or decreases in liquidity due to temporary factors.

In contrast, in speculative-grade ratings, greater emphasis is generally placed on the actual expected liquidity profile of the issuer over the 13 months that follow, including the impact of temporary improvement or declines in liquidity.

Feedback Request

As part of the introduction of ST IDRs, Fitch seeks comments from rating users on the appropriateness of this "sustainable liquidity approach" for investment-grade issuers, and "actual expected liquidity approach" for non-investment-grade issuers, given the manner in which short-term ratings are applied in their own marketplace.

Assessing Short-Term Ratings – Sustainable Liquidity

Investment-grade short-term ratings imply a satisfactory level of liquidity on an ongoing basis. Liquidity is judged by assessing a mixture of the operational or internal cash flow, capital structure, available resources and other factors, relative to demands on liquidity that conform to the standard stresses associated with that sector and rating category.

In light of the asymmetry noted under a. and b. on page 1 above, liquidity informs long-term as well as short-term ratings at all levels in the rating scale. Issuers with deficient short-term liquidity will not receive strong long-term ratings. As a result, the first step in determining short-term ratings is usually to consider the issuer's long-term rating, which will often itself incorporate substantial consideration of that issuer's liquidity profile. In a second step, where the issuer's long-term ratings would be consistent with more than one 'F'-rating, the decision as to which 'F'-rating is appropriate is made by referring to specific liquidity criteria relevant to that sector. Where an issuer demonstrates strong features relating to liquidity in a broad range of areas (and no major deficiencies in any area), the higher 'F'-rating will typically be assigned.

Issuer versus Instrument

Where both short-term instrument and issuer ratings are assigned by Fitch, a distinction has on occasion been drawn between the short-term rating of the issuer and the short-term rating of its instruments. The two primary distinctions have covered:

- cases where explicit and limited enhancement was provided (as for public finance, where letters of credit-backed commercial paper have been common);
- certain limited cases where preferences exist under law for a class of rated short-term obligations, such as deposits at US banks, and where the comparable long-term rating of the same obligation is itself consistent with a higher short-term rating (e.g., where a US bank has an IDR of 'BBB+', with commercial paper rated 'F2', but also has a long-term deposit rating of 'A-' and hence a short-term deposit rating of 'F1').

The more recent introduction of recovery given default concepts, even at higher levels within the rating scale, has provided the opportunity to distinguish further between ratings on instruments and the pure default risk of the issuer as reflected in its IDR. In a number of cases, Fitch has assigned ratings for unsecured long-term senior debt at a lower or higher level than the long-term IDR. This reflects above or below average expectations of recovery should that issuer default. This distinction has been made even for investment-grade issuers, predominantly in the regulated utility and insurance sectors.

Consequently, Fitch is proposing to incorporate recovery given default considerations within its ratings of short-term instruments. This would thus mimic the differences applied on the long-term scale discussed above.

The issuer's ST IDR would 'map' to the long-term IDR, in accordance with Chart 1. However, short-term ratings for specific instruments could be applied at a lower or higher level, mapping more closely to the long-term debt ratings for equivalent instruments. For example, the commercial paper rating, recognising that commercial paper is unsecured senior debt, would be assigned by mapping it to the long-term unsecured senior debt rating, not to the IDR. Thus, in a limited number of cases, differences in the long-term unsecured senior debt rating and long-term IDR due to above- or below-average recovery prospects on the senior debt would also be reflected in the commercial paper rating.

Example 1 – Corporate, No Change

XYZ Corp. has an IDR of 'BBB+'. As there are no outstanding recovery given default features relating to its unsecured obligations, XYZ Corp.'s unsecured debt is also rated 'BBB+'. XYZ Corp. thus has an ST IDR of 'F2' and a commercial paper rating of 'F2'.

XYZ Corp.

Issuer Ratings		Instrument Ratings	
Long-Term IDR	Short-Term IDR	Long-Term Senior Unsecured Debt	Commercial Paper
BBB+	F2	BBB+	F2

Source: Fitch

Example 2 – Utility, Change

ABC Power, Inc. is a utility with an IDR of 'BBB+', but with a long-term senior unsecured debt instrument rated above its IDR at 'A-'. Based on issuer-specific liquidity considerations, the commercial paper of ABC Power, Inc. may be rated either 'F1' or 'F2' based on Chart 1, and based on a mapping to the long-term unsecured debt ratings rather than to the issuer ratings. In the above example, strong liquidity characteristics have supported assignment of an 'F1' to ABC Power, Inc.'s commercial paper.

ABC Corp.

Issuer Ratings		Instrument Ratings	
Long-Term IDR	Short-Term IDR	Long-Term Senior Unsecured Debt	Commercial Paper
BBB+	F2	A-	F1

Source: Fitch

In other words, ABC Power, Inc.'s commercial paper ranks pari passu with the issuer's other unsecured senior debt, and would, by Fitch's expectations, have a comparable recovery given default expectation.

Example 3 – Bank, No Change

Bank QRS has an IDR of 'A+', and is located in a jurisdiction where a preference for depositors has led to a higher long-term rating assigned to deposits. Mapping to the relevant long-term obligation rating, rather than to the long-term IDR, gives a short-term deposit rating of 'F1+', compared with a short-term IDR of 'F1'.

Bank QRS

Issuer Ratings		Instrument Ratings	
Long-Term IDR	Short-Term IDR	Long-Term Deposits	Short-Term Deposits
A+	F1	AA-	F1+

Source: Fitch

Scale of Expected Impact

In reality, the expected loss option generally influences the ratings only where issuers are rated at the cusp. In such cases, it is quite possible that the features driving the difference on the long-term debt ratings (e.g., subordination of unsecured debt by virtue of structure for lower-rated holding company debt, greater market access for refinancing for regulated entities) will also have implications for the sustainable liquidity of the issuer. Thus the difference between the two approaches is likely to affect a very small percentage of rated instruments.

Feedback Request

As part of the introduction of ST IDRs, Fitch seeks comments from rating users on the appropriateness of incorporating loss severity alongside liquidity in the ratings of individual short-term instruments.

Commercial Paper Ratings

Fitch will also continue its current policy, where instrument ratings are assigned to commercial paper only when the criteria outlined in the agency's "*Corporate Commercial Paper Liquidity Guidelines*" and "*Commercial Paper – Liquidity Guidelines for Banks and Brokers*" criteria reports (dated 24 April 2001 and 10 August 2001 respectively and both available at www.fitchratings.com) are met. The decision to assign a commercial paper rating is a binary one – if criteria are not fully met, no rating is assigned (rather than a lower rating).

An issuer may possess strong stand-alone liquidity, but that liquidity may not be structured in a manner which, using Fitch's criteria, is supportive of certain of its short-term debt instruments. An issuer may thus still be assigned an ST IDR of 'F1', even where commercial paper issued by that entity does not qualify for the assignment of an 'F1' rating. It is therefore important that investors check that ratings have formally been assigned to an issue.

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