Why do Standard & Poor’s credit ratings remain an important benchmark for global credit risk?

Find out at understandingratings.com

Listen to our people. Learn about our analytics. See how our ratings perform.

Guide to Credit Rating Essentials

What are credit ratings and how do they work?
The origin of Standard & Poor’s Credit Ratings

Standard & Poor’s Ratings Services traces its history back to 1860, the year that Henry Varnum Poor published the History of Railroads and Canals of the United States.

Poor was concerned about the lack of quality information available to investors and embarked on a campaign to publicize details of corporate operations. Standard & Poor’s has been publishing credit ratings since 1916, providing investors and market participants worldwide with independent analysis of credit risk.

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Standard & Poor’s thanks Lightbulb Press for its collaboration in developing the Guide to Ratings Performance.

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Credit ratings are one of several tools that investors can use when making decisions about purchasing bonds and other fixed income investments. The purpose of this guide is to help explain what credit ratings are, and are not, who uses them, and how they may be useful to the capital markets.

The guide provides an overview of different business models and methodologies used by credit rating agencies. It also describes generally how Standard & Poor’s forms its ratings opinions about issuers and individual debt issues, monitors and adjusts its ratings, and studies ratings changes over time.

In addition, the *Guide to Credit Rating Essentials* points out several key things you should know about credit ratings:

> Credit ratings are opinions about relative credit risk.

> Credit ratings are not investment advice, or buy, hold, or sell recommendations. They are just one factor investors may consider in making investment decisions.

> Credit ratings are not indications of the market liquidity of a debt security or its price in the secondary market.

> Credit ratings are not guarantees of credit quality or of future credit risk.

If you would like to learn more about credit ratings, additional information is available at www.AboutCreditRatings.com or www.UnderstandingRatings.com.
<table>
<thead>
<tr>
<th>Page</th>
<th>Topic</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>What are credit ratings</td>
</tr>
<tr>
<td>5</td>
<td>Why credit ratings are useful</td>
</tr>
<tr>
<td>6</td>
<td>Who uses credit ratings</td>
</tr>
<tr>
<td>6</td>
<td>Credit rating agencies</td>
</tr>
<tr>
<td>10</td>
<td>The ABCs of rating scales</td>
</tr>
<tr>
<td>11</td>
<td>Rating issuers and issues</td>
</tr>
<tr>
<td>15</td>
<td>Surveillance</td>
</tr>
<tr>
<td>15</td>
<td>Why credit ratings change</td>
</tr>
<tr>
<td>16</td>
<td>How Standard &amp; Poor’s communicates credit ratings</td>
</tr>
</tbody>
</table>
What are credit ratings

Credit ratings are opinions about credit risk. Standard & Poor’s ratings express the agency’s opinion about the ability and willingness of an issuer, such as a corporation or state or city government, to meet its financial obligations in full and on time.

Credit ratings can also speak to the credit quality of an individual debt issue, such as a corporate or municipal bond, and the relative likelihood that the issue may default.

Ratings are provided by credit rating agencies which specialize in evaluating credit risk. In addition to international credit rating agencies, such as Standard & Poor’s, there are regional and niche rating agencies that tend to specialize in a geographical region or industry.

Each agency applies its own methodology in measuring creditworthiness and uses a specific rating scale to publish its ratings opinions. Typically, ratings are expressed as letter grades that range, for example, from ‘AAA’ to ‘D’ to communicate the agency’s opinion of relative level of credit risk.

A matter of opinion

Standard & Poor’s ratings opinions are based on analysis by experienced professionals who evaluate and interpret information received from issuers and other available sources to form a considered opinion.

Unlike other types of opinions, such as, for example, those provided by doctors or lawyers, credit ratings opinions are not intended to be a prognosis or recommendation. Instead, they are primarily intended to provide investors and market participants with information about the relative credit risk of issuers and individual debt issues that the agency rates.

