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How Credit Stability Figures Into Standard & Poor's Ratings

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How Credit Stability Figures Into Standard & Poor's Ratings

Since 2008, Standard & Poor's Ratings Services has made major revisions to several key ratings criteria, and many of these criteria changes have led to rating actions. As we continue to enhance our ratings criteria to achieve further consistency and comparability, a factor we call credit stability will continue to play a central role.

Credit stability is a fundamental input into Standard & Poor's ratings, but it's separate from the actual ratings. As part of our analysis, we consider the degree of credit stability of an issuer or issue (a "credit"), and we assign a rating that reflects that credit's creditworthiness, including the likelihood of an adverse change in its credit quality. We'll adjust a given credit's rating to reflect any changes in credit quality. Credit stability varies across the credit spectrum, with higher-rated credits demonstrating greater stability than lower-rated credits. This is not surprising because a credit must be more stable to achieve a higher rating.

Overview

- Credit stability is a key component of Standard & Poor's rating analysis.
- Credit stability may be a limiting factor in the rating analysis, possibly capping the rating we would assign to a credit.
- Generally, we calibrate our criteria to promote greater stability in higher ratings than in lower ratings.

Standard & Poor's first published criteria for credit stability in 2008 and further clarified the criteria in 2010 (see "Methodology: Credit Stability Criteria," published May 3, 2010). These criteria note that a credit's inherent stability (or instability) may result from credit-specific characteristics or may reflect the nature of a specific sector or asset class. Regardless of the nature of the stability (or instability), the degree of stability influences Standard & Poor's final rating.

What Is Credit Stability?

It is important to understand that credit stability and rating stability are not the same. Credit stability is an intrinsic characteristic of a credit or a sector and should not be confused with rating stability. Ratings represent our forward-looking view on creditworthiness, and they migrate in line with any change in our view on credit conditions or expectations.

Credit stability is the ability or capacity to largely maintain credit quality under conditions of moderate stress. The primary focus of credit stability is ordinary business risk rather than special types of risk, such as changes in laws, fraud, or corporate acquisitions. To promote rating comparability, we use hypothetical stress scenarios as benchmarks for calibrating our criteria across different sectors and over time (see "Understanding Standard & Poor's Rating Definitions," published June 3, 2009). Each scenario broadly corresponds to one of the rating categories 'AAA' through 'B'. The scenario for a particular category reflects the level of stress that issuers or issues rated in that category should be able to withstand without defaulting, in our view. Standard & Poor's defines a moderate stress as the 'BBB' stress

scenario.

Credit stability is affected by the performance of the underlying collateral pool in the case of structured finance ratings and by a company's actions in other cases. Broader market factors and monetary policy changes that cause economic shifts play a role as well. Banks' attitudes toward perceived risks and lending practices may also affect their own credit stability or the market's.

Just as credit quality ranges from strong to weak, credit stability varies as well. Credits showing characteristics of greater credit stability may achieve higher ratings than those showing lesser stability, all else being equal. Factors such as volatility or uncertainty in future earnings potential or the ability to maintain capital can make an entity vulnerable during a period of moderate stress. These latent risks influence the rating we would assign in such a case. Credits with higher ratings demonstrate more credit stability than those with lower ratings. By definition, credits with speculative-grade ratings ('BB+' or lower) are more sensitive to changes in economic conditions or to sector-specific variations, such as changes in prices or supply, than investment-grade credits (those rated 'BBB-' or higher).

Another dimension to credit stability is the credit's industry or sector. As we look across industries, the stability of those credits varies. In the U.S., for example, the regulated utilities sector has had more stable fundamentals over the past few years than the health care and aerospace and defense sectors. And our ratings reflect those sectors' various characteristics: From 2011 through the first half of 2013, the number of upgrades exceeded the number of downgrades in the regulated utilities sector, but the opposite was true for both the health care and aerospace and defense sectors.

