Credit Ratings Fact Sheet

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Credit assessment and evaluation for companies and governments is generally done by a credit rating agency such as Standard & Poor's (S&P), Moody's, or Fitch. These rating agencies are paid by the entity that is seeking a credit rating for itself or for one of its debt issues.

CREDIT RATING AGENCIES

From governments to corporate companies, credit rating agencies analyse various institutions and assess credit risk and the likelihood of default. The three leading agencies are: **Standard & Poor's** (S&P); **Moody's**; and **Fitch**. Each agency will have their own preferred methodology when looking at the credit risk of institutions, but, typically, the evaluation will centre on factors such as the capacity and willingness to pay financial obligations.

UNDERSTANDING THE RATINGS AND BOND TERMS

Looking at credit ratings has been made somewhat easier for investors given that they are expressed primarily through a letter grading. Triple 'A' (AAA) is the highest possible rating that can be given to a country or company and is a strong endorsement that the issuer is financially capable of satisfying its bond commitments. Ratings C to D indicate the highest perceived credit risk (see fig.1). Triple 'A' is a much coveted rating as it not only raises the issuer's profile, but, perhaps more importantly, facilitates cheaper borrowing costs.

However, investors should keep in mind that not all bonds are rated and this is not necessarily an indication that it is a 'bad' bond. To receive a credit rating, the issuer actually pays the agency to rate its bonds, which has led to some concern over conflict of interest.

Investors should be aware that bonds from the same issuer may be termed differently and may have different 'seniority' or collateral levels, which will have an impact on the rating. This can lead to the scenario whereby several bonds from the same issuer have different credit ratings. There should also be consideration if a subsidiary of a parent company issues bonds which can carry differing credit ratings.

RELIANCE ON CREDIT RATINGS

Credit ratings should not be taken as a signal to buy, hold or sell. They are purely a guidance measurement on credit risk and reflect the opinions of the credit rating agencies. By no means does a Triple 'A' rating indicate a default-free bond as there is credit risk with all bonds; however, it is perceived to have less risk of default. The credit market is dynamic and ratings can and do change. It should be borne in mind that the agencies wield considerable influence. However, their role during the financial crisis was criticised for the exaggerated ratings given to mortgage-backed securities. In 2011, the Financial Crisis Inquiry Commission said the ratings agencies "were key enablers of the financial meltdown".

A further point to highlight is that guidance provided by agency ratings are a lagging indicator which the market will have already priced in. This was evident at the height of the financial crisis following a host of downgrades on peripheral Eurozone nations. By the time the three main agencies amended their ratings, the market had already priced in the increasing credit risk within the region.

Overall, credit ratings are one of many indicators that can be used to assess the attractiveness of a bond and can be used in conjunction with indicators such as interest rate and inflation risk.

FIG. 1 – CREDIT RATING TABLE

	MOODY'S	S&P	FITCH
HIGHEST CREDIT RATING	Aaa	AAA	AAA
	Aa1	AA+	AA+
	Aa2	AA	AA
	Aa3	AA-	AA-
	A1	A+	A+
	A2	A	A
	A3	A–	A–
	Baa1	BBB+	BBB+
	Baa2	BBB	BBB
	Baa3	BBB–	BBB–
	Ba1	BB+	BB+
	Ba2	BB	BB
	Ba3	BB–	BB–
	B1	B+	B+
	B2	B	B
	B3	B–	B–
	Caa1	CCC+	CCC+
	Caa2	CCC	CCC
	Caa3	CCC–	CCC–
	Ca	CC	CC
	–	C	C
	–	–	–
	C	RD	DDD
	–	SD	DD
LOWEST CREDIT RATING	–	D	D

INVESTMENT GRADE – Considered to have strong capacity to meet financial obligations

NON-INVESTMENT GRADE – Also known as "junk bonds" where there is an increased perception of credit risk

Investments and income arising from them can fall as well as rise in value and you may lose some or all of the amount you have invested. The payment of income and the return of capital could be in jeopardy in the event that the issuer has problems meeting its financial obligations.