FitchRatings

Short-Term Markets Deserve a Fresh Approach

EUROPEAN EDITION

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Why Global Markets Include Fitch

Global debt markets and best practices for risk management and investment guidelines take into account all of the "big three" global rating agencies (Fitch Ratings, S&P and Moody's) to achieve a threefold objective:

- This allows market participants to reflect the reality of the modern market and investors to access their **whole investable universe**.
- It protects against excessive reliance on a single agency and ensures **multiple views on issuer creditworthiness**, especially in instances where there may be differing opinions around cross-over points.
- It protects investors and risk managers against the **risk of ratings volatility** from a single outlying agency, which can lead to undue forced-selling in some situations.

For all these reasons – access to investable universe, multiple credit views, and mitigation of rating volatility risk – you may want to check your investment guidelines, documentations, credit workflow and treasury policy reflect best practices and include Fitch.

Major short-term and investment-grade bond indices eligibility rules illustrate the large adoption by debt markets of these practices. Indices require assets to be "rated investment grade using the middle rating of Fitch Ratings, S&P and Moody's". This essentially means at least two of the three credit rating agencies need to rate a bond as investment grade to qualify it for investment grade indices. Similarly, the vast majority of bond mutual funds in Europe and in the U.S. are inclusive of all three major agencies in their credit risk guidelines.

Fitch Inclusion in Fixed Income Indices

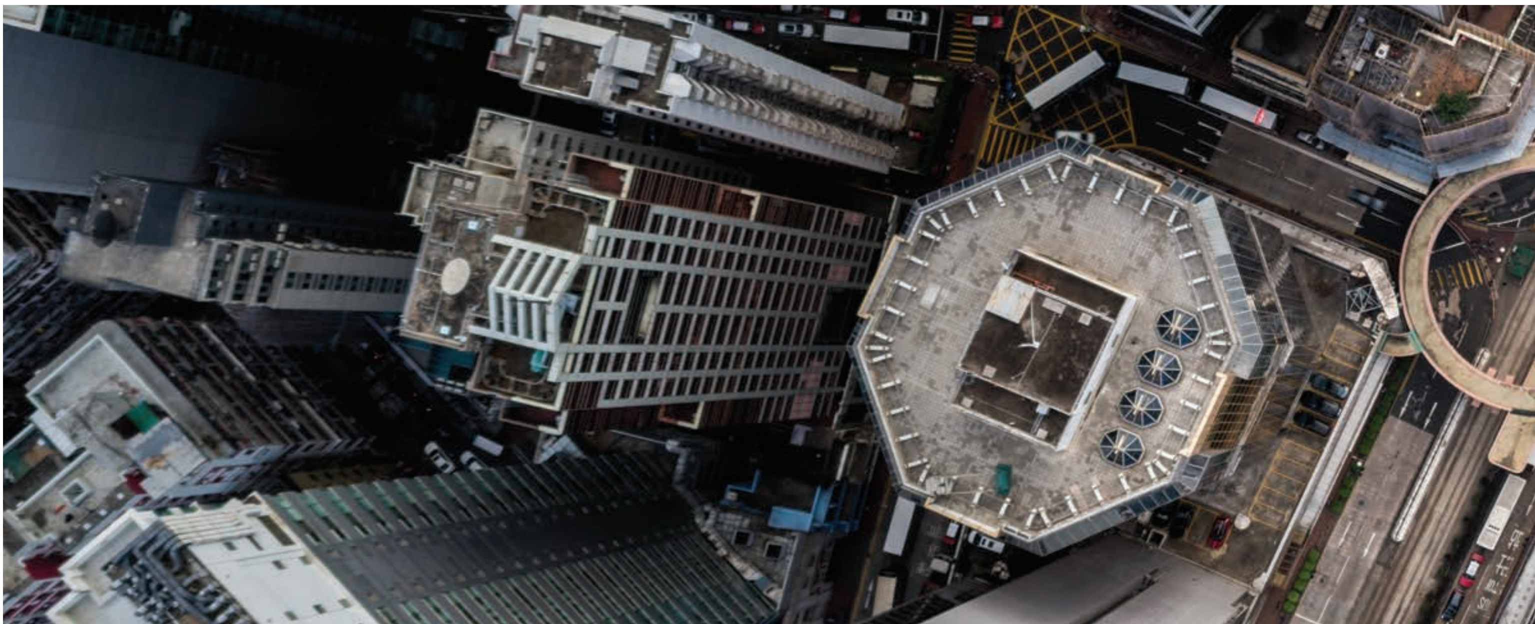
Index	Examples of Relevant Indices	Interpretation of Rules for Inclusion
ECB	• Short-Term European Papers (STEP)	• Lower of Fitch, S&P, Moody's short-term ratings
Euroclear	• Euro Commercial Paper (ECP) Index	• F1, A-1 or P-1 by Fitch, S&P, Moody's
Bloomberg	• Global Aggregate Index • Corporate Indices	• General: Middle rating of Fitch, S&P, Moody's • 2 Ratings: Defaults to Lower • 3 Ratings: 2 of 3 in category
Credit Suisse	• Investment Grade Indices • High Yield Indices	• General: Median ratings from three major agencies • 2 Ratings: Defaults to lower • 3 Ratings: 2 of 3 in category
IHS Markit	• iBoxx EUR, GBP and USD Indices	• General: Average of Fitch, S&P, Moody's
IHS Markit	• CDX Indices	• General: Median of Fitch, S&P, Moody's • 2 Ratings: Defaults to lower • 3 Ratings: 2 of 3 in category
FTSE Russell	• FTSE Canada Bond Indices	• 2 Ratings: Defaults to Lower • 3 Ratings: Middle of Fitch, S&P, Moody's, DBRS • 4 Ratings: Middle of the 3 lowest ratings
JPMorgan	• Global Aggregate Bond and HY Indices	• General: Average of Fitch, S&P, Moody's