Standard & Poor’s public credit ratings opinions are also disseminated broadly and free of charge to recipients all over the world on www.standardandpoors.com
Credit ratings are forward looking
As part of its ratings analysis, Standard & Poor’s evaluates available current and historical information and assesses the potential impact of foreseeable future events. For example, in rating a corporation as an issuer of debt, the agency may factor in anticipated ups and downs in the business cycle that may affect the corporation’s creditworthiness. While the forward looking opinions of rating agencies can be of use to investors and market participants who are making long- or short-term investment and business decisions, credit ratings are not a guarantee that an investment will pay out or that it will not default.

Credit ratings do not indicate investment merit
While investors may use credit ratings in making investment decisions, Standard & Poor’s ratings are not indications of investment merit. In other words, the ratings are not buy, sell, or hold recommendations, or a measure of asset value. Nor are they intended to signal the suitability of an investment. They speak to one aspect of an investment decision—credit quality—and, in some cases, may also address what investors can expect to recover in the event of default.

In evaluating an investment, investors should consider, in addition to credit quality, the current make-up of their portfolios, their investment strategy and time horizon, their tolerance for risk, and an estimation of the security’s relative value in comparison to other securities they might choose. By way of analogy, while reputation for dependability may be an important consideration in buying a car, it is not the sole criterion on which drivers normally base their purchase decisions.

Credit ratings are not absolute measures of default probability
Since there are future events and developments that cannot be foreseen, the assignment of credit ratings is not an exact science. For this reason, Standard & Poor’s ratings opinions are not intended as guarantees of credit quality or as exact measures of the probability that a particular issuer or particular debt issue will default.

Instead, ratings express relative opinions about the creditworthiness of an issuer or credit quality of an individual debt issue, from strongest to weakest, within a universe of credit risk.

For example, a corporate bond that is rated ‘AA’ is viewed by the rating agency as having a higher credit quality than a corporate bond with a ‘BBB’ rating. But the ‘AA’ rating isn’t a guarantee that it will not default, only that, in the agency’s opinion, it is less likely to default than the ‘BBB’ bond.
Credit ratings may play a useful role in enabling corporations and governments to raise money in the capital markets. Instead of taking a loan from a bank, these entities sometimes borrow money directly from investors by issuing bonds or notes. Investors purchase these debt securities, such as municipal bonds, expecting to receive interest plus the return of their principal, either when the bond matures or as periodic payments.

Credit ratings may facilitate the process of issuing and purchasing bonds and other debt issues by providing an efficient, widely recognized, and long-standing measure of relative credit risk. Investors and other market participants may use the ratings as a screening device to match the relative credit risk of an issuer or individual debt issue with their own risk tolerance or credit risk guidelines in making investment and business decisions.

For instance, in considering the purchase of a municipal bond, an investor may check to see whether the bond’s credit rating is in keeping with the level of credit risk he or she is willing to assume. At the same time, credit ratings may be used by corporations to help them raise money for expansion and/or research and development as well as help states, cities, and other municipalities to fund public projects.

**Raising capital through rated securities**

- **Investors**
- **Intermediaries**
- **Issuers**

**Purchase rated securities**

**Issue rated securities to raise capital**

PREVIOUS NEXT
Investors most often use credit ratings to help assess credit risk and to compare different issuers and debt issues when making investment decisions and managing their portfolios. Individual investors, for example, may use credit ratings in evaluating the purchase of a municipal or corporate bond from a risk tolerance perspective.

Institutional investors, including mutual funds, pension funds, banks, and insurance companies often use credit ratings to supplement their own credit analysis of specific debt issues. In addition, institutional investors may use credit ratings to establish thresholds for credit risk and investment guidelines.

A rating may be used as an indication of credit quality, but investors should consider a variety of factors, including their own analysis.

Intermediaries

Investment bankers help to facilitate the flow of capital from investors to issuers. They may use credit ratings to benchmark the relative credit risk of different debt issues, as well as to set the initial pricing for individual debt issues they structure and to help determine the interest rate these issues will pay.

Investment bankers and entities that structure special types of debt issues may look to a rating agency’s criteria when making their own decisions about how to configure different debt issues, or different tiers of debt.

Investment bankers may also serve as arrangers of special debt issues. In this capacity, they establish special entities that package assets, such as retail mortgages and student loans, into securities, or structured finance instruments, which they then market to investors.

