Background Information on
Bond Credit Ratings

Sources: Wikipedia and Investopedia

1. Purpose of Credit Ratings of Securities. Credit ratings are intended provide individual and institutional investors with information that assists them in determining whether or not the issuers of debt obligations and fixed-income securities will be able to meet their obligations with respect to those securities. Credit rating agencies are intended to provide investors with objective analyses and independent assessments of companies and countries that issue such securities.

2. Primary Security Rating Agencies. There are three major rating agencies of investments in the United States. Those rating agencies are:

   a. Fitch. John Knowles Fitch founded the Fitch Publishing Company in 1913 and published financial statistics for use in the investment industry via "The Fitch Stock and Bond Manual" and "The Fitch Bond Book." In 1924, Fitch introduced the letter (AAA through D) rating system that has become the basis for ratings throughout the industry. Following plans to become a full-service global rating agency, in the late 1990s Fitch merged with IBCA of London, a subsidiary of Fimalac, S.A., a French holding company. Fitch also acquired market competitors Thomson BankWatch and Duff & Phelps Credit Ratings Co.

   b. Moody's. John Moody and Company first published "Moody's Manual" in 1900, which published basic statistics and general information about stocks and bonds of various industries. From 1903 until the stock market crash of 1907, "Moody's Manual" was a national publication. In 1909 Moody began publishing "Moody's Analyses of Railroad Investments", which added analytical information about the value of securities. Expanding this idea led to the 1914 creation of Moody's Investors Service which, in the following decade, would provide ratings for nearly all of the government bond markets at the time. By the 1970s, Moody's began rating commercial paper and bank deposits.

   c. Standard & Poor's. Henry Varnum Poor first published the "History of Railroads and Canals in the United States" in 1860 as the forerunner of securities analysis and reporting to be developed over the next century. Standard Statistics formed in 1906, which published corporate bond, sovereign debt and municipal bond ratings. Standard Statistics merged with Poor's Publishing in 1941 to form the Standard and Poor's Corporation. It was acquired by The McGraw-Hill Companies, Inc. in 1966. Standard and Poor's has become best known by virtue of its assembled indexes such as the S&P 500.

3. Bond Credit Ratings. In investment, the bond credit rating is intended to assess the credit worthiness of corporate or government debt issues. It is analogous in purpose to credit ratings for individuals. The credit rating is a financial indicator to potential investors of debt securities such as bonds. These are assigned by credit rating agencies such as Moody's, Standard & Poor's, and Fitch Ratings to have letter designations (such as AAA, B, CC) which represent the quality of a bond. Bond ratings below BBB/Baa are considered to be not investment grade and are colloquially called “junk bonds.”