Likewise, major institutions include Fitch's ratings in their risk processes. Examples include

- The European Central Bank , the Federal Reserve and the Bank of England for their asset purchase programmes
- Norges Bank Investment Management, the largest sovereign wealth fund, for its fixed income portfolio and unsecured counterparty exposures
- Calpers Liquidity Programme Policy, for credit risk control
- Mayor of London treasury management strategy; Greater London Authority Group Investment Syndicate (GIS) investment strategy

In the short-term markets, investors and risk managers are typically highly risk averse and define risk limits using short-term ratings from Fitch Ratings, S&P and Moody's. The most conservative short-term investors require credit ratings of A-1/P-1/F1, or Tier 1, according to JP Morgan Investment Peer View and AAAmmf ratings (or equivalent) for money market funds.

> *"All investments will be rated a minimum of A-2, P-2 or F2 by Standard & Poor's, Moody's or Fitch Ratings credit rating agencies, with no more than 20 per cent of the portfolio invested in counterparties with a credit rating of less than any of A-1, P-1 or F1."*
>
> **Transport for London treasury management strategy**
>
> *"Money market funds must be rated AAAmmf by Fitch, or equivalent by S&P or Moody's."*
>
> **Treasury management strategy from a major UK public authority**



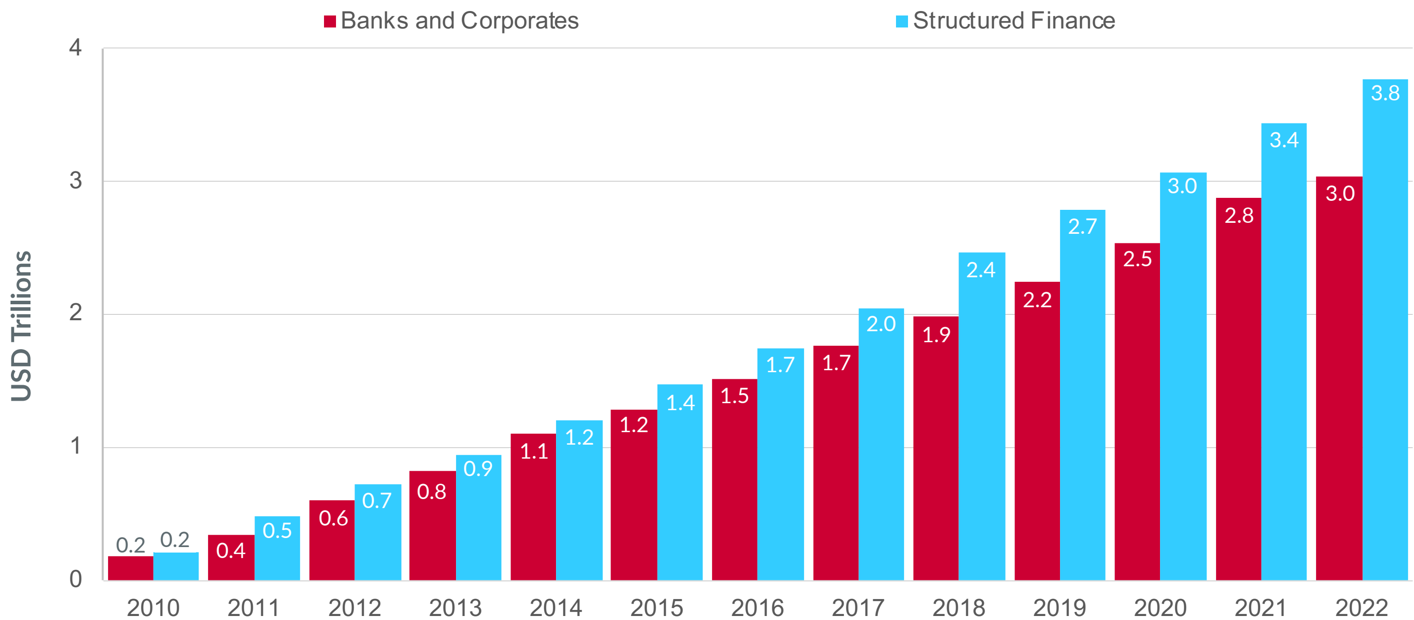
The Reality of Rating Agency Coverage Has Changed

The recent decade saw major changes in rating coverage by the three major agencies:

- Fitch now rates 2,888 banks and 4,314 Corporates. We now have approximately 76% global bank issuance market share and 56% of corporates, based on issuance.