Credit rating agencies

Some credit rating agencies, including major global agencies like Standard & Poor’s, are publishing and information companies that specialize in analyzing the credit risk of issuers and individual debt issues. They formulate and disseminate ratings opinions that are used by investors and other market participants who may consider credit risk in making their investment and business decisions. In part because rating agencies are not directly involved in capital market transactions, they have come to be viewed by both investors and issuers as impartial, independent providers of opinions on credit risk.
Issuers
Issuers, including corporations, financial institutions, national governments, states, cities and municipalities, use credit ratings to provide independent views of their creditworthiness and the credit quality of their debt issues.

Issuers may also use credit ratings to help communicate the relative credit quality of debt issues, thereby expanding the universe of investors. In addition, credit ratings may help them anticipate the interest rate to be offered on their new debt issues.

As a general rule, the more creditworthy an issuer or an issue is, the lower the interest rate the issuer would typically have to pay to attract investors. The reverse is also true: an issuer with lower creditworthiness will typically pay a higher interest rate to offset the greater credit risk assumed by investors.

Businesses and financial institutions
Businesses and financial institutions, especially those involved in credit-sensitive transactions, may use credit ratings to assess counterparty risk, which is the potential risk that a party to a credit agreement may not fulfill its obligations.

For example, in deciding whether to lend money to a particular organization or in selecting a company that will guarantee the repayment of a debt issue in the event of default, a business may wish to consider the counterparty risk.

A credit rating agency’s opinion of counterparty risk can therefore help businesses analyze their credit exposure to financial firms that have agreed to assume certain financial obligations and to evaluate the viability of potential partnerships and other business relationships.

Rating methodologies
In forming their opinions of credit risk, rating agencies typically use primarily analysts or mathematical models, or a combination of the two.

Model driven ratings. A small number of credit rating agencies focus almost exclusively on quantitative data, which they incorporate into a mathematical model. For example, an agency using this approach to assess the creditworthiness of a bank or other financial institution might evaluate that entity’s asset quality, funding, and profitability based primarily on data from the institution’s public financial statements and regulatory filings.
Analyst driven ratings. In rating a corporation or municipality, agencies using the analyst driven approach generally assign an analyst, often in conjunction with a team of specialists, to take the lead in evaluating the entity’s creditworthiness. Typically, analysts obtain information from published reports, as well as from interviews and discussions with the issuer’s management. They use that information to assess the entity’s financial condition, operating performance, policies, and risk management strategies.
How agencies are paid for their services

Agencies typically receive payment for their services either from the issuer that requests the rating or from subscribers who receive the published ratings and related credit reports.

Issuer-pay model. Under the issuer-pay model, rating agencies charge issuers a fee for providing a ratings opinion. In conducting their analysis, agencies may obtain information from issuers that might not otherwise be available to the public and factor this information into their ratings opinion. Since the rating agency does not rely solely on subscribers for fees, it can publish current ratings broadly to the public free of charge.

Subscription model. Credit rating agencies that use a subscription model charge investors and other market participants a fee for access to the agency’s ratings. Critics point out that like the issuer-pay model, this model has the potential for conflicts of interest since the entities paying for the rating, in this case investors, may attempt to influence the ratings opinion.

Critics of this model also point out that the ratings are available only to paying subscribers. These tend to be large institutional investors, leaving out smaller investors, including individual investors. In addition, rating agencies using the subscription model may have more limited access to issuers. Information from management can be helpful when providing forward looking ratings.

To protect against potential conflicts of interest when paid by the issuer, Standard & Poor’s has established a number of safeguards.

These measures include, for example, a clear separation of function between those who negotiate the business terms for the ratings assignment and the analysts who conduct the credit analysis and provide the ratings opinions. This separation is similar in concept to the way newspapers distinguish their editorial and advertising sales functions, since they report on companies from which they may also collect advertising fees.

