FitchRatings

# Short-Term Markets Deserve a Fresh Approach

**EUROPEAN EDITION**

# Contents



# A New Approach to Short-Term Ratings

Fitch Ratings published new criteria for short- term ratings in 2019 providing more differentiated views of short-term creditworthiness. It ensures the short-term rating scale offers greater value to investors.

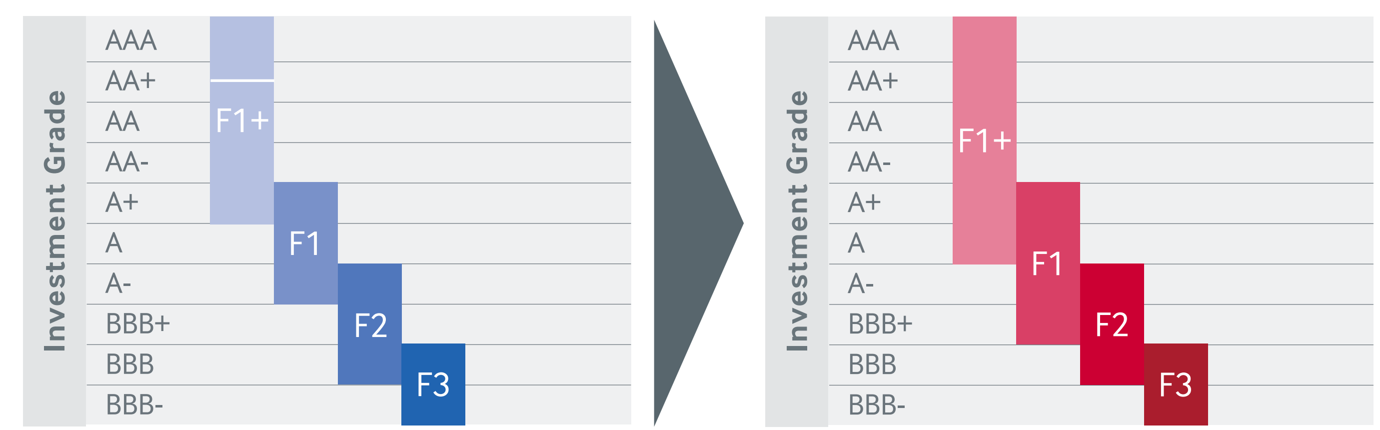
A recurring market question over many years has been whether the traditional correspondence table approach used by all rating agencies for investment-grade short-term ratings allowed adequate distinction for better short-term profiles from the baseline expected at each long-term rating level. The traditional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

Fitch Ratings' short-term rating criteria revision concluded a major review of the function and utility of Fitch's short-term rating scale that began in August 2018, and a broad-based market dialogue, which has helped shape our approach to a short-term scale for today's capital markets.

Most investors advocated more granular information on an issuer's short-term risk profile and felt that the mechanical mapping approach from all agencies added only limited incremental analytical value beyond the senior long-term ratings.

Taking short-term investors' feedback into account, Fitch amended 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 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.

**Previous Scale** **New Scale**




three crossover points

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 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.

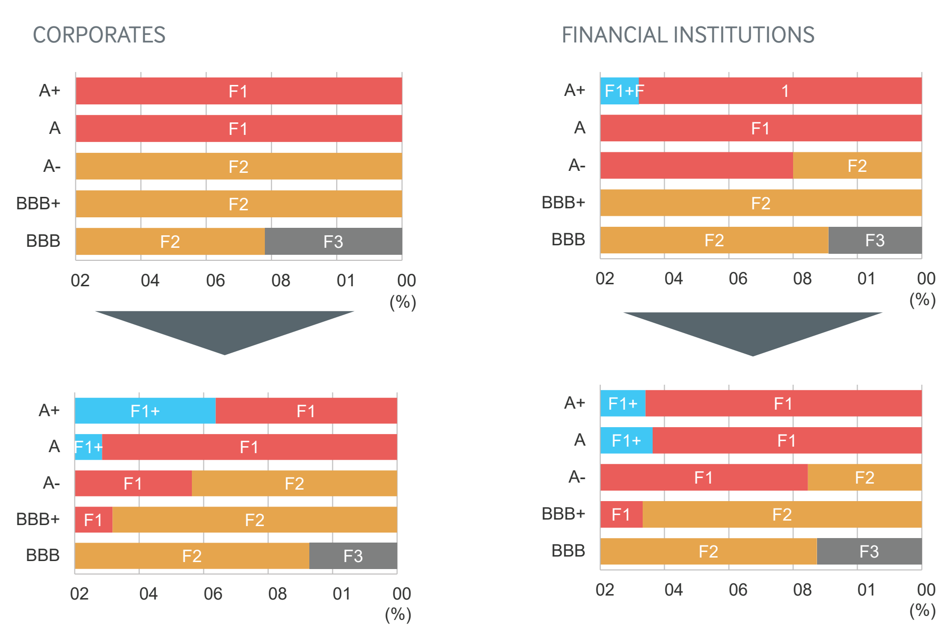
For Corporates, financial flexibility factors are primary determinants, subject to constraints of leverage and location. These factors are similar across sectors, including financial discipline, liquidity, FFO fixed charge cover, FX exposure, as well as other quantitative measures specific to each sector.

