



Inside the Ratings: What Credit Ratings Mean

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Fitch's credit ratings provide an independent, timely and prospective opinion on the creditworthiness of an entity or transaction. Fitch has built a reputation for insightful research and analytical excellence and has developed many different rating scales to address creditworthiness and other areas of relative financial strength. These include credit ratings using the traditional 'AAA' scale, first introduced by John Knowles Fitch in 1924. Fitch has since added Individual (financial strength) and Support ratings for banks, Insurer Financial Strength (IFS) ratings for insurance companies, Recovery Ratings and Distressed Recovery ratings for securities, asset manager ratings, managed fund volatility ratings and National scale ratings. This report will focus primarily on the traditional international long-term credit ratings of the 'AAA' scale – the scale with the broadest usage and the highest profile within the international capital markets.

This report is subject to the complete definitions of our ratings, set forth on our free public website, www.fitchratings.com, as well as the disclaimers with respect to ratings set forth in our Code of Conduct, also available on our website.

› What Do Credit Ratings Mean?

Fitch's credit ratings provide an opinion on the relative ability of an entity or transaction to meet financial commitments such as interest payments, repayment of principal, insurance claims or counterparty obligations. Credit ratings are used by investors as an indication of the likelihood of receiving their money back in accordance with the terms on which they invested. Fitch's credit ratings cover the global spectrum of corporate, sovereign (including supranational and sub-national), bank, insurance, municipal and other public finance entities, and the securities or other obligations they issue, as well as structured finance securities backed by receivables or other assets.

The rating scale is traditionally divided into two sections, "investment grade" and "speculative grade". "Investment grade" ratings (International Long-Term: 'AAA' to 'BBB-' (BBB minus), Short-Term: 'F1+' to 'F3') indicate relatively low to moderate credit risk. "Speculative grade" categories (International Long-Term: 'BB+' to 'D'; Short-Term: 'B' to 'D') signal either a higher level of credit risk or that a default has already occurred. Credit ratings express risk in relative rank order, which is to say they are ordinal measures of credit risk. Thus, they should be seen as broadly consistent indicators of relative vulnerability, rather than predictive indicators of actual, cardinal default rates. Obligations that are highly-rated have lower credit risk than lower-rated obligations, but the individual ratings themselves are not intended to be predictive of a cardinal frequency of default or a percentage expected loss.

Given the profound effect that economic cycles may have on cardinal default experience, and the differing economic cycles that sectors and regions may face, entities or issues which carry the same rating will be of broadly comparable, but not necessarily identical, credit quality¹. Studies of default experience nonetheless provide users with both long-term and short-term average default experiences as a guideline indication.

¹ Excludes the US public or municipal finance debt market. Fitch's ratings on US public finance debt securities measure credit quality relative only to other US public finance debt securities. Default rates of most Fitch-rated US public finance debt securities have historically been significantly lower, and are expected to continue to be significantly lower, than other debt instruments rated comparably by Fitch.



Defining Creditworthiness

Credit ratings can apply both to entities and to individual obligations, and can be broadly separated into two types.

1. Ratings Which Address Relative Likelihood of Default (“First Dollar of Loss”)

Corporate, bank, insurance and sovereign issuers are typically assigned Issuer Default Ratings (IDRs), which express creditworthiness in terms of relative measures of default likelihood.

Structured finance ratings are typically assigned to an individual security or tranche in a transaction, and not to an issuer. Ratings in structured finance primarily reflect the relative probability of default of the rated liability², and not its loss severity given a default, although loss severity on underlying *assets* is incorporated in the analysis.

2. Ratings Combining Relative Default Likelihood and Loss Severity

Individual securities or obligations of a corporate or sovereign issuer, in contrast, are rated on the long-term scale taking into consideration *both* the relative likelihood of default and the recovery given default of that liability. As a result, individual securities of entities, such as corporations, are assigned ratings higher, lower, or the same as that entity’s issuer rating or IDR. The difference between issuer and security rating reflects expectations of the relative recovery prospects for each class of obligation. At the lower end of the ratings scale, Fitch now additionally publishes explicit Recovery Ratings in many cases to complement issuer and issue ratings.