- In 2022, Fitch rated USD 298.4 billion in North American Structured Finance and USD 416.3 billion in Global Structured Finance.
- Since 2009, Fitch Ratings substantially increased its rating coverage of prime money market funds. There are currently 122 U.S. and European MMFs rated by Fitch totaling USD 2.1 trillion equivalent in assets under management (AUM). Of these funds, over half are rated by Fitch only or Fitch plus one other major credit rating agency.
- More recently, ultra-short bond funds and U.S. local government investment pools (LGIPs) are increasingly rated by Fitch, in many cases replacing one of the other rating agencies.
- This trend has been primarily driven by this other agency's rating criteria, which unnecessarily restricts the investable universe in a self-serving way. Indeed, the agency in question requires that all underlying holdings in the portfolio are rated by them, otherwise punitive notching is applied. By contrast, Fitch-rated funds are not constrained to only invest in Fitch-rated assets. Fitch's coverage of ultra-short bond funds and LGIPs continues to rise, with recent new coverage of several funds managed by JPMorgan Asset Management, Canada Life, Northern Trust and PTA/PFM.
- There is now a wide variation of coverage between the agencies in the various segments of the fixed-income market. Banks and Corporates increasingly carry ratings from two of the three global rating agencies, in particular Fitch plus only one other major agency (Fitch +1.) Since the financial crisis over USD 6.8 trillion of debt (Corporate, Bank and Structured) is rated by Fitch+1 and this number will continue to grow.

USD 6.8 Trillion of Issuance Rated by Fitch Plus One Other Major Rating Agency (Fitch+1) Speaks to Fitch's Acceptance

