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Standard & Poor's Reaffirms Its Commitment To The Goal Of Comparable Ratings Across Sectors And Outlines Related Actions

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Standard & Poor's Reaffirms Its Commitment To The Goal Of Comparable Ratings Across Sectors And Outlines Related Actions

Standard & Poor's Ratings Services uses the same rating scale across the structured finance, corporate, and government sectors. We strongly believe in the usefulness of our traditional rating scale because it is designed to provide a common language for evaluating and comparing creditworthiness across all major sectors and their subsectors, including U.S. municipals. This is in keeping with our goal of providing credit ratings that are reasonably comparable measures of credit quality. For example, in assigning 'A' ratings to asset-backed securities, manufacturing firms, or local governments, we intend to connote an opinion that they have a comparable level of credit risk.

Some market participants have suggested that Standard & Poor's has used or should use different rating scales for different sectors. However, most market participants, especially those that use ratings in their credit and investment processes, acknowledge the benefits of having a common rating scale, despite the challenges such a scale presents, and instead encourage rating agencies to adjust their criteria to strive for reasonably consistent credit opinions, or ratings, across sectors and regions.

Such views reflect the emergence of global markets for credit, and the convergence of credit factors affecting all sectors.

How Rating Comparability Is Assessed

Ratings are opinions of relative creditworthiness, defined as an issuer's capacity to repay financial obligations. 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' rating, and so on. Although observing and comparing average historical default rates over long periods--preferably over multiple economic cycles--is one way to quantitatively evaluate rating performance and comparability across sectors, individual ratings have never been meant to be precise measures of default probability.

Ratings in aggregate have indeed been excellent indicators of relative default risk. High ratings are associated with low default rates, and low ratings are associated with high default rates. This differentiation of credit risk generally has been reflected in bond yield spreads within each sector over the years.

An important goal is maintaining reasonably comparable forward-looking credit opinions across the diverse types of issuers and issues that we rate while also preserving differentiation among rating categories. The goal is to maintain a body of criteria and methodologies that, to the extent possible across diverse sectors and instruments, assesses risks in comparable ways. We believe that, over the long term, comparable credit opinions are likely to result in reasonably similar average default rates for each rating category across sectors and regions. However, fluctuation in each rating category's default rates is clearly seen in historical default and transition studies, and future fluctuation is unavoidable. Moreover, meaningful variability in specific sectors' credit conditions will also be evident in the variability of their rating transition and default rates, especially as the samples measured become smaller.

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The concentration of unusually high default rates in a specific industry or asset type for a year or two can skew the overall performance trends, depending on the sample size and the time frame. For example, it would be misleading to look at the energy industry's performance only in the mid-1980s, when energy prices fell sharply and there was a bout of leveraged M&A activity, or in contrast, only in recent years, when energy prices surged to unprecedented heights.

It is important to note that, although we do aim for reasonably comparable default rates over time, we do not expect rating change frequency to be consistent across sectors. Moreover, there is some evidence that intrasector default-rate correlation for individual structured finance (SF) asset types is generally greater than that for individual corporate and government subsectors. There are also differences in the way our issue credit ratings incorporate assumptions about post-default recovery. We are well along with enhancing our corporate speculative-grade ratings with supplemental recovery information, and we are committed to providing more explicit recovery information on structured securities as well.

Frequently Asked Questions

How Do You Endeavor To Achieve Credit Opinions That Are Comparable?

We continue to revise our criteria and assumptions to reflect what we believe to be relevant factors, including market performance. For example, changes in the housing and home finance markets, especially the U.S. subprime sector, have resulted in material revisions of rating assumptions in this sector. Similarly, we have revised our assumptions in other sectors where the housing exposure was leveraged in cash flow, synthetic, derivative, or market-value transactions. These revisions (discussed more fully below) should broadly strengthen the rating performance of SF securities and are intended to bring future SF rating performance back in line with historical norms.