How Standard & Poor's Uses Credit Stability In Its Rating Analysis

When assigning and monitoring ratings, we consider whether a credit has a high likelihood of experiencing unusually large adverse changes in credit quality under conditions of moderate stress. If we believe that likelihood is high, we would assign a rating that is lower than what we would have assigned absent this instability. Sometimes our rating analysis factors in stability qualitatively, such as when potential political unrest influences our assessment of country risk, and, when possible, quantitatively via alternative projected loss scenarios.

Stressing losses

To rate securities backed by credit card receivables, we assess the credit quality of the underlying receivables and determine the level of credit enhancement needed by considering the portfolio's loss rate, the total payment rate, the portfolio's yield, and the purchase rate. The criteria stress the base-case assumptions for these factors to derive a 'AAA' stress scenario, which we use to determine the 'AAA' credit enhancement level for the portfolio.

Although the asset-backed securities (ABS) portfolio may have sufficient credit enhancement to support a 'AAA' rating, we may not assign a 'AAA' rating. Before assigning a rating, we would consider the credit stability and conduct a sensitivity analysis for that portfolio to determine if it can maintain its creditworthiness under a moderate stress scenario. According to the table immediately following paragraph 7 in the Credit Stability Criteria, the maximum projected deterioration under a moderate stress scenario for a credit rated 'AAA' is 'AA' within one year. Similarly, over a three-year horizon, the maximum projected deterioration under a moderate stress scenario for a credit rated 'AAA' is 'BBB'. This table provides the guidance for our sensitivity analysis.

Before assigning a final rating on the ABS portfolio, we run several scenarios of increased loss rates to assess if the portfolio's credit enhancement would be sufficient to absorb the losses associated with a moderate stress scenario over a 12-month period and still provide an at least 'AA' level of credit enhancement. If it can, we would assign a 'AAA' rating. If not, the rating would be limited to a lower rating that the credit enhancement could support under the sensitivity analysis (for more details, see "General Methodology And Assumptions For Rating U.S. ABS Credit Card Securitizations," published April 19, 2010, and "Revised Purchase And Payment Rate Assumptions For U.S. Credit Card ABS," published Sept. 14, 2011).

Knockout factors

The effect of credit stability can limit ratings by way of caps, or "knockout" factors. That is, a credit may satisfy the criteria for achieving a certain rating, but we would cap the assigned rating at a lower rating because one or more factors reflect inherent instability or weakness in the credit.

Under Standard & Poor's criteria for rating banks, our assessment of a bank's capital and earnings is one of the factors we use to determine its stand-alone credit profile (SACP). To determine the SACP, we apply relevant modifiers to the bank's anchor SACP, which is derived from the economic and industry risks of the country or countries in which the bank operates (see "How We Rate Banks," published July 8, 2013). Our assessment of a bank's capital and earnings is one of the modifiers that we can use to adjust the anchor SACP up or down to derive the SACP. We cap the SACP when we assess the bank's regulatory capital as "at risk," "subject to regulatory forbearance," or "insolvent," as outlined in table 3, section F, of the bank criteria, "Banks: Rating Methodology And Assumptions," published Nov. 9, 2011. Although the caps are not explicitly tied to the stability criteria as in the stressed loss example we have outlined above, the caps reflect our view of the instability in creditworthiness that weak regulatory capital creates for a bank.

Our insurance criteria provide another example of how credit stability influences the rating on a credit (see "Insurers: Rating Methodology," published May 7, 2013). Under the insurance criteria, we assess an insurer's business risk profile and financial risk profile to derive the anchor. We determine an insurer's business risk profile by evaluating its competitive position. According to table 6 in the insurance criteria, the competitive position assessment is capped at "less than adequate" ('5') if "either the insurer's gross annual premiums or its total assets do not consistently exceed approximately $50 million or equivalent unless the insurer's niche product is sufficiently differentiated from that of larger competitors or it uses a niche distribution channel through which no larger competitors operate."