Cumulative since 2010



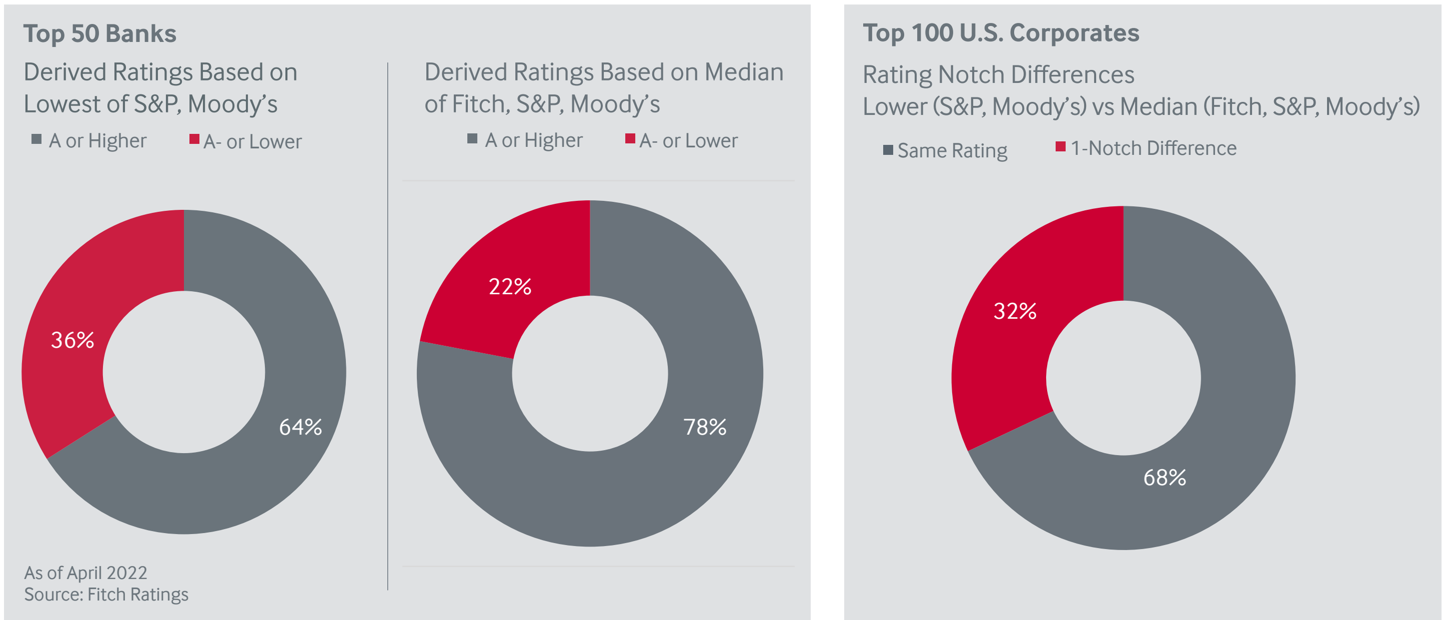
Fitch Ratings, Bloomberg

Investment Flexibility Matters

Investment guidelines and risk management practices that do include Fitch's ratings offer more flexibility and opportunities, which is particularly important at times of supply-constrained markets across asset classes and instruments (commercial papers, deposits, swaps, repo collateral, etc). As the graph below shows, an investor who only considers the lowest of S&P and Moody's ratings with an 'A' threshold would miss the opportunity to invest in 14% of the top 50 global bank issuance. Likewise, the composite rating based on the lowest of S&P and Moody's is one or two notches lower than the median of all three agencies for 32% of the top 100 U.S. corporates.

It is important for investors to have access to the full universe of investable assets, particularly in today's supply-constrained market and at times of rating migration below thresholds of 'A' or 'BBB-'.

Investment Flexibility Matters with Decreased Eligible Supply



As of April 2022
Source: Fitch Ratings

Flexible CP Market Offers More Opportunities

(Sample of Split Ratings for Euro and U.S. CP Programs)

Name	Industry	Fitch	Moody's	S&P
Bank of Ireland	Banks	F2	P-1	A-2
BASF SE	Chemicals	F1	P-2	A-1
BBVA	Banks	F2	P-1	A-1
Boeing Co/The	Aerospace & Defense	F3	P-2	A-3
BP PLC	Integrated Oils	F1	P-1	A-2
Campbell Soup Co	Food & Beverage	F2	P-2	A-3
Deutsche Bank AG	Diversified Banks	F2	P-1	A-2
DTE Electric Co	Utilities	F2	P-1	A-2
Edison International	Utilities	F3	P-3	A-2
Elevance Health (f/k/a as Anthem Inc)	Managed Care	F2	P-2	A-1
Fortune Brands Home & Security Inc	Home Improvement	F2	P-3	A-2
Goldman Sachs Group Inc/The	Financial Services	F1	P-1	A-2
ONEOK Inc	Pipeline	F2	P-3	A-2
PECO Energy Co	Utilities	F2	P-1	A-2
Prudential Financial	Life Insurance	F1	P-2	A-1
Rockwell Automation Inc	Electrical Equipment Manufacturing	F1	P-2	A-1
Snap-on Inc	Home Improvement	F1	P-1	A-2
Stanley Black & Decker Inc	Home Improvement	F1	P-2	A-1
Transport for London	Government Local	F1+	P-2	A-1
UnitedHealth Group Inc	Managed Care	F1	P-2	A-1
Walt Disney Co/The	Entertainment Content	F2	P-1	A-2