In the government sector, we have regularly published articles on how U.S. public finance (USPF) defaults on rated issues have, in recent years, been less frequent, particularly on general obligation debt, than defaults on similarly rated corporate or taxable structured debt (see "U.S. Public Finance Rating Characteristics," published March 7, 2008, and "U.S. Municipal Rating Transitions And Defaults, 1986-2008," published March 20, 2008, both on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis). In addition, we have been conducting an ongoing review of USPF criteria with the goal of enhancing the comparability of our credit opinions across sectors. This review has resulted in general obligation ratings' sustained and substantial upgrade trend over the past few years. Given market interest and the recent differences in default rates between USPF and other sectors, we are undertaking a more detailed review of the comparability of credit characteristics of the public finance sector relative to those in other areas to make our criteria more transparent to the public and to promote comparability of credit opinions.

What Related Actions Are You Taking?

In response to market requests, we are exploring the expansion of our analytical products to cover more dimensions of creditworthiness or risk, including recovery or loss given default, volatility, liquidity, and correlation of defaults and rating transitions. This continues our efforts with so-called rating deconstruction, initiated in 2002, which led to our enhanced recovery analytics and thousands of new recovery ratings for the corporate and sovereign sectors in 2007 and 2008.

In addition, we announced on April 10, 2008, that we have developed a proposal to identify ratings on

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securitizations. (Please see "Progress Update: Standard & Poor's Steps To Strengthen The Ratings Process," on RatingsDirect.)

What Processes Are In Place To Support Comparability Of Credit Opinions, And Are These Processes Changing?

Several substantive processes are in place, each of them dynamic, which support comparability of our credit opinions. The rating surveillance, criteria, and quality review processes all help sustain this effort. Our current analytic and governance processes generally support this comparability, and our leadership actions announced on Feb. 7 enhance those processes.

First, our credit opinions are derived from and substantially based on comparative analysis of financial statements and other data. The primary analytical functions are organized by global practice, often operating through global industry focus teams that enable analysts in different locations to develop a common understanding of credit factors and credit trends in specific industries. In addition, teams are established across analytical practices devoted to some areas such as housing finance, consumer finance, commercial real estate, project finance, and covered bonds, to name a few, where similar risks are evaluated. These teams are part of an effort to foster rating comparability.

Second, the criteria development and decision process also is organized by global practice, but with guidelines for broadening participation when the criteria could affect other practices. Consequently, our analytical methodologies and qualitative judgments, as well as analytical assumptions that underpin our criteria, are shared and implemented across groups and frequently form a common basis for assessing risks.

Finally, ratings and the rating criteria are responsive to changes in the economic and business environments, the evolution of financial instruments, and the identification of new risks. Adjustments to ratings and criteria, which are both forward looking, may be informed by historical default experience, but criteria reviews may well be prompted by internal rating performance reviews, which occur routinely as part of the quality review process.

How Are Historical Default And Transition Studies Used To Drive Comparability Across Sectors?

We publish default and transition statistics for our ratings, making our rating performance transparent and facilitating market scrutiny, and the debate that sometimes accompanies that scrutiny. This market scrutiny is one of the underpinnings supporting comparability. As expected, we monitor default and transition rates. Performance that varies meaningfully from long-term average experience will draw the scrutiny of the analytical practice management and the independent quality-review function. Sharp or rapid deterioration from investment grade to default will almost certainly prompt a review of our criteria, methodologies, or risk assumptions, but other, more moderate changes may also prompt a review. But historical rating behavior is only one catalyst for reviewing criteria, assumptions, or methodologies. It is not, by itself, a justification for changing ratings. This is especially true for comparisons within higher rating categories, where defaults and substantive rating transitions are sparse and statistical comparisons have more limited usefulness. Ratings are forward-looking assessments--based on expectations--and the influence of historical statistical performance is therefore necessarily limited.

The pattern of average historical defaults rates, measured over the long term, largely demonstrates comparability within tolerable ranges, in our view. For instance, although some variation in default performance has been observed and is expected, the 'A' five-year cumulative average default rates through year-end 2007 show that more than 99% of 'A' rated SF issues and corporate and government issuers did not default.

