Agency ratings are a standard metric of credit quality. Yet the blowup of large corporations like WorldCom, Enron and Parmalat has raised questions about the timeliness of rating changes. Nevertheless, agency ratings are a convenient, widely used indicator for a borrower’s ability to service its liabilities. In their mission statement Moody’s, one of the world’s leading rating agencies, argue that “Credit ratings and research help investors analyze the credit risks associated with fixed-income securities. Ratings also create efficiencies in fixed-income markets and similar obligations, such as insurance and derivatives, by providing reliable, credible, and independent assessments of credit risk. For issuers, Moody’s services increase market liquidity and may reduce transaction costs.” This statement stresses that rating agencies see themselves as the providers of independent assessments of the credit quality of an issuer. Thus their objective is to promote the efficiency of credit markets by reducing the information asymmetry between borrowers and lenders.

Clearly corporate borrowers have more detailed information about their businesses and credit profiles than do lenders, in particular when they access capital markets to finance their business. Commercial banks usually have a close contact with their clients, thus lending decisions are based on a profound understanding of the borrowers. Because relations between companies and banks tend to be long term, commercial banks are able to monitor the credit quality of a borrower constantly and use covenants to prevent potentially credit-detrimental activities. If necessary, banks can agree to restructure loans in order to recover funds before allowing the company to default.

When companies decide to access the capital markets the relationship between borrower and lender is rather impersonal in the sense that
borrowers do not know nor control who lent them the money. Conversely, bond investors often are not able to meet the company management regularly and thus rely primarily on information published by the company itself. Because of this distance between borrowers and lenders, rating agencies’ assessments of the credit quality of an issuer help investors to mitigate the information asymmetry.

Credit rating agencies try to provide investors with a reliable estimate of credit risk. While S&P’s assessment of credit quality is based on the probability of default, Moody’s uses the product of the probability of default and loss given default, or in other words loss severity, to arrive at a rating. The default probability tracks relative risk over time. When loss severity is estimated, rating agencies consider issue characteristics, the degree of seniority and sector differences. Furthermore, it has to be taken into account that recovery rates vary over time and across jurisdictions. Ultimately, the rating is expected to mirror the future expected loss over time, based on historical experience.

The rating process itself is based on three pillars:

- Evaluation of financial strength with respect to the quantifiable aspects of a particular company’s business;
- Assessment of the management quality and its commitment and ability to maintain a certain credit profile;
- Analysis of the impact of various scenarios on the credit quality of an issuer.

In order to arrive at a rating, one crucial assumption is made: creditworthiness is a stable concept. This means that historical data may be used to transform the information obtained from a company into estimates for default probability and loss severity. Since fundamentals change gradually over time, multinotch rating changes are unlikely. Rating agencies therefore use Outlooks and Watch Lists as leading indicators for potential rating changes. They signal in which direction the next rating step will probably occur. If, for example, a negative outlook is assigned, the rating agency usually defines certain criteria that have to be met by the issuer over a certain period of time, otherwise a rating downgrade can be expected. An example would be that a company must achieve positive free cash flows within a predetermined time-horizon. The failure to do so will result in the loss of the current rating.

However, rating outlooks and watchlists tend to have a built-in lag, too. Moody’s has an 18-month horizon for its outlooks and 90 days for its watchlist, whereas S&P targets 90 days for its credit watch listings, and a longer but unspecified time-horizon for outlooks. Hence, credit ratings appear to be serially correlated. This in turn creates the impression that