Another safeguard is the committee process that limits the influence any single person can have on Standard & Poor’s ratings opinions. The role of the committee is to review and assess the analyst’s recommendation for a new rating or a ratings change as well as to provide additional perspectives and checks and balances regarding adherence to the agency’s ratings criteria.
The ABCs of rating scales

Standard & Poor’s credit rating symbols provide a simple, efficient way to communicate creditworthiness and credit quality. Its global rating scale provides a benchmark for evaluating the relative credit risk of issuers and issues worldwide.

General summary of the opinions reflected by Standard & Poor’s ratings

<table>
<thead>
<tr>
<th>INVESTMENT GRADE</th>
<th>SPECULATIVE GRADE</th>
</tr>
</thead>
<tbody>
<tr>
<td>‘AAA’</td>
<td>Extremely strong capacity to meet financial commitments. Highest rating</td>
</tr>
<tr>
<td>‘AA’</td>
<td>Very strong capacity to meet financial commitments</td>
</tr>
<tr>
<td>‘A’</td>
<td>Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances</td>
</tr>
<tr>
<td>‘BBB’</td>
<td>Adequate capacity to meet financial commitments, but more subject to adverse economic conditions</td>
</tr>
<tr>
<td>‘BBB-’</td>
<td>Considered lowest investment grade by market participants</td>
</tr>
<tr>
<td>‘BB+’</td>
<td>Considered highest speculative grade by market participants</td>
</tr>
<tr>
<td>‘BB’</td>
<td>Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions</td>
</tr>
<tr>
<td>‘B’</td>
<td>More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments</td>
</tr>
<tr>
<td>‘CCC’</td>
<td>Currently vulnerable and dependent on favorable business, financial and economic conditions to meet financial commitments</td>
</tr>
<tr>
<td>‘CC’</td>
<td>Currently highly vulnerable</td>
</tr>
<tr>
<td>‘C’</td>
<td>A bankruptcy petition has been filed or similar action taken, but payments of financial commitments are continued</td>
</tr>
<tr>
<td>‘D’</td>
<td>Payments default on financial commitments</td>
</tr>
</tbody>
</table>

Ratings from ‘AA’ to ‘CCC’ may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.
Investment- and speculative-grade debt
The term “investment grade” historically referred to bonds and other debt securities that bank regulators and market participants viewed as suitable investments for financial institutions. Now the term is broadly used to describe issuers and issues with relatively high levels of creditworthiness and credit quality. In contrast, the term “non-investment grade,” or “speculative grade,” generally refers to debt securities where the issuer currently has the ability to repay but faces significant uncertainties, such as adverse business or financial circumstances that could affect credit risk.

In Standard & Poor’s long-term rating scale, issuers and debt issues that receive a rating of ‘BBB–’ or above are generally considered by regulators and market participants to be “investment grade,” while those that receive a rating lower than ‘BBB–’ are generally considered to be “speculative grade.”

Ratings definitions
For a complete list of Standard & Poor’s Rating Definitions, including issuer credit ratings as well as a related article on Understanding Standard & Poor’s Ratings Definitions, please go to www.AboutCreditRatings.com and enter the module entitled The ABCs of S&P’s Rating Scales.

Rating issuers and issues
Credit rating agencies assign ratings to issuers, such as corporations and governments, as well as to specific debt issues, such as bonds, notes, and other debt securities.

Rating an issuer
To assess the creditworthiness of an issuer, Standard & Poor’s evaluates the issuer’s ability and willingness to repay its obligations in accordance with the terms of those obligations.

To form its ratings opinions, Standard & Poor’s reviews a broad range of financial and business attributes that may influence the issuer’s prompt repayment. The specific risk factors that are analyzed depend in part on the type of issuer. For example, the credit analysis of a corporate issuer typically considers many financial and non-financial factors, including key performance indicators, economic, regulatory, and geopolitical influences, management and corporate governance attributes, and competitive position. In rating a sovereign, or national government, the analysis may concentrate on political risk, monetary stability, and overall debt burden.
Rating issuers and issues

For high-grade credit ratings, Standard & Poor’s considers the anticipated ups and downs of the business cycle, including industry-specific and broad economic factors. The length and effects of business cycles can vary greatly, however, making their impact on credit quality difficult to predict with precision. In the case of higher risk, more volatile speculative-grade ratings, Standard & Poor’s factors in greater vulnerability to down business cycles.