as of December 2022

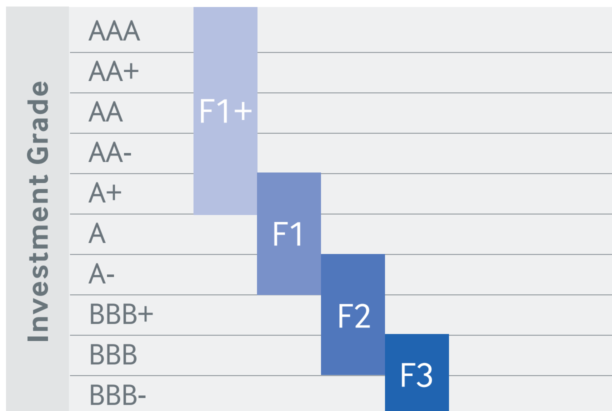
Fitch's Approach to Short-Term Ratings

Since May 2019, Fitch Ratings applies criteria for short-term ratings that provide more differentiated views of short-term creditworthiness at each investment grade long-term rating level. The enhanced framework ensures the short-term rating scale offers greater value to investors.

A recurring market question over many years had been whether the traditional correspondence table approach used by all rating agencies for investment grade short-term ratings allowed adequate distinction for better short-term profiles from the baseline expected at each long-term rating level. The traditional correspondence table approach inevitably resulted in an inflexible linkage between long-term and short-term ratings, especially for corporate ratings.

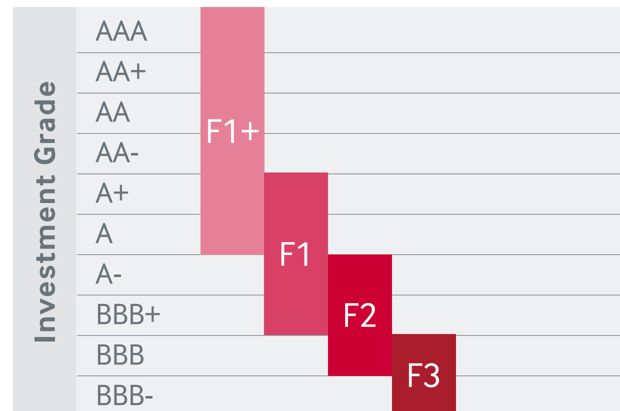
Taking short-term investors' feedback into account, Fitch amended in 2019 its correspondence table between Long- and Short-Term Issuer Default Ratings (IDRs) to provide a more differentiated analytical view of short-term risk between issuers. The criteria introduced two new cusp points at 'A' and 'BBB+', in addition to the previously-existing three cusp points ('A+', 'A-' and 'BBB') where one of two short-term ratings can be assigned based on the liquidity profile of the rated entity. This reflects the fact that credit risks driving the long-term rating and the short-term rating are linked but distinct and some issuers may have a stronger short-term credit profile than implied by the long-term rating.

Previous Scale



three crossover points

New Scale



moving to five crossover points

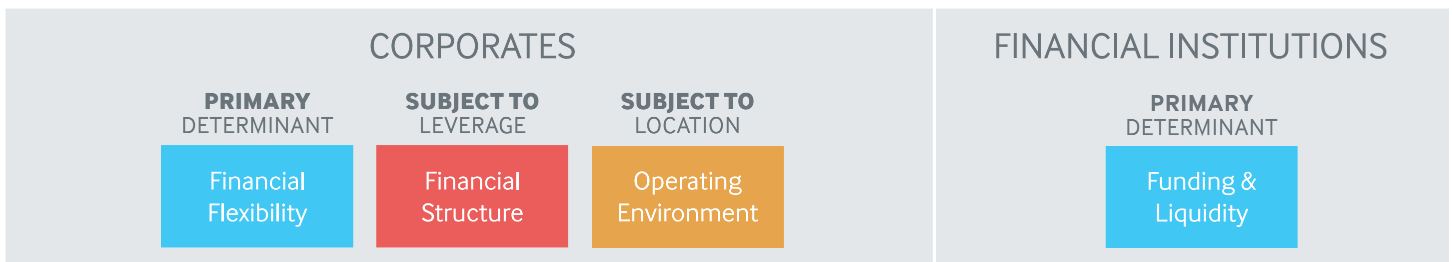
In addition to the new cusp points, Fitch defined sector-specific factors that determine which of the two short-term ratings is assigned for issuers at the cusp points.