	Corporate & Sovereign Finance	Structured Finance
Issuer	Rating covers Default	-
Issue	Rating covers Default/Loss Severity	Rating covers Default ²

Foreign and Local Currency Ratings

International credit ratings relate to either foreign currency or local currency commitments and, in both cases, assess the capacity to meet these commitments using a globally applicable scale. As such, both foreign currency and local currency international ratings are internationally comparable assessments.

The local currency international rating measures the likelihood of repayment in the currency of the jurisdiction in which the issuer is domiciled and hence does not take account of the possibility that it will not be possible to convert local currency into foreign currency, or make transfers between sovereign jurisdictions (transfer and convertibility risk).

Foreign currency ratings additionally consider the profile of the issuer or note *after* taking into account transfer and convertibility risk. This risk is usually communicated for different countries by the Country Ceiling, which ‘caps’ the ratings of most, though not all, issuers within a given country.

² At the distressed level, elements of loss severity may be incorporated in structured finance bond ratings in the ‘B’ and ‘C’ categories



Loss Severity – How and When is it Included?

Loss severity (using an assessment of recovery given default) is included in instrument ratings in three significant ways.

Corporate Bond Ratings

Corporate issuer ratings (Issuer Default Ratings or “IDRs”) reflect a relative likelihood of default. For the separate ratings of corporate bonds, loss severity is used to notch obligations relative to that issuer’s IDR. A bond with average recovery given default expectations will be rated at the same level as the issuer’s rating. A bond with notably above-average recovery given default expectations will be notched up from the IDR. A bond with notably below-average recovery given default expectations will be notched down from the IDR.

Structured Finance Bond Ratings

Structured finance bond ratings generally only reflect a relative likelihood of default (or “first dollar of loss”). However, to ascertain the likelihood of a default, loss severity of the underlying assets is typically analysed. For example, in analysing a portfolio of residential mortgages, both the default likelihoods and recovery prospects of individual mortgages will be considered, as both affect the cash flows available to the securitisation structure’s bondholders. However, the rating of the bonds issued against this portfolio generally only consider the relative likelihood that cash flows jointly available from performing and liquidated mortgages support the relevant tranche of the securitisation, and prevent a default, and not the loss severity on that tranche if it does default.

Dedicated Recovery Ratings (Low Speculative Grade only)

As default and loss severity are two very different considerations, Fitch has pioneered additional, separate rating scales to represent ‘recovery given default.’ These ratings – ‘RR1’-‘RR6’ for corporate and sovereign obligations and ‘DR1’-‘DR6’ for structured obligations – relate to relative “bands” of potential loss severity. Introduced in 2005 and currently assigned to individual obligations at the lower end of speculative grade, Fitch will consider in future the appropriateness of extending the use of these loss severity ratings further up the ratings scale.

› Application of Rating Watch and Rating Outlook

Rating Watches and Rating Outlooks are mutually exclusive and have different meanings and purposes. There is no single test which can separate the two concepts, although one guiding principle is that a Watch should be applied in any case where a rating cannot be affirmed at its current level.

Rating Watch

Rating Watches indicate that there is a heightened probability of a rating change and the likely direction of such a change. These are designated as “Positive”, indicating a potential upgrade, “Negative”, for a potential downgrade, or “Evolving”, if ratings may be raised, lowered or maintained. However, ratings that are not on Rating Watch can be upgraded or downgraded without being placed on Rating Watch first if circumstances warrant such an action.

A Rating Watch is typically event-driven and, as such, it is generally resolved over a relatively short period. The event driving the Watch may be either anticipated or have already occurred, but in both



cases, the exact rating implications remain undetermined. The Watch period is typically used to gather further information and/or subject the information to further analysis. Additionally, a Watch may be used where the rating implications are already clear, but where a triggering event (e.g. shareholder or regulatory approval) exists. The Watch will typically extend to cover the period until the triggering event is resolved, or its outcome is predictable with a high enough degree of certainty to permit resolution of the Watch. Rating Watches can be employed by all analytical groups and are applied to the ratings of individual entities and/or individual instruments.