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

| CORPORATES | | | FINANCIAL INSTITUTIONS |
|---|---|---|---|
| **PRIMARY** DETERMINANT | **SUBJECT TO** LEVERAGE | **SUBJECT TO** LOCATION | **PRIMARY** DETERMINANT |
| Financial Flexibility | Financial Structure | Operating Environment | Funding & Liquidity |

Fitch's new Short-Term Rating framework is effective since May 2019 and its implementation has been completed. The picture of short-term rating distribution after criteria implementation highlights significantly enhanced short-term rating differentiation for issuers whose long-term ratings are at cusp points.

**More Optionality – The Picture After Implementation**




# Transparency for Investors

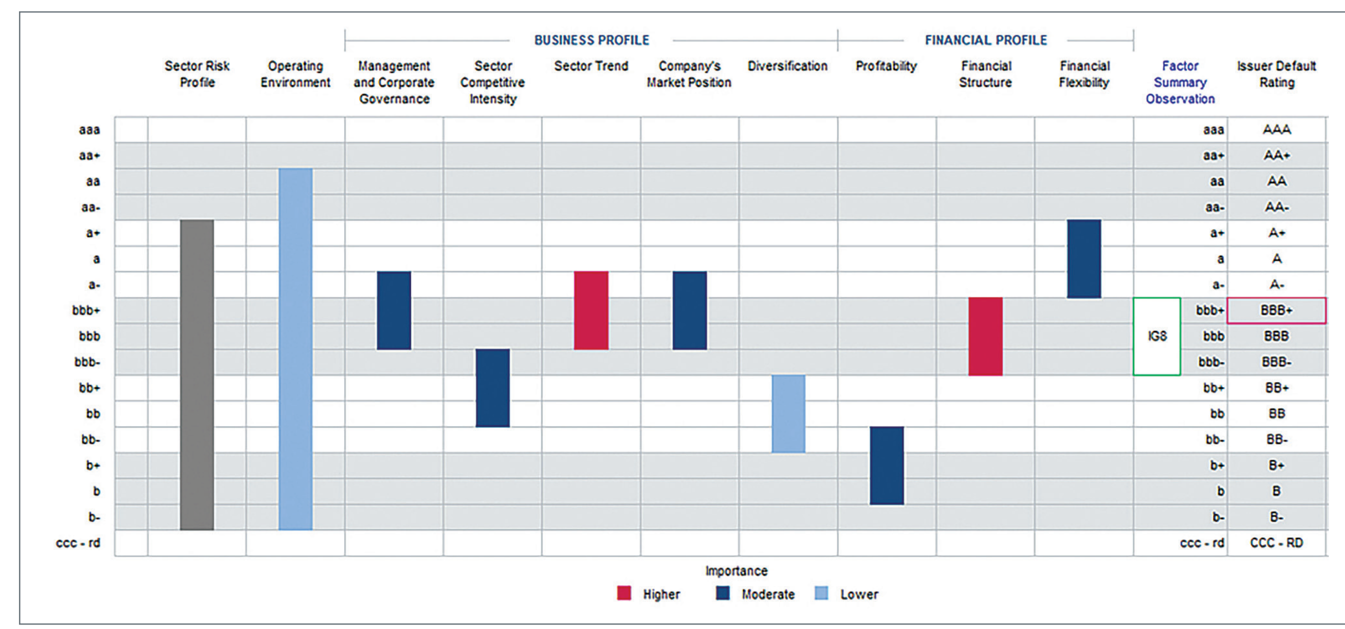
Fitch's Ratings Navigator is a visual summary of the key quantitative factors driving each entity's credit rating and embodies our commitment to providing other measures of transparency to investors and issuers. Employed as a key part of Fitch Ratings' own internal rating process, Ratings Navigator is aligned with the agency's published Rating Criteria, and articulates how a rating is constructed.