This cap reflects the inherent credit instability of an insurer's creditworthiness under these conditions. The competitive position assessment together with the insurance industry and country risk assessment (IICRA) determine the business risk profile. Regardless of the IICRA, an insurer with a competitive position assessment of '5' will have a business risk profile assessment no higher than "fair," which in turn caps the insurer's anchor at 'bbb+', according to table 1 in the insurance criteria. Therefore, the inherent risk that the uncertainty about credit stability introduces limits the assessment of a subfactor, which in turn limits the business risk profile assessment and in turn indirectly limits the anchor.

Higher Ratings Reflect Greater Credit Stability

Standard & Poor's historical data provide evidential support to the notion that higher ratings are more stable, which in turn reflect greater credit stability. Tables 20 through 23 in "Default, Transition, and Recovery: 2013 Annual Global Corporate Default Study And Rating Transitions," published March 19, 2014, provide the transition rates for corporate ratings over various time horizons and a cumulative history from 1981. From these data, we can see that higher ratings are generally more stable than lower ratings, and more broadly, taken together, investment-grade ratings are more stable than speculative-grade ratings. From table 20, we see that about 92% or more of U.S. corporate ratings in the 'BBB' and higher categories remain unchanged in 2013, compared to about 82% or less for speculative-grade ratings. Globally, nearly 90% or more of corporate ratings in the 'BBB' and higher categories remain unchanged in 2013, compared to about 82% and lower for speculative-grade ratings. Comparing specific ratings shows an even greater difference. For example, the percent of unchanged corporate ratings in 2013 for the 'A', 'BB', and 'CCC/C' rating categories was about 93%, 82%, and 43%, respectively, for U.S. corporates, and 92%, 82%, and 46%, globally. This relationship has held over time, based on the average one-year transition rates for 1981 through 2012.

As Standard & Poor's develops new criteria or revises existing criteria, it explicitly considers the sector's potential stability when calibrating the criteria. For example, when we revised our market value criteria ("Methodology And Assumptions For Market Value Securities," published Sept. 17, 2013), we first estimated the worst historical price declines (peak to trough) for select asset types to which the criteria apply over various liquidation horizons, consisting of days, months, or years. (These measurements were taken over a 33-year period, beginning in 1979.) And we calibrated the estimated worst historical price decline measurement to a 'BBB' stress scenario. We then multiplied the estimated worst historical price decline by various rating stress factors, ranging from 1.4x to 2.4x to determine the 'AAA' stress scenarios. As a result, market value securities rated according to these criteria should be able to withstand the price declines roughly associated with a moderate degree of stress without defaulting. Therefore, a level of stability is designed into the criteria through calibration.

Because stability remains a factor in our rating analysis, the ratings we assign to a given credit will not only reflect its credit quality, based on our criteria, but also its credit stability, considering credit-specific and broader economic factors. We calibrate our criteria so that higher ratings reflect our view of greater credit stability, which may manifest, among other ways, as greater resiliency to economic changes, the ability to sustain growth, or the ability to withstand losses on an underlying portfolio. Of course, as the stability in any underlying credit or sector becomes uncertain, we may raise or lower our ratings to reflect this uncertainty.

Related Criteria And Research

Related Criteria

- Default, Transition, and Recovery: 2013 Annual Global Corporate Default Study and Rating Transitions, March 19, 2014
- Methodology And Assumptions For Market Value Securities, Sept. 17, 2013
- Insurers: Rating Methodology, May 7, 2013
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011

- Revised Purchase And Payment Rate Assumptions For U.S. Credit Card ABS, Sept. 14, 2011
- Methodology: Credit Stability Criteria, May 3, 2010
- General Methodology And Assumptions For Rating U.S. ABS Credit Card Securitizations, April 19, 2010
- Understanding Standard & Poor's Rating Definitions, June 3, 2009

Related Research

- The Credit Cloud: While Some U.S. Corporate Sectors Face Headwinds, A Majority Enjoy More Favorable Credit Conditions, Aug. 15, 2013
- How We Rate Banks, July 8, 2013

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