For Corporates, financial flexibility factors are primary determinants, subject to constraints of leverage and location. These factors are similar across sectors, including financial discipline, liquidity, FFO fixed charge cover, FX exposure, as well as other quantitative measures specific to each sector.

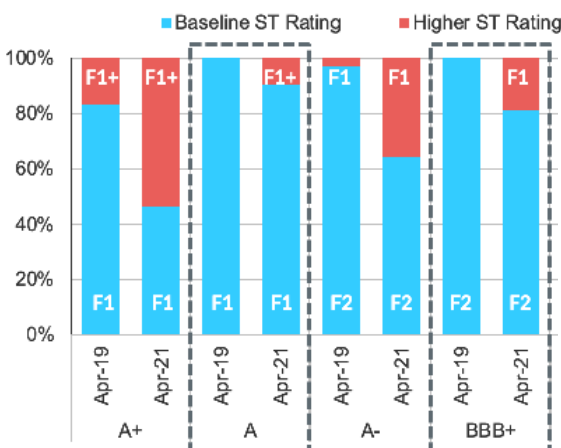
For Financial Institutions, funding and liquidity factors are the key drivers. They include structural balance sheet features, such as loans-to-customer deposit ratios, and shorter-term liquidity or LCR.

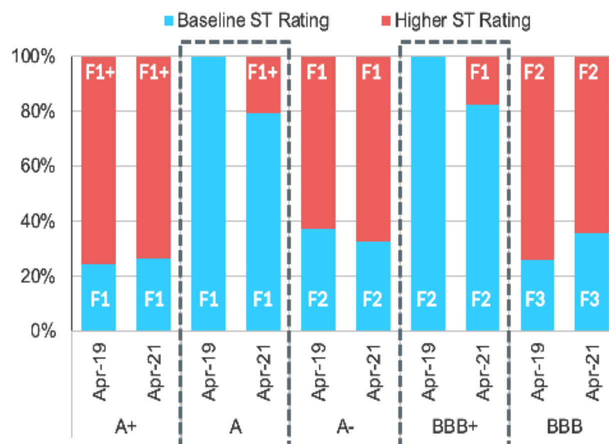
These changes improved the risk differentiation of issuers at these levels: 20% to 25% of the ratings at 'A' and 'BBB+' were assigned the newly created higher Short-Term IDR options of 'F1+' and 'F1', respectively, after the criteria change in 2019 and this share has remained broadly stable since.

Learn more about this approach at: **https://www.fitchratings.com/topics/short-term-credit**



More Optionality – The Picture Two Years After Implementation





Mitigate Your Exposure to Outliers

Market participants rely on ratings from the three major credit agencies to reduce their exposure to rating volatility that may result in potential undue forced-selling, especially around cross-over points. Only using the "lowest of two" credit ratings to evaluate investment eligibility and credit risk creates excessive reliance on the credit view of a single credit rating agency.

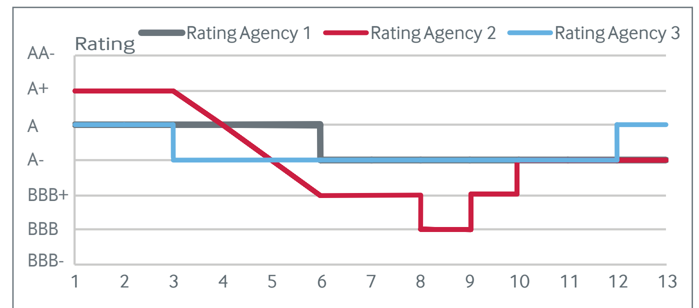
The hypothetical example below shows how using the median of three ratings versus the lowest of two reduces the reliance to an outlying credit rating.