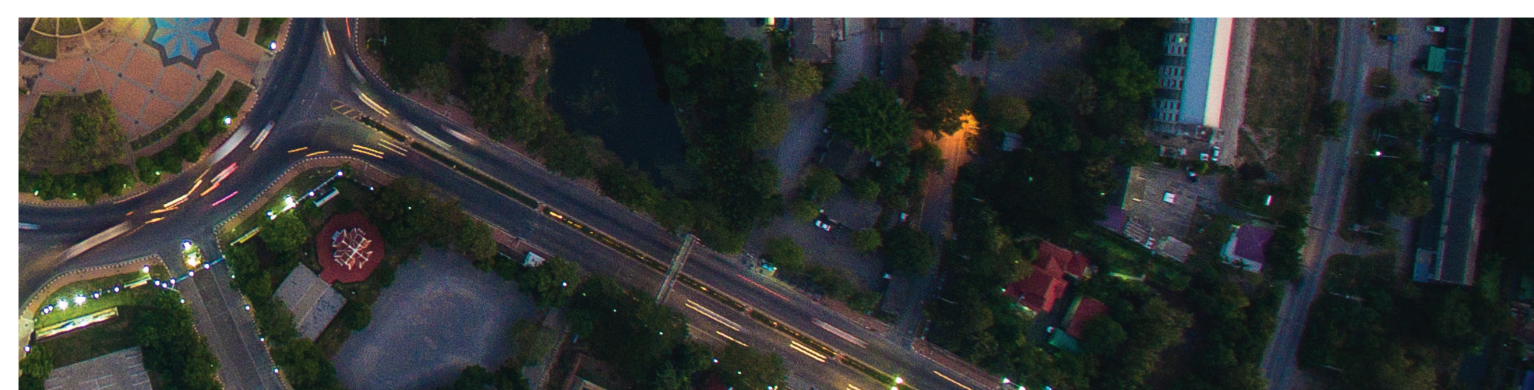
It notably clearly highlights Fitch's view on factors that are primary determinants to short-term ratings, namely financial flexibility for corporates and funding and liquidity for financial institutions.

Each report:

- Shows the relative importance of each factor in determining the final ratings and gauges potential rating sensitivities.
- Presents the fundamental trends or outlooks underlying each component of a credit rating, including operating environment, management, company profile, and financial profile in an accessible format.
- Assesses each rating factor using the traditional 'AAA' scale as well as sector-specific rating scales.

**Corporate Navigator – Highlighting 'Financial Flexibility' Factor**



# 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<br>• Corporate Indices | • General: Middle rating of Fitch, S&P, Moody's<br>• 2 Ratings: Defaults to Lower<br>• 3 Ratings: 2 of 3 in category |
| **Credit Suisse** | • Credit Suisse Index | • General: Median ratings from three major agencies<br>• 2 Ratings: Defaults to lower<br>• 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<br>• 2 Ratings: Defaults to lower<br>• 3 Ratings: 2 of 3 in category |
| **FTSE Russell** | • FTSE Canada Bond Indices | • 2 Ratings: Defaults to Lower<br>• 3 Ratings: Middle of Fitch, S&P, Moody's, DBRS<br>• 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.