<table>
<tr><th colspan="2">Moody's</th><th colspan="2">S&P</th><th colspan="2">Fitch</th><th></th></tr>
<tr><th>Long-term</th><th>Short-term</th><th>Long-term</th><th>Short-term</th><th>Long-term</th><th>Short-term</th><th></th></tr>
<tr><td>Aaa</td><td rowspan="6">P-1</td><td>AAA</td><td rowspan="4">A-1+</td><td>AAA</td><td rowspan="4">F1+</td><td>Prime</td></tr>
<tr><td>Aa1</td><td>AA+</td><td>AA+</td><td rowspan="3">High grade</td></tr>
<tr><td>Aa2</td><td>AA</td><td>AA</td></tr>
<tr><td>Aa3</td><td>AA-</td><td>AA-</td></tr>
<tr><td>A1</td><td>A+</td><td rowspan="2">A-1</td><td>A+</td><td rowspan="2">F1</td><td rowspan="3">Upper medium grade</td></tr>
<tr><td>A2</td><td>A</td><td>A</td></tr>
<tr><td>A3</td><td rowspan="2">P-2</td><td>A-</td><td rowspan="2">A-2</td><td>A-</td><td rowspan="2">F2</td></tr>
<tr><td>Baa1</td><td>BBB+</td><td>BBB+</td><td rowspan="3">Lower medium grade</td></tr>
<tr><td>Baa2</td><td rowspan="2">P-3</td><td>BBB</td><td rowspan="2">A-3</td><td>BBB</td><td rowspan="2">F3</td></tr>
<tr><td>Baa3</td><td>BBB-</td><td>BBB-</td></tr>
<tr><td>Ba1</td><td rowspan="3">Not prime</td><td>BB+</td><td rowspan="3">B</td><td>BB+</td><td rowspan="3">B</td><td rowspan="3">Non-investment grade speculative</td></tr>
<tr><td>Ba2</td><td>BB</td><td>BB</td></tr>
<tr><td>Ba3</td><td>BB-</td><td>BB-</td></tr>
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<tr><th colspan="2">Moody's</th><th colspan="2">S&P</th><th colspan="2">Fitch</th><th></th></tr>
<tr><th>Long-term</th><th>Short-term</th><th>Long-term</th><th>Short-term</th><th>Long-term</th><th>Short-term</th><th></th></tr>
<tr><td>B1</td><td rowspan="11"></td><td>B+</td><td rowspan="3"></td><td>B+</td><td rowspan="3"></td><td rowspan="3">Highly speculative</td></tr>
<tr><td>B2</td><td>B</td><td>B</td></tr>
<tr><td>B3</td><td>B-</td><td>B-</td></tr>
<tr><td>Caa1</td><td>CCC+</td><td rowspan="5">C</td><td rowspan="5">CCC</td><td rowspan="5">C</td><td>Substantial risks</td></tr>
<tr><td>Caa2</td><td>CCC</td><td>Extremely speculative</td></tr>
<tr><td>Caa3</td><td>CCC-</td><td rowspan="3">In default with little prospect for recovery</td></tr>
<tr><td rowspan="2">Ca</td><td>CC</td></tr>
<tr><td>C</td></tr>
<tr><td>C</td><td rowspan="3">D</td><td rowspan="3">/</td><td>DDD</td><td rowspan="3">/</td><td rowspan="3">In default</td></tr>
<tr><td>/</td><td>DD</td></tr>
<tr><td>/</td><td>D</td></tr>
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4. <u>Recent Debate Over the Debt Rating System</u>. The effectiveness of the debt rating system is a hotly debated subject recently because of the subprime crisis of 2007, which revealed the system's flaws when highly-rated structured securities were suddenly revealed to be of very questionable value. The loans supporting these structured securities were made to marginally qualified borrowers and the loans were often backed by very inadequate collateral, but these circumstances did not result in significant downgrades from ratings agencies. Questions have been raised as to whether this could have been a result of a potential conflict of interest and/or a lack of competition in the industry.

   When an individual invests in a fixed-income security, the individual is essentially loaning money for a promise of scheduled, fixed-interest payments and for the eventual return of principal when the loan matures. An investment in this type of security involves a risk that the company might not do well enough to pay the agreed-upon interest on the scheduled dates. There is an even greater risk that the company will not be able to return the principal borrowed when the security matures. To help investors assess these risks, the ratings agencies analyze and rate companies and the fixed-income securities they issue, to determine the likelihood that companies will default on their loans.

   According to a report published by the Basel Committee on Banking Supervision in 2000, there are about 150 credit rating agencies worldwide, but only a handful of these companies are nationally recognized as major players, called Nationally Recognized Statistical Rating Organizations (NRSRO).

   So much is riding on the rating bestowed on the security that it may be possible for rating agencies to become involved in or threatened by conflicts of interest. Another concern is that the debt rating industry is dominated by only three companies: Standard & Poor's (S&P), Moody's, and Fitch.

   Because the rating companies receive their compensation from the companies whose structured securities they rate, ratings company critics suggest that the fact that the ratings companies obtain fees from the companies that issue structured securities may make the ratings agencies susceptible to issuing artificially high ratings. In addition, critics suggest that the rating agencies may become reluctant to downgrade the securities of firms they were involved with for fear of losing future business. Some ratings agencies also advise issuers on structured debt securities and then rate the securities they helped structure, which many critics believe to be a questionable business practice leading to inflated ratings.