Rating Outlook

Rating Outlooks indicate the direction a rating is likely to move over a one- to two-year period. They reflect financial or other trends that have not yet reached the level that would trigger a rating action, but which may do so if such trends continue. The majority of Outlooks are generally Stable, which is consistent with the historical migration experience of ratings over a one- to two-year period. Positive or Negative rating Outlooks do not imply that a rating change is inevitable and, similarly, ratings with Stable Outlooks can be upgraded or downgraded without a prior revision to the Outlook if circumstances warrant such an action. Occasionally, where the fundamental trend has strong, conflicting elements of both positive and negative, the Rating Outlook may be described as Evolving.

Outlooks are currently applied to issuer ratings in corporate finance (including sovereigns, industrials, utilities, banks and insurance companies) and public finance outside the United States, issue ratings in public finance in the United States, to certain issues in project finance, to Insurer Financial Strength ratings, issuer and/or issue ratings in a number of national rating scales, and to the ratings of selected structured finance transactions.

Deciding to Assign a Watch rather than Change the Outlook

Timing is informative but not critical to the choice of a Watch rather than an Outlook. A discrete event which is largely clear and the terms of which are defined, but which will not happen for more than six months – such as a lengthy regulatory approval process – would nonetheless likely see ratings placed on Watch rather than a revision to the Outlook. An Outlook revision may, however, be deemed more appropriate where a series of potential event risks has been identified, none of which individually warrants a Watch but which cumulatively indicate heightened probability of a rating change. A revision to the Outlook may also be appropriate where a specific event has been identified, but where the conditions and implications of that event are largely unclear and subject to high execution risk over an extended period – for example a proposed, but politically controversial, privatisation.

> Cyclicity of Ratings and Rating Time Horizons

Fitch's traditional credit ratings are designed as "through-the-cycle" assessments. As such, they aim to react to fundamental changes in an issuer or transaction profile, and not temporary changes in condition. Fundamental changes could include relative issuer performance that falls above or below Fitch's original expectations in a sustained manner, a move towards deeper, longer cycles for a given industry, or a change in the operating environment based upon a fundamental increase or decrease in systemic risk.

Cyclicity will nonetheless have a profound impact on actual default rates. As a result, default rates often vary widely for a given rating category between any two given years. Pro-cyclical ratings that



followed the cycle and tracked anticipated percentage default frequencies for each category, although they would produce results that are closer to cardinal default experience, would also display substantially more volatility than is the case for Fitch's traditional ratings. In turn this would reduce the ability of ratings to communicate relative changes in creditworthiness between two issuers, above and beyond cyclical developments affecting all issuers.

What Does a 'AAA' Rating Mean?

'AAA' ratings are defined as denoting "*the lowest expectation of credit risk*", further defined as an "*exceptionally strong capacity for payment of financial commitments.*" As at June 30, 2007, 'AAA' obligors represented only 1% of Fitch's corporate and financial institution coverage. The absolute universe of 'AAA' ratings has however grown as structured finance issuance has grown. 'AAA' ratings are much more common for structured finance transactions (60% of outstanding ratings at June 30, 2007) due to the ability to "tranche" securities into various layers. A target rating level can usually be achieved through the amount of subordination, or "credit enhancement" created. In a tranching structure, the so-called equity layer represents the first loss position, and typically only after it is exhausted will each successive tranche potentially be exposed to loss. Thus, even with a high risk pool of assets, a senior layer can be sized with sufficient credit enhancement below it to absorb losses (i.e. equity, subordinated and/or mezzanine tranches) to create a security commensurate with a 'AAA' rating.

Crucially, for corporate and bank issuer ratings, and for structured finance instrument ratings, the 'AAA' rating refers to relative likelihood of default. It does *not* opine as to expected recovery given a default, or to relative market pricing or market liquidity. Investor assumptions regarding the characteristics of a 'AAA' rating other than relative default likelihood essentially derive from historical features associated with 'AAA' obligors and their obligations. While not included in Fitch's rating analysis, 'AAA'-rated debt is often assumed to have low loss severity rates and very high market liquidity – a logical assumption for highly-rated corporates, banks and sovereigns, as well as for many traditional structured finance instruments.