"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:

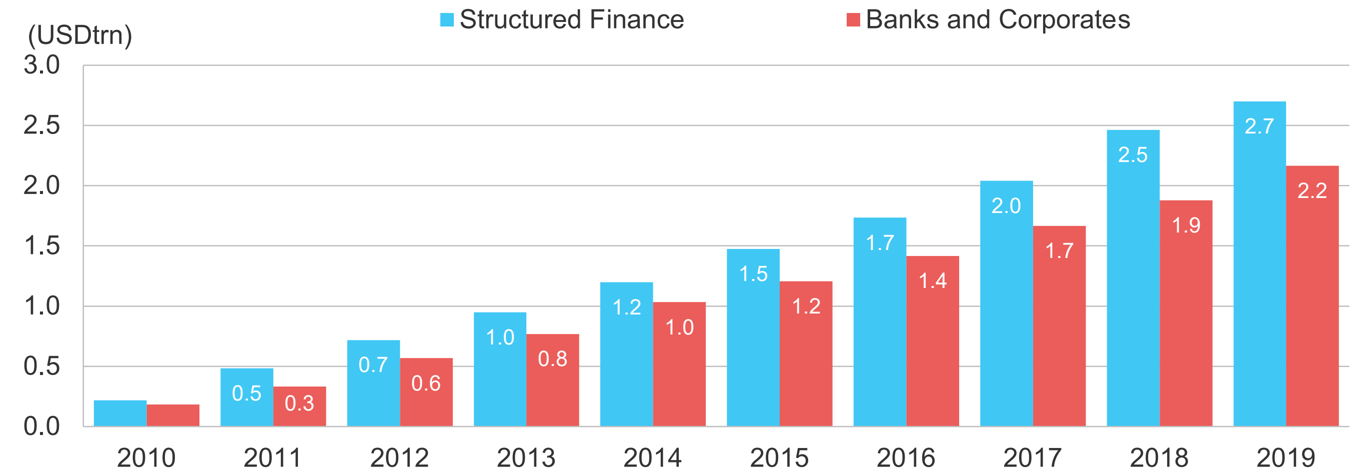
- Fitch now rates 2,448 banks and 1,460 corporates. In the last three years, Fitch has rated 82% of global banks and 77 % of corporates, based on issuance.
- Fitch's Structured Finance coverage was #1 in the U.S. with $359 billion rated in 2018 and #2 globally with $533.5 billion rated in 2018.
- Since 2009, Fitch Ratings substantially increased its rating coverage of prime money market funds. There are currently 105 U.S. and European MMFs rated by Fitch totalling $1.4 trillion 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 the other agencies' rating criteria, which unnecessarily restrict the investable universe in a self-serving way and require 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 Amundi Funds Cash USD, Aviva Sterling Liquidity Plus Fund, Insight ILF EUR Liquidity Plus Fund, Florida Local Government Investment Trust and Colorado Core.

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.) In the last ten years, over $4.9 trillion of debt (Corporate, Bank and Structured) is rated by Fitch+1 and this number will continue to grow.

