Moody's Investors Service
Global Credit Research

February 2002

Contact	Phone
New York	
Christopher Mahoney	1.212.553.1653
Fran Laserson	

Rating Policy

The Bond Rating Process: A Progress Report

Christopher Mahoney
Senior Managing Director
Chairman, Credit Policy Committe
11 February 2002

Last month, Moody's published a Special Comment *(The Bond Rating Process in a Changing Environment)* which discussed a number of initiatives intended to enhance the quality and timeliness of our ratings and research, including:

- Providing analysts with information about the market's opinion of an issuer's creditworthiness
- Conducting a census of rating triggers in the contractual agreements of rated issuers
- Providing an in-depth analysis of the liquidity risk profiles of commercial paper issuers
- Consideration of measures intended to improve rating timeliness, including shortening rating reviews, quicker reaction to material events, increased incidence of rating changes without formal reviews, and streamlining or eliminating rating outlooks.

The special comment stated that "we will not make material changes to our rating process, nor will we move forward with any proposal without extensive market dialogue". We are well into that dialogue, and have met with and heard from many investors and other interested parties globally to discuss our ideas. This progress report summarizes our preliminary findings. We will continue to publish updated findings as we meet with other market participants. We will also be publishing a companion White Paper *(Moody's White Paper: Rating Volatility)*, which should be released shortly.

continued on page 3

Author	Production Associate
Christopher Mahoney	*Alba Ruiz*

PRINTED IN U.S.A.

What We Have Heard

- Investors are wary of introducing market opinion (as expressed in stock prices and credit spreads) into the bond rating process. They feel that market opinion is volatile, and that incorporating it into bond ratings would produce a procyclical feedback process leading to even greater volatility and further disruption of the capital formation process.
- Investors worry that rating agencies place excessive emphasis on the potential risk of the loss of market access, such that their rating downgrades become self-fulfilling prophecies. In their view, ratings should emphasize medium to long-term fundamentals, as opposed to changeable market conditions.
- Investors are strongly opposed to volatile ratings; they expect ratings to be a stable signal of medium to long-term *fundamental* credit risk. This is in part because ratings have become so embedded in investment guidelines and bond indices that volatile and unexpected rating changes force asset managers to buy and sell securities against their will, and at inopportune times.
- Investors agree with the goal of more timely rating actions including shorter review periods. However, they use and appreciate the rating review and rating outlook signaling process; they derive substantial information from them, and they desire that issuers be given an opportunity to act on correctable conditions that could otherwise lead to credit deterioration.
- Investors would like the agencies to become more aggressive on issues of accounting quality, corporate governance and disclosure.
- Investors have heightened expectations regarding the role of rating agencies as the "policemen of the capital markets". They expect the agencies to demand undisclosed financial data that may be relevant to the credit risk of the issuer.
- Investors desire greater transparency in our written research. They would like to know what our main concerns are, and what are the tensions within the rating outcome. They would like clearer, less nuanced rating rationales and rating outlooks.
- Investors are supportive of our plan to offer in-depth research on issuer's liquidity risk and our efforts to identify rating triggers and other forms of conditionality in financial contracts.

Our Response

While our market outreach efforts are incomplete, we have reached the following conclusions:

MARKET SENTIMENT

We believe that it is possible to be aware of market opinion without allowing it to substitute for fundamental credit analysis. Market opinion is typically extraneous to the analysis of the issuer's fundamental creditworthiness, except when an issuer's loss of market access has near-term liquidity implications. In such instances, we view market opinion as an important element of fundamental credit analysis. (See the discussion of Quantitative Tools below.)

RATING VOLATILITY

We understand from our preliminary discussions with investors that there is a nearly unanimous objection to increased rating volatility. Therefore, we will continue to seek to provide a signal that looks through cycles and immaterial events and focuses on long-term creditworthiness. However, in periods of heightened credit stress, Moody's ratings will continue to adjust more frequently, which is consistent with historical practices. (We will shortly publish a White Paper on this topic.)

QUANTITATIVE TOOLS

As we stated in our January paper, our intention is not to encourage fundamental ratings to migrate to the implied ratings from quantitative models and bond spreads. We believe that ratings should be understood as professional credit opinions that look beyond each day's news in order to provide a more stable signal than market-based mechanisms. Our objective in using market-based tools is to identify material and systematic gaps between our fundamental ratings and the ratings implied by market data. We want to be aware of the positions that we are taking with our intellectual capital as well as to ensure that we are clearly articulating to market participants our rationales for those positions.

In our ratings process, our analysts are aware of alternative opinions from many sources: the financial media, Wall Street analysts, other rating agencies. Traditionally, the principal sources of counterpoint in the rating process have been the opinions of sell-side analysts and of other rating agencies. Introducing bond and stock market opinion into the comparison provides additional sources of counterpoint with substantially more diverse perspective than can be obtained elsewhere.

Nonetheless, we will not allow such market opinion to take the place of fundamental credit analysis.

RATING TIMELINESS

We will seek to improve rating timeliness in the form of shorter rating reviews, but we will retain rating outlooks.

ACCOUNTING, GOVERNANCE, TRANSPARENCY AND DISCLOSURE

We will endeavor to provide greater discussion of the quality and transparency of financial accounting. We will, where possible, highlight aggressive or potentially misleading accounting practices, and we will indicate areas in which greater disclosure would be desirable. We will also highlight relevant corporate governance issues.

Rating agencies routinely request nonpublic data in the course of their surveillance activities. However, unlike accounting firms, rating agencies have no authority to demand such data, and indeed many firms do not provide requested data. (Indeed, issuers are under no obligation to cooperate with rating agencies at all.) Therefore, while it is clearly reasonable to expect rating agencies to do their best to discover relevant nonpublic data in the course of their surveillance activities, they can only work with the information which has been disclosed or which management has elected to provide.

GREATER TRANSPARENCY

We are constantly seeking to improve the clarity of our written research. Well-written research should answer the following frequently-asked questions: “What are our principal concerns?”; “What are the tensions within the rating?”; “Why isn’t the rating higher or lower?”; “What could make it go up or down?”; and in situations with divergent potential outcomes, “What are the potential rating implications of multiple scenarios?”.

LIQUIDITY RISK ANALYSIS AND RATING TRIGGERS

We will enhance our credit research with in-depth analyses of issuer’s liquidity risk, and we are continuing to pursue our search for triggers and other forms of conditionality in financial and nonfinancial contracts. The liquidity risk assessments will be introduced in early March, and we will publish a follow-up report on triggers and conditionality.

Conclusion

Given the importance and complexity of these topics, this is by no means the last word on the subject, and we will continue our dialogue with the market, and will continue to publish on these subjects during the year.

To order reprints of this report (100 copies minimum), please call 1.212.553.1658.

Report Number: 74079