The fixed income market has, however, now expanded to include structured finance instruments which combine extremely low relative default likelihood, consistent with the 'AAA' rating, with the potential for either non-negligible levels of loss severity (e.g. through multiple tranching at the 'AAA' level), or with only limited liquidity (e.g. through bespoke construction). Thus traditional investor assumptions 'beyond the rating' regarding the characteristics of a 'AAA'-rated instrument may no longer be valid in all cases. Investors and other rating users should be aware of these developments when compiling and operating guidelines which incorporate ratings.

Rating Time Horizon

While ratings are attached to issuers without a formal time limit, and to transactions for the full maturity of the obligation, the analysis behind the ratings is based on assumptions today which may change as time passes, and is thus subject to a time horizon.

Ratings in the corporate and public finance sectors relate to entities that usually have no finite lifespan or immutable operating boundaries. As such, the ratings are subject to a wider array of exogenous and



event-driven risks than is the case for structured finance. Corporate and public finance ratings are generally referred to as having a time horizon of 3-5 years, this being the period of greatest visibility for an entity's prospects.

That said, corporate and public finance ratings will incorporate some elements that are potentially very short-term in nature, such as liquidity position or crisis management performance, as well as some risk elements that have a much longer-term impact, such as potential technological obsolescence or exposure to long-cycle volatility. So, while the rating horizon is often referred to as 3-5 years for such entities, the ratings can reflect considerations that are unlikely to occur within the next five years but which are likely to occur in the longer run, if these are believed to present a material threat, or support, for the entity concerned. Equally, they may be driven by events of a much shorter-term nature, particularly where these affect issuer-specific or systemic liquidity problems.

For structured finance, the rating horizon is generally recognised as being the legal maturity of the note. However, a range of shorter- and longer-term considerations similar to those noted above for corporate and public finance issuers apply also to structured finance ratings, as the environment in which the instrument exists, and the transaction's own performance, can change over time.

› **Treatment of Default**

Default is typically defined by Fitch as one of the following:

- › Failure of an obligor to make payment of principal and/or interest in accordance with the terms of any financial obligation;
- › The bankruptcy filing, administration, receivership, liquidation or other winding-up or cessation of business of an obligor; or
- › The distressed or other coercive exchange of an obligation, where creditors were offered securities with diminished structural or economic terms compared with the existing obligation.

As a legal matter, Fitch does not 'declare' a default on any obligation. Default, of both the obligations of entities and structured finance transactions, is determined by reference to the terms of the relevant documentation and is typically 'declared' by the trustee or another representative of the creditors. Fitch will assign default ratings where it has reasonably determined that payment has not been made on an obligation in accordance with the requirements of the obligation's documentation, and also where it believes that default ratings consistent with Fitch's definition of default are the most appropriate ratings to assign.

Ratings at Default

For IDRs or other issuer ratings, the threshold default event at which an issuer rating is lowered to 'D' will be that of the obligations, non-payment of which would generally best represent the uncured financial failure of that entity, most usually its senior debt obligations. Where the issuer has defaulted on some, but not all, of its financial obligations the IDR or issuer rating will generally be lowered to 'RD' (Restricted Default).



Where Fitch believes that a default has occurred for a corporate finance or sovereign issuer, only the issuer will be rated 'D' or 'RD'. Defaulted and distressed corporate obligations are not taken to 'D' on the international scale, but are rated along the continuum of 'B' to 'C' rating categories, depending upon their recovery prospects and other relevant characteristics. Fitch may choose to maintain an issuer's ratings once an entity or instrument has defaulted, but generally ratings are withdrawn once 30 days have elapsed from the assignment of a default rating.

In the case of structured finance transactions, where analysis indicates that an instrument is irrevocably impaired such that it is not expected to pay interest and/or principal in full in accordance with the terms of the obligation's documentation during the life of the transaction, but where no actual payment default in accordance with the terms of the documentation is imminent, the obligation may also be rated in the 'B' to 'C' categories, and will be assigned a Distressed Recovery ("DR") rating.