## $4.9 Trillion of Assets Rated by Fitch Plus One Other Major Rating Agency (Fitch+1) Since 2010

**Global Structured Finance Cumulative Issuance Rated by Fitch+1**

**Cumulative from 2010**



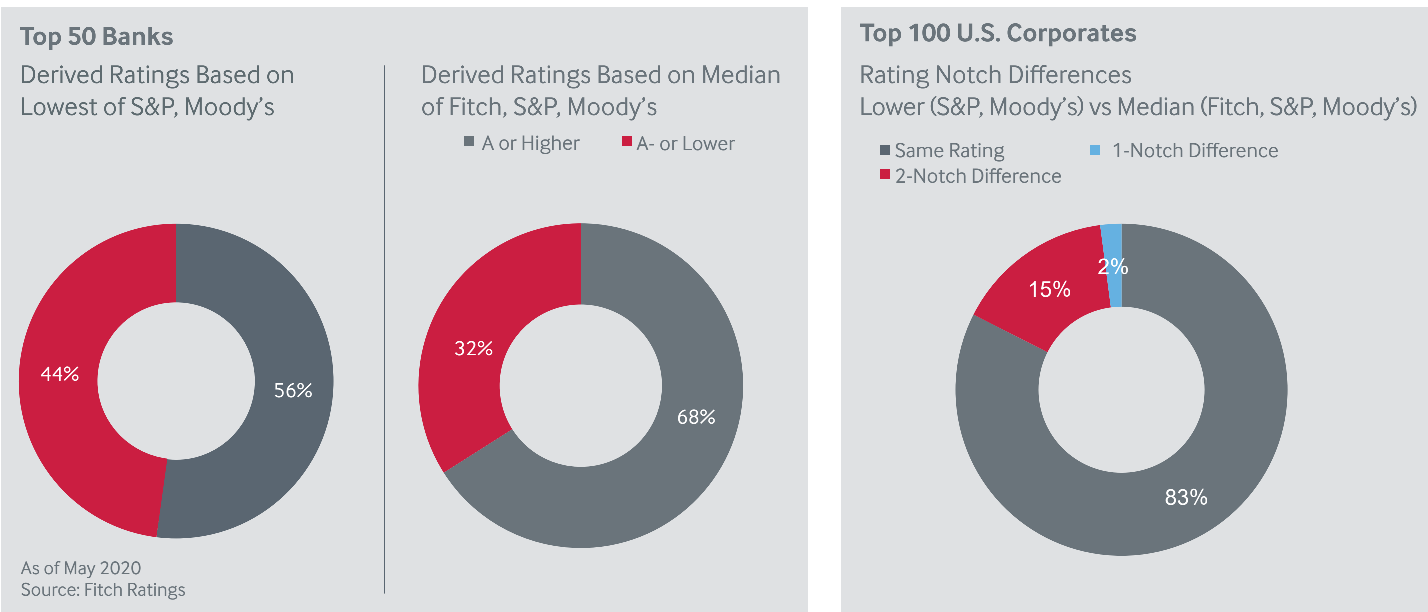

Source: Fitch Ratings
Data from Bloomberg

# Investment Flexibility Matters

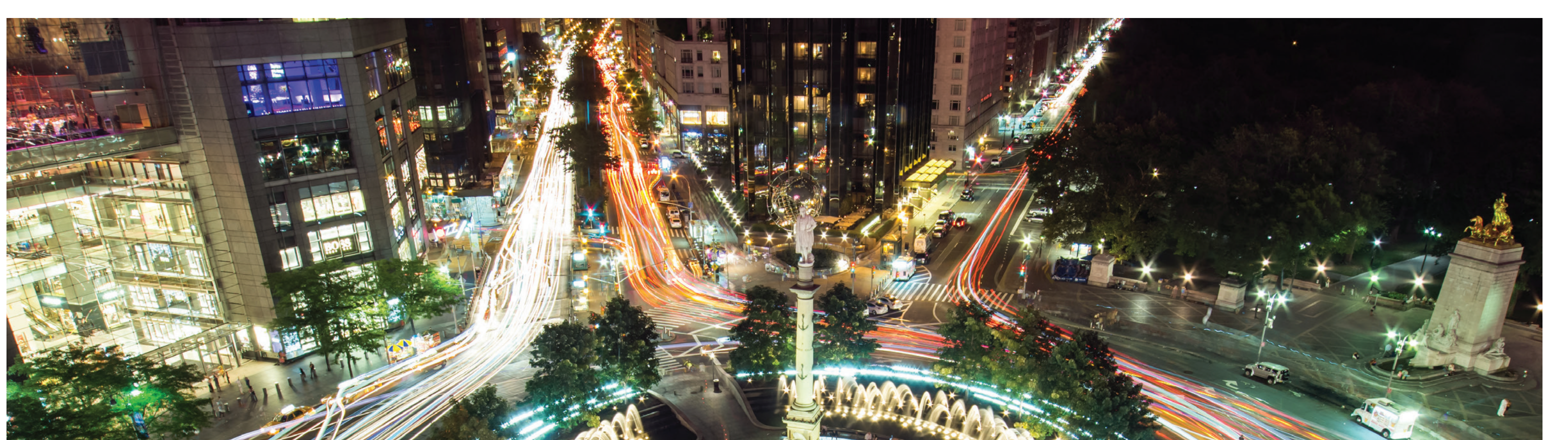
Investment guidelines and risk management practices that do include Fitch's ratings offer more flexibility and opportunities, which is particularly important at times of supply-constrained markets across asset classes and instruments (commercial papers, deposits, swaps, repo collateral, etc). As the 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 12% 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 17% 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 May 2020
Source: Fitch Ratings