Rating an issue
In rating an individual debt issue, such as a corporate or municipal bond, Standard & Poor’s typically uses, among other things, information from the issuer and other sources to evaluate the credit quality of the issue and the likelihood of default. In the case of bonds issued by corporations or municipalities, rating agencies typically begin with an evaluation of the creditworthiness of the issuer before assessing the credit quality of a specific debt issue.

In analyzing debt issues, for example, Standard & Poor’s analysts evaluate, among other things:

> The terms and conditions of the debt security and, if relevant, its legal structure.
> The relative seniority of the issue with regard to the issuer’s other debt issues and priority of repayment in the event of default.
> The existence of external support or credit enhancements, such as letters of credit, guarantees, insurance, and collateral. These protections can provide a cushion that limits the potential credit risks associated with a particular issue.

Recovery of investment after default
Credit rating agencies may also assess recovery, which is the likelihood that investors will recoup the unpaid portion of their principal in the event of default. Some agencies incorporate recovery as a rating factor in evaluating the credit

Standard & Poor’s risk factors for corporate ratings

- Country risk
- Industry characteristics
- Company position
- Profitability, peer group comparison
- Accounting
- Governance, risk tolerance, financial policy
- Cash flow adequacy
- Capital structure
- Liquidity/short term factors

BUSINESS RISK

FINANCIAL RISK

RATING
quality of an issue, particularly in the case of non-investment-grade debt. Other agencies, such as Standard & Poor’s, issue recovery ratings in addition to rating specific debt issues. Standard & Poor’s may also consider recovery ratings in adjusting the credit rating of a debt issue up or down in relation to the credit rating assigned to the issuer.

Rating structured finance instruments
A structured finance instrument is a particular type of debt issue created through a process known as securitization. In essence, securitization involves pooling individual financial assets, such as mortgage or auto loans, and creating, or structuring, separate debt securities that are sold to investors to fund the purchase of these assets.

The creation of structured finance instruments, such as residential mortgage-backed securities (RMBS), asset-backed securities (ABS), and collateralized debt obligations (CDOs), typically involves three parties: an originator, an arranger, and a special purpose entity, or SPE, that issues the securities.
Rating issuers and issues

> The **originator** is generally a bank, lender, or a financial intermediary who either makes loans to individuals or other borrowers or purchases the loans from other originators.

> The **arranger**, which may also be the originator, typically an investment bank or other financial services company, securitizes the underlying loans as marketable debt instruments.

> The **special purpose entity (SPE)**, generally created by the arranger, finances the purchase of the underlying assets by selling debt instruments to investors. The investors are repaid with the cash flow from the underlying loans or other assets owned by the SPE.

Stratifying a pool of undifferentiated risk into multiple classes of bonds with varying levels of seniority is called **tranching**. Investors who purchase the senior tranche, which generally has the highest quality debt from a credit perspective and the lowest interest rate, are the first to be repaid from the cash flow of the underlying assets. Holders of the next-lower tranche, which pays a somewhat higher rate, are paid second, and so forth. Investors who purchase the lowest tranche generally have the potential to earn the highest interest rate, but they also tend to assume the highest risk.

In forming its opinion of a structured finance instrument, Standard & Poor’s evaluates, among other things, the potential risks posed by the instrument’s legal structure and the credit quality of the assets the SPE holds. Standard & Poor’s also considers the anticipated cash flow of these underlying assets and any credit enhancements that provide protection against default.

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**Expressions of change: Outlook and CreditWatch**

If Standard & Poor’s anticipates that a credit rating may change in the coming 6 to 24 months, it may issue an updated ratings outlook indicating whether the possible change is likely to be “positive,” “negative,” “stable,” or “developing” (meaning it’s uncertain whether a rating might go up or down). Or, if events or circumstances occur that may affect a credit rating in the near term, usually within 90 days, Standard & Poor’s may place the rating on CreditWatch. Typically, an updated outlook or CreditWatch from Standard & Poor’s includes a rationale for the potential change and the extent of the change, up or down, that may occur. However, updating a ratings outlook or placing a rating on CreditWatch does not mean a ratings change is inevitable.