Default ratings are not assigned prospectively. Within this context, non-payment on an instrument that contains a deferral feature or grace period will not be considered a default until after the expiration of the deferral period (if any) or grace period. Deferrals in accordance with documentation will generally not represent a default, particularly in structured finance. The impact of deferral on ratings will depend on the circumstances surrounding the deferral. If the deferral is viewed as temporary for a corporate issuer, for example, then both IDR and affected issue rating may be unaffected, reflecting the expectation of a quick return to performing status. Conversely, if the deferral is viewed as the result of sustained deterioration in creditworthiness, any relevant IDR and issue rating will likely see negative pressure. In all cases, however, the deferred instrument, however, will not be rated as a defaulted bond until any deferral period and subsequent grace period have expired.

Default Experience

Default studies measure the actual level of default experienced at each rating level over one- and multiple-year horizons. Fitch uses default studies to assess whether the primary component of credit risk, the likelihood of default, is being appropriately rank-ordered by Fitch's rating scale on a relative basis. That is, default studies show whether issuers and/or securities rated 'AAA' have, in aggregate, defaulted less frequently than those rated 'AA' and so on, and whether this relationship has held over time and through the cycle.

Fitch does not generally rate to a specific probability of default and fully expects variations in default rates depending on economic and credit conditions. Indeed, default rates for each rating category are expected to worsen in difficult economic times and improve in good times. Nonetheless, the general pattern of higher default rates with each movement down the rating scale ('AAA' to 'AA' and so on) should consistently hold for each analytical sector. In particular, speculative grade ratings as a whole should experience substantially higher default rates than investment grade ratings as a whole.

Rating committees only use these historical default statistics as an abstract source of reference during their deliberations. As mentioned above, Fitch does not typically rate to specific default probabilities. Historic default rates are used as the basis for inputs into certain rating tools, such as the VECTOR models which are used by Fitch's structured products and structured finance groups. In this context, the rates are used to help assess relative creditworthiness between underlying components of the transaction only, and the use of these models is additionally subject to a qualitative committee overlay.



› **Comparability of Ratings across Sectors**

It is Fitch's aim that creditworthiness should be broadly comparable by category across all major sectors of debt (with the exception of US Public or Municipal Finance, as mentioned above). For any given point in time or observation period, market conditions, regional factors and sector-specific influences may nonetheless cause issuers or obligations with a given rating in one sector to have different actual default or migration experience than issuers or obligations with the same rating in another sector.

This is an inevitable consequence of the combination of the rarity of default events, a "through-the-cycle" approach to ratings, and Fitch's goal of providing opinions to the fullest possible range of asset classes in all regions. Default is generally a low frequency event. Additionally this frequency exhibits high volatility across the economic cycle. The pool of ratings covered by an agency is also highly dynamic. As not all issuers in a given sector or region receive ratings simultaneously, coverage levels and concentrations may influence statistics. Methodologies are regularly revised in light of experience and new asset classes, with different rating migration characteristics, join the rated universe each year.

As an example of differing performance statistics, there have been more instances of multi-notch rating changes in structured relative to corporate finance, which can be attributed to the nature of structured transactions. As the latter typically involve fixed pools of assets whose performance expectations once realised are less fluid than corporate transactions, rating changes due to improving or deteriorating credit quality have a higher propensity to be multi-notch. In contrast, a company under duress typically has greater latitude in dealing with its circumstances, for example by seeking additional funding or selling non-core assets. This type of flexibility often contributes to more graduated rating changes on the corporate side than on the structured side.

As a result, although ultimate default rates are comparable across the major asset classes, actual default and migration experience will typically vary between sectors and regions within those asset classes. Over the very long-term, Fitch anticipates that actual default experiences will likely converge between sub-classes, as coverage levels and time series expand to support this analysis. Fitch will continue to monitor and publish research which looks at its rating performance in this context.