We continually review our criteria to help confirm that they produce ratings that best reflect credit quality. We

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reviewed USPF criteria after considering the historical default experiences we saw in the USPF default studies. In part because of these efforts, the distribution of USPF ratings has in recent years moved up the rating scale in a number of areas, including lease and appropriation, state-supported bonding programs, and special sales and gas tax revenue bonds.

Was The Recent Rating Performance Of Structured Securities Consistent With This Notion Of Rating Comparability?

No. The recent high volume and magnitude of negative rating actions does not follow historical patterns. We are reviewing and revising our criteria, methodologies, and assumptions to rebalance SF ratings toward our long-term goal of rating comparability. As new transactions are rated with these revisions, we expect their ratings' long-term performance to conform more closely to historical trends.

In Light Of The Recent Performance Of Certain SF Instruments, What Actions Have You Taken To Make These Ratings Consistent With The Goal Of Rating Comparability Over The Long Term?

We have undertaken extensive criteria revisions in several areas, including housing finance, collateralized debt obligations (CDOs), and market-value-based transactions, to reflect recent market performance. More broadly, we are stress-testing all areas of SF securities under assumptions of adverse economic scenarios, including increasing delinquencies and losses in the underlying portfolios. And we are sharing these results with the marketplace to provide greater transparency on the performance of these securities.

Regarding U.S. residential mortgage-backed securities (RMBS), we have revised our criteria to increase the credit support in newly rated mortgage securities and on outstanding transactions, resulting in lower ratings on the latter. These revisions include:

- Increased default frequency expectations for subprime loans, Alt A hybrid adjustable-rate mortgages, purchase loans, and second mortgages;
- Increased loss assumptions for loans with limited documentation;
- Increased expected severity of loss upon foreclosure;
- Revised assumptions for the timing of loss;
- Reduced credit for excess spread;
- Tightened performance assumptions in step-down provisions and triggers increasing the transaction's floor credit support;
- Revised loss assumptions for modified loans;
- Reduced weighting of FICO as a predictor of creditworthiness; and
- New requirements for loan-level detail in all existing and newly rated mortgage security transactions.

In CDOs, we have adjusted the assessment of subprime and other mortgage-related collateral, established new guidelines for rating structures that use ratings-based haircuts in the calculation of overcollateralization tests, and changed correlation and loss assumptions for U.S. RMBS and related CDO collateral. Default, recovery, and correlation assumptions for other types of collateral are under review.

For structured transactions, including structured investment vehicles (commonly known as SIVs), where debt repayment depends substantially on the market value or liquidation of portfolio assets, we have revised advance rates significantly to capture the current market disruption and have emphasized the importance of third-party liquidity arrangements to support 100% of newly issued debt of certain structures. More broadly, we are reviewing issuer and third-party valuation processes in light of the severity and unprecedented nature of the ongoing market

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disruption. We have also revised criteria methodologies and assumptions used to rate constant proportion debt obligations and similar instruments whose credit risk is a function of the prices of referenced securities.

The criteria changes mentioned above generally raise the capacity of highly rated transactions to withstand increasing economic or market adversity. We are committed to making our criteria transparent to the market, and publishing stress scenario analyses for each structured asset type will help significantly in this effort.

How Do You Propose To Address The Volatility Of Ratings? Is Rating Volatility Comparable?

Volatility of ratings is measured by the speed, direction, and extent of rating changes, although it can also be expressed as the proportion of ratings that change or the frequency of change. A long-term study of ratings indicates that, during that period, a greater percentage of corporate ratings changed year to year than did structured and public finance ratings. This year's rating performance in SF may narrow that gap, and perhaps reverse it temporarily. Moreover, when SF ratings do change, they generally change more than corporate ratings, and changes may be more highly correlated within an asset type. This confirms the casual observation that SF rating changes tend to be more pronounced than those of corporates. We expect the recent rating experience in subprime and CDO securities to add to the evidence that during periods of stress, SF ratings in general may change more rapidly and severely than corporate ratings.

Credits at the high end of the rating spectrum have shown, in general over the long term, greater rating stability than credits at the low end. These results reflect our overall approach to ratings--basically, that a higher-rated credit is less vulnerable to or has the capacity to manage changes in the economy and market than a lower-rated credit.

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