If Standard & Poor’s has all the information available to warrant a ratings change, it may upgrade or downgrade the rating immediately, without placing the rating on CreditWatch or changing its outlook, to reflect these circumstances and its current opinion of relative credit risk.
Surveillance: Tracking credit quality

Agencies typically track developments that might affect the credit risk of an issuer or individual debt issue for which an agency has provided a ratings opinion. In the case of Standard & Poor’s, the goal of this surveillance is to keep the rating current by identifying issues that may result in either an upgrade or a downgrade.

In conducting its surveillance, Standard & Poor’s may consider many factors, including, for example, changes in the business climate or credit markets, new technology or competition that may hurt an issuer’s earnings or projected revenues, issuer performance, and regulatory changes.

The frequency and extent of surveillance typically depends on specific risk considerations for an individual issuer or issue, or an entire group of rated entities or debt issues. In its surveillance of a corporate issuer’s ratings, for example, Standard & Poor’s may schedule periodic meetings with a company to allow management to:

> Apprise agency analysts of any changes in the company’s plans.
> Discuss new developments that may affect prior expectations of credit risk.
> Identify and evaluate other factors or assumptions that may affect the agency’s opinion of the issuer’s creditworthiness.

As a result of its surveillance analysis, an agency may adjust the credit rating of an issuer or issue to signify its view of a higher or lower level of relative credit risk.

Why credit ratings change

The reasons for ratings adjustments vary, and may be broadly related to overall shifts in the economy or business environment or more narrowly focused on circumstances affecting a specific industry, entity, or individual debt issue.

Growing or shrinking debt burdens, hefty capital spending requirements, and regulatory changes may also trigger ratings changes.

While some risk factors tend to affect all issuers—an example would be growing inflation that affects interest rate levels and the cost of capital—other risk factors may pertain only to a narrow group of issuers and debt issues. For instance, the creditworthiness of a state or municipality may be impacted by population shifts or lower incomes of taxpayers, which reduce tax receipts and ability to repay debt.

In some cases, changes in the business climate can affect the credit risk of a wide array of issuers and securities. For instance, new competition or technology, beyond what might have been expected and factored into the ratings, may hurt a company’s expected earnings performance, which could lead to one or more rating downgrades over time.
Why credit ratings change

When ratings change
Credit rating adjustments may play a role in how the market perceives a particular issuer or individual debt issue. Sometimes, for example, a downgrade by a rating agency may change the market’s perception of the credit risk of a debt security which, combined with other factors, may lead to a change in the price of that security.

Market prices continually fluctuate as investors reach their own conclusions about the security’s shifting credit quality and investment merit. While ratings changes may affect investor perception, credit ratings constitute just one of many factors that the marketplace should consider when evaluating debt securities.

Agency studies of defaults and ratings changes
To measure the performance of its credit ratings, Standard & Poor’s conducts studies to track default rates and transitions, which is how much a rating has changed, up or down, over a certain period of time. Agencies use these studies to refine and evolve their analytic methods in forming their ratings opinions.

Transition rates can also be helpful to investors and credit professionals because they show the relative stability and volatility of credit ratings. For example, investors who are obligated to purchase only highly rated securities and are looking for some indication of stability may review the history of rating transitions and defaults as part of their investment research.

How Standard & Poor’s communicates credit ratings

Standard & Poor’s makes its credit ratings, criteria, and research available in a number of ways, including:

> Press releases
> Web sites
  www.standardandpoors.com
  www.RatingsDirect.com
  www.AboutCreditRatings.com
  www.UnderstandingRatings.com
> Podcasts (www.podcasts.standardandpoors.com)
> Newsletters (CreditMatters Today at www.standardandpoors.com/getcmt)
> Standard & Poor’s Service Desk
  Email: research_request@standardandpoors.com
> Standard & Poor’s hosted events
> Direct contact with market participants
> Participation in industry and credit events

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