› **Broader Rating Considerations**

A wide range of factors will feed into the determination of any rating, from cash generation, balance sheet or asset pool analysis to a review of the wider economic and financial outlook for the entity or transaction under consideration. A number of important factors can be incorporated to a greater or lesser extent – examples of how these factors may be included or excluded include:

- › **Corporate Governance:** Fitch will typically combine external feedback on an entity's corporate governance with internal views formed by Fitch analysts from recent management actions, ownership and any interaction with management to form an opinion on an entity's corporate governance practices and the competence of the entity's management.
- › **Tax and Legal Issues:** The analysis supporting a Fitch rating is generally conducted on the basis of the existing tax and legal regimes. However, clear pending changes in the tax or legal regime may be addressed on a case by case basis and commented on in the rating commentary and any



supporting research reports. Where an existing or proposed tax affects a rating, assumptions may be made about the future rate of that tax in formulating stress tests. In the case of structured finance ratings, Fitch's analysis of the legal regime is based on the opinions and advice provided by transaction counsel. Fitch's legal staff or external counsel typically review these opinions to understand the extent to which legal risk may affect our analysis of the issuer/issuance, and thus our rating; but Fitch does not review legal opinions on behalf of investors or any other party.

The legal analysis performed by Fitch is not designed to supplant or replace that performed by transaction counsel, but is instead undertaken simply to understand the legal analysis provided by transaction counsel. The legal analysis therefore has a similar relationship to the transaction legal opinion as Fitch's financial analysis of a corporate debt issuer has to that issuer's audited financial statements.

- **Issue-Related Market Risk:** In assigning ratings to specific obligations of an issuer, Fitch takes into consideration the likely impact that market volatility will have on that issuer's ability to meet their obligations. However, Fitch distinguishes between:
- market risks that impact the issuer's ability to meet an obligation, which typically figure in the rating determination (e.g. exposure to commodity prices), and
 - market risks that determine the nature or amount of the obligation regardless of the creditworthiness of the issuer (e.g. linkage to an index in an index-linked bond issued by a bank), which typically do not figure in the rating determination.

Where market risks are a determinant of creditworthiness, they are taken into consideration. Where this distinction is not clear or where a structured finance transaction is primarily designed to transfer a pure market risk, such as stock index risk or foreign exchange risk, to investors, the rating committee will apply the appropriate methodology, and elements of market risk considered in the analysis will be disclosed in Fitch's rating commentaries.

- **Event Risk:** Ratings provide an opinion based on assumptions, which cover many areas of an issuer's profile. Over time, such assumptions can change as events unfold. While ratings are forward-looking, many forms of event risk (e.g. merger & acquisition activity, fraud, natural disasters, etc) cannot practically be captured in an issuer's rating. As a result, event risks often cannot drive rating changes until they occur.

With regard to corporate bond ratings, covenant provisions within the relevant documentation can limit the financial impact of event risk on some (though not all) investors in an issuer's bonds. However, the complex interplay of investor behaviour and formal triggers required for such covenants to be effective means that generally they provide little benefit in corporate bond rating terms.

Ratings benefit can be achieved in project or special-purpose financings. For structured finance transactions, structural features are designed to insulate investors more effectively from event risk, mainly corporate strategy and investment risk, and as a result provide more tangible risk limitation. However, as event risk still affects underlying assets, the insulation is not complete, and structured finance ratings may also be subject to revisions based on event risk.



› Other Limitations

In all cases, and as specified in our Code of Conduct, ratings are based on information obtained directly from issuers, underwriters, their experts and other sources that Fitch believes to be reliable. Fitch does not audit or verify the truth or accuracy of such information, and has undertaken no obligation to audit or verify such information, or to perform any other kind of investigative diligence into the accuracy or completeness of such information. This reflects Fitch's role, which is limited to gathering and analysing a variety of financial, industry, market and economic information, synthesising that information, and publishing independent, credible assessments of the creditworthiness of securities and issuers, thereby providing a convenient way for investors to judge the credit quality of various alternative investment options.

While the rating process in structured finance is an iterative one, Fitch does not structure transactions. Arrangers are able to combine and re-combine assets to achieve a target rating for the liability. Models published by Fitch to make its methodologies transparent are also sometimes used by arrangers/originators in their initial review of the assets that they wish to include in a transaction. The decision of which assets to allocate, and which ratings to target, nonetheless remains entirely that of the arranger or originator. The rating committee will not propose alternative assets to include in a transaction, suggest alternative rating levels that may be targeted, or develop alternative legal structures that could be applied.