This is why major bond indices decided to include Fitch almost 15 years ago:

> *"The addition of Fitch afforded a more consensus opinion, in addition to promoting longer-term index rating stability. The advantage of this method, as opposed to a most conservative rule, is that at least two agencies need to agree on a rating to prompt an index rating change. The original method [...] proved sub-optimal in cases of split-rated issues; [...] the desire to mitigate further reliance on a single outlier agency prompted the addition of Fitch ratings in 2005 and the transition to the use of the middle of three ratings."*
>
> *– Bloomberg Barclays Index Methodology*

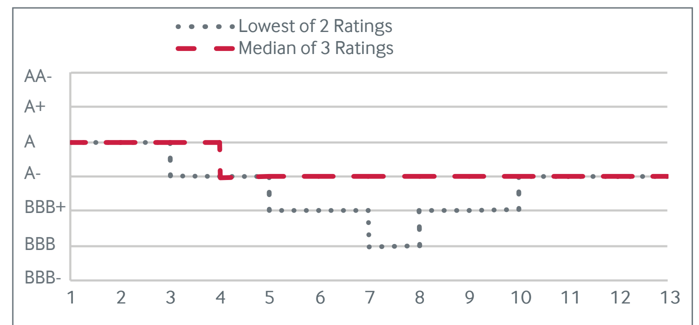
Not Including Fitch Increases Rating Volatility

Rating Trajectories on Hypothetical Issuer



Source: Fitch Ratings

Derived Composite Ratings



Source: Fitch Ratings

Fitch's Ratings Are Time-Tested

Guidelines are part of an investor's infrastructure, so it is important that they are based on reliable and time-tested indicators. Fitch's ratings offer a long track record and robust stability, on par with other agencies, as evidenced by the long-term transition and default data (see tables below).

Fitch Global Corporates Average Annual Transition Matrix: 1990–2021

(%)	To AAA	To AA	To A	To BBB	To BB	To B+ and below	To unrated
From AAA	88.77	5.04	0.23	0.00	0.00	0.11	5.84
From AA	0.13	86.18	8.62	0.32	0.02	0.06	4.66
From A	0.01	1.51	88.93	5.01	0.35	0.12	4.08
From BBB	0.00	0.10	2.63	87.88	3.33	0.52	5.54
From BB	0.00	0.02	0.08	6.66	77.50	7.68	8.07

Source: Fitch's Global Corporate Finance 2021 Transition and Default Study, March 2022

Moody's Global Corporates Average Annual Transition Matrix: 1970–2021

(%)	To AAA	To AA	To A	To BAA	To Ba	To B1 and below	To unrated
From Aaa	87.94	7.69	0.56	0.07	0.02	0.00	3.72
From Aa	0.75	85.50	8.35	0.40	0.05	0.05	4.87
From A	0.05	2.44	87.34	5.02	0.43	0.12	4.55
From Baa	0.03	0.13	3.77	86.63	3.45	0.76	5.11
From Ba	0.01	0.04	0.38	5.95	76.78	7.73	8.33

Source: Annual Default Study: After a sharp decline in 2021, defaults will rise modestly this year, February 2022

S&P Global Corporates Average Annual Transition Matrix: 1981–2021

(%)	To AAA	To AA	To A	To BBB	To BB	To B+ and below	To unrated
From AAA	87.09	9.05	0.53	0.05	0.11	0.08	3.10
From AA	0.48	87.32	7.72	0.46	0.05	0.10	3.88
From A	0.02	1.56	88.73	4.97	0.25	0.17	4.29
From BBB	0.00	0.08	3.19	86.72	3.48	0.66	5.86
From BB	0.01	0.02	0.10	4.52	78.12	7.79	9.43

Source: S&P's 2021 Annual Global Corporate Default Study and Rating Transitions, April 2022

In Summary

Global debt markets and best practices for risk management and investment guidelines take into account all of the "big three" global rating agencies (Fitch Ratings, S&P and Moody's) to access their whole investable universe, to ensure multiple credit views are used and to mitigate the risk of ratings volatility from a single outlying agency and related undue forced-selling.

Investment and risk management best practices call for a senior-level review of investment policies generally on an annual basis. Investment flexibility calls for using ratings that have a long track record of good performance and ones you can trust.

Guidelines should not impede flexibility and should not expose clients to ratings volatility or undue forced selling. Market changes, including changing rating agency coverage, make these thoughtful, strategic reviews imperative.

As we enter volatile times, investors need to adopt guidelines that reflect the new short-term market reality. When performing these reviews and making changes, it is critical to understand that the world has changed and you need to position yourself in the best possible way. This includes how you use credit ratings for addressing credit and counterparty risk. It is in investors' best interest.

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