### Flexible CP Market Offers More Opportunities

(Sample of Split Ratings for Euro and U.S. CP Programs , as at Feb 2020)

| Name | Industry | Fitch | Moody's | S&P |
|---|---|---|---|---|
| Aetna | Healthcare Services | F1 | P-2 | A-1 |
| Amazon.com | Retailing | F1+ | P-2 | A-1+ |
| American Express Credit Corp | Diversified Financial Serv. | F1 | P-1 | A-2 |
| At&T Inc | Telecommunications | F1 | P-2 | A-2 |
| Bank Of Ireland | Banks | F2 | P-1 | A-2 |
| Bbva | Banks | F1 | P-2 | A-2 |
| British Telecommunications | Telecommunications | F3 | P-2 | A-2 |
| Carlsberg Breweries | Food & Beverage | F1 | P-2 | |
| Caterpillar | Machinery Constr. & Mining | F1 | P-2 | A-1 |
| Daimler Ag | Automobiles Manufacturing | F1 | P-2 | A-2 |
| De Volksbank Nv | Banks | F1 | P-2 | A-2 |
| Diageo Plc | Food & Beverage | F1 | P-2 | A-2 |
| Engie | Utilities | F1 | P-2 | A-1 |
| Eni | Oil & Gas | F1 | P-2 | A-2 |
| Kellog | Food & Beverage | F3 | P-2 | A-2 |
| Florida Power & Light Co | Electric | F1 | P-1 | A-2 |
| Hubbell | Electric Compo. & Equip. | F2 | P-2 | A-2 |
| Nykredit Bank | Bank | F1 | P-2 | A-1 |
| Parker-Hannifin | Machinery | F2 | P-2 | A-1 |
| Prudential Financial | Insurance | F1 | P-2 | A-1 |
| Raytheon | Aerospace & Defense | F2 | P-2 | A-1 |
| Rockwell Automation | Machinery | F1 | P-2 | A-1 |
| Rwe Ag | Utilities | F2 | P-3 | |
| Stanley Black & Decker | Building Materials & Construction | F2 | P-2 | A-1 |
| Target | Retailing | F1 | P-1 | A-1 |
| Unitedhealth Group | Healthcare Services | F1 | P-2 | A-1 |
| Volkswagen Ag | Automobiles Manufacturing | F1 | P-2 | A-2 |
| Wisconsin Electric Power Co | Electric | F1 | P-1 | A-2 |

# 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.

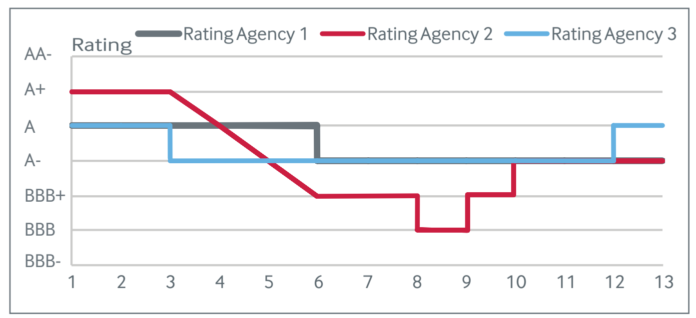
The hypothetical example below shows how using the median of three ratings versus the lowest of two reduces the reliance to an outlying credit rating.

This is why major bond indexes 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

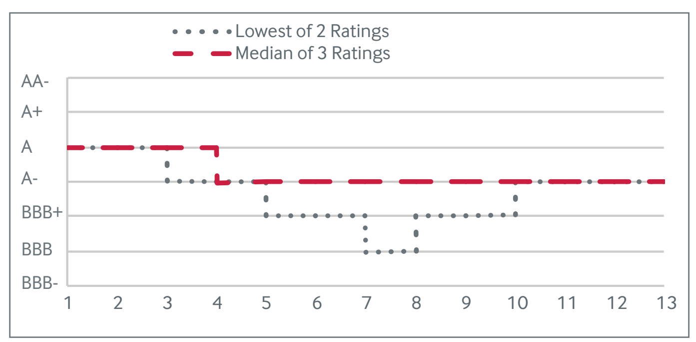
## Not Including Fitch Increases Rating Volatility