In the surveillance process, while transactions may incorporate a rating confirmation feature, this does not constitute an endorsement by the agency of any change that may occur in the transaction. As such, Fitch does not 'require', 'approve', or 'endorse' issuer behaviour. This reflects the nature of the particular role filled by rating agencies. Any rating review is simply an observation of relative creditworthiness, and Fitch is indifferent to the level of any rating assigned.

Ratings are not a recommendation or suggestion, directly or indirectly, to buy, sell, make or hold any investment, loan or security or to undertake any investment strategy with respect to any investment, loan or security or any issuer. Ratings do not comment on the adequacy of market price, the suitability of any investment, loan or security for a particular investor (including without limitation, any accounting and/or regulatory treatment), or the tax-exempt nature or taxability of payments made in respect of any investment, loan or security.

The above information relates to credit ratings on the international scale as of 1 August 2007. Separate considerations may apply to non-credit ratings, quantitative ratings and market-implied ratings or national scale ratings applied in certain jurisdictions.



➤ Frequently Asked Questions

“Does a credit rating communicate a percentage default expectation?”

No, credit ratings are an ordinal ranking. They communicate *relative* strength or vulnerability to credit events, rather than any absolute measure. Default experience has shown, historically, that default frequencies were higher in the ‘BBB’ category than in the ‘A’ category, higher in the ‘B’ category than in the ‘BB’ category, and so on. But the individual rating categories do not represent a predicted percentage or range of percentages.

“Does the rating address expected loss?”

Expected loss incorporates both likelihood of default and loss severity. Credit ratings primarily look at the first of the components rather than the second. The above table on page 2 and sidebar on page 3 indicate which of Fitch’s scales look at both relative default likelihood and relative loss severity. Essentially, only the ratings of corporate, bank, insurer and sovereign *obligations* incorporate a consideration of both at all parts of the ‘AAA’-scale.

However, default risk and loss severity are not perfectly correlated. A bond can thus combine low default risk with high loss severity. In combining these two potentially diverging considerations, the existing market convention is that credit ratings on corporate bonds give primacy to default risk rather than overall loss risk. The impact of loss severity on any corporate instrument’s rating is therefore effectively limited to a maximum number of notches above or below that instrument’s relative likelihood of experiencing a default.

Consequently, the choice to give primacy to default risk in the rating of individual instruments for corporate and sovereign finance limits the ability to provide an entirely ordinal ranking based upon expected loss. For their part, structured finance ratings only incorporate both elements in the rating of a bond when that bond is at a distressed level, similarly preventing an entirely ordinal representation of expected loss.

As markets evolve, Fitch will continue to review this approach for appropriateness.

“Should an investor expect two bonds with the same ratings to be comparable in all ways?”

The performance of bonds, in terms of credit risk and market risk, may vary substantially even where they have similar ratings. In terms of credit risk, as noted above, ratings can combine low default risk (which is represented in the rating), with high loss severity (which is either excluded from or reflected to a lesser degree in the credit rating). Migration characteristics vary between sectors, depending on the influence of factors such as event risk (for corporate finance) and seasoning (mainly for structured finance).

Pricing of the two instruments may also differ markedly for a variety of reasons. While the underlying credit risk attached to an instrument is one factor, it can frequently be outweighed by other



considerations, including market supply/demand dynamics and liquidity. Pricing may be artificially suppressed or boosted depending on the amount of market demand for a particular type of asset, or for fixed income assets in general. New instruments issued by an issuer or sector with a large amount of paper already in the market may be more or less liquid as a result. Small or largely amortised issuances may be less liquid in the secondary market, as may larger issuances made by small/lesser known obligors.

“How does Fitch use models in deriving ratings?”

Models are used within Fitch to test significant volumes of data against assumptions determined by Fitch’s analysts. For example, models are constructed which contain Fitch analysts’ assumptions on mortgage or corporate bond recovery rates, or likely payment patterns on trade receivables. As such, the assumptions used in such models are typically reviewed by a committee as part of their construction.

In addition, with the exception of explicitly quantitative ratings³, all credit ratings are subject to an individual committee process. The committee examines the output of the model as one factor, assessed against additional qualitative criteria, including structural, legal, operational and other risks.

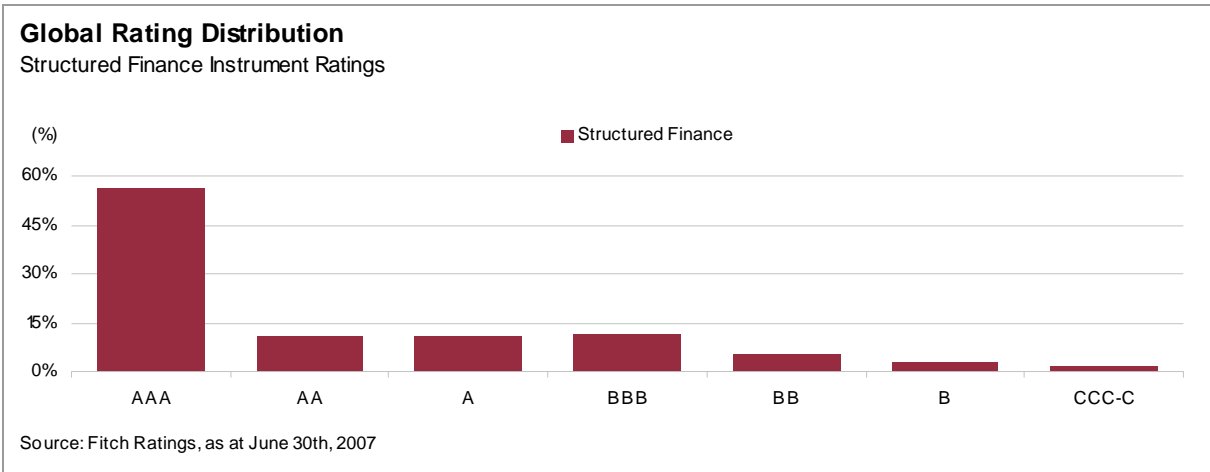
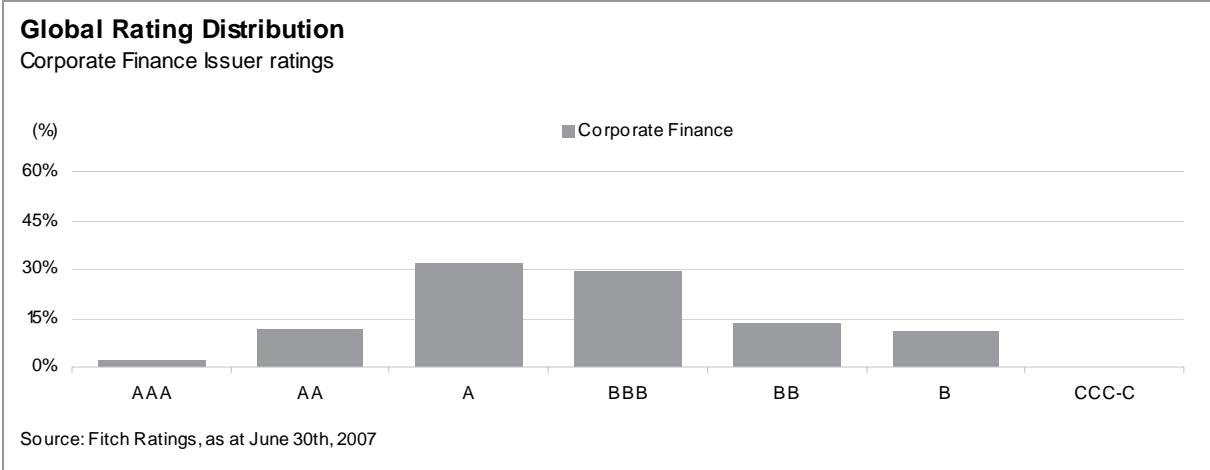
“What is the balance between quantitative and qualitative analysis?”

Fitch’s ratings employ both qualitative and quantitative factors, other than in explicitly quantitative scales disclosed as such. While Fitch does not record, *ex ante*, particular weightings between qualitative and quantitative considerations, *ex post* analysis of corporate finance ratings indicates that over a cycle both are responsible in roughly equal measure for rating changes made to outstanding ratings.

³ e.g. Quantitative-Insurer Financial Strength (or “Q-IFS”) scores



> **Rating Distribution**





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