### Rating Trajectories on Hypothetical Issuer

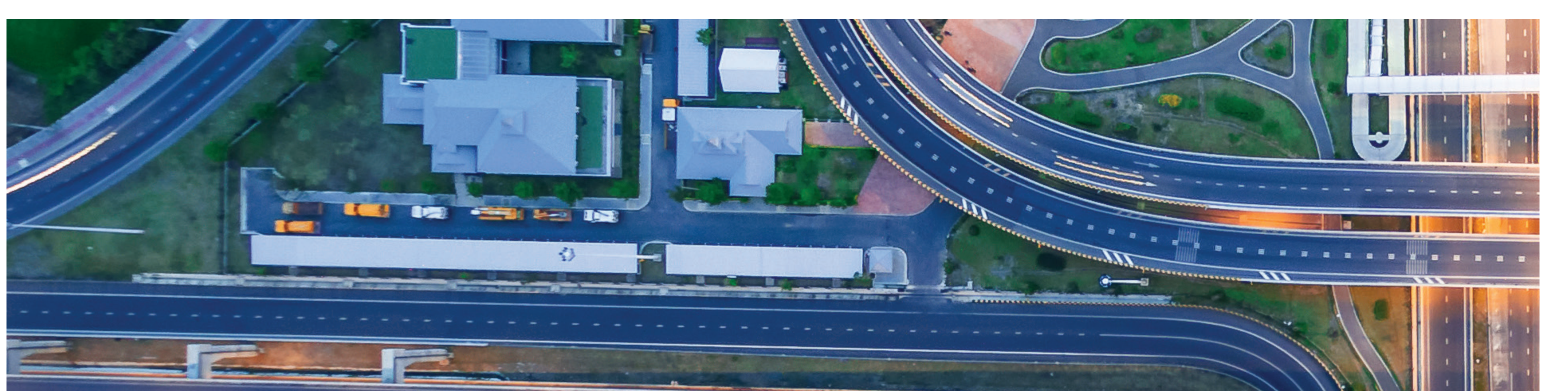



Source: Fitch Ratings

### 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: 1990-2018

| % | to AAA | to AA | to A | to BBB | to BB | to B+ and below | To unrated |
|---|---|---|---|---|---|---|---|
| From AAA | 88.09 | 5.35 | 0.24 | - | - | 0.12 | 6.20 |
| From AA | 0.10 | 85.76 | 8.85 | 0.35 | 0.02 | 0.07 | 4.85 |
| From A | 0.01 | 1.60 | 88.42 | 5.26 | 0.39 | 0.14 | 4.19 |
| From BBB | 0.01 | 0.12 | 2.89 | 87.41 | 3.35 | 0.60 | 5.63 |
| From BB | - | 0.03 | 0.11 | 7.14 | 76.59 | 7.81 | 8.32 |

Source: Fitch's Global Corporate Finance 2018 Transition and Default Study, November 2019

### Moody's Global Corporates Average Annual Transition Matrix: 1970-2018

| % | to Aaa | to Aa | to A | to Baa | to Ba | to B1 and below | To unrated |
|---|---|---|---|---|---|---|---|
| From Aaa | 87.76 | 7.88 | 0.58 | 0.07 | 0.02 | 0.00 | 3.68 |
| From Aa | 0.80 | 85.24 | 8.52 | 0.42 | 0.06 | 0.07 | 4.90 |
| From A | 0.05 | 2.47 | 86.87 | 5.25 | 0.48 | 0.19 | 4.69 |
| From Baa | 0.03 | 0.14 | 4.07 | 85.89 | 3.70 | 1.00 | 5.18 |
| From Ba | 0.01 | 0.04 | 0.41 | 6.19 | 76.50 | 8.71 | 8.14 |

Source: Moody's Annual Default Study: Defauts will rise moderately in 2019 amid higher volatility. February 2019

### S&P Global Corporates Average Annual Transition Matrix: 1981-2018

| % | to AAA | to AA | to A | to BBB | to BB | to B+ and below | To unrated |
|---|---|---|---|---|---|---|---|
| From AAA | 86.99 | 9.12 | 0.53 | 0.05 | 0.08 | 0.08 | 3.15 |
| From AA | 0.50 | 87.06 | 7.85 | 0.49 | 0.05 | 0.10 | 3.94 |
| From A | 0.03 | 1.69 | 88.17 | 5.16 | 0.29 | 0.20 | 4.48 |
| From BBB | 0.01 | 0.09 | 3.42 | 86.04 | 3.62 | 0.74 | 6.10 |
| From BB | 0.01 | 0.03 | 0.11 | 4.83 | 77.50 | 7.85 | 9.67 |

Source: S&P's 2018 Annual Global Corporate Default Study and Rating Transitions, April 2019

# 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 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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