AAA RATED

Unscrambling the Bond Market

Occasional Papers #22

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AAA Rated: Unscrambling the Bond Market

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Of course, a big portion of the credit must go to the program speakers Louise Klusek and Steven L. Lubetkin, who converted their oral presentations into a written format, and to their companies Salomon Brothers and Standard & Poor's Ratings Service, who allowed them to contribute their time and expertise.

Introduction

In early 1995, when the Business Reference and Services Section (BRASS) 1996 Program Planning Committee first met to choose a topic for the ALA Annual Conference in New York, we felt we had a unique opportunity to capitalize on the expertise of specialists located in the hub of the U.S. financial market. There are many aspects of finance that being in New York would have allowed us to explore. In the end, we chose bonds as our focus because it is an area so frequently overlooked that many librarians, especially non-business librarians, are uncomfortable helping patrons with questions on the subject.

The financial literature on bonds, itself, is not very helpful in this respect. It is either too technical or too focused on investment strategies for the do-it-yourself investor to offer the kind of concise, basic background knowledge needed by a librarian. In planning the program we wanted to offer an alternative approach geared to librarians that would provide a basic understanding of what a bond is, how to distinguish between different types of bonds, how to evaluate bonds and track their performance, and the most useful reference sources. Armed with this knowledge, librarians could feel more confident assisting patrons in identifying the correct information for their bond research needs.

We were fortunate to find two speakers with extensive experience in bonds who could offer unique perspectives owing to the different areas of the business in which they operate. The first was Louise Klusek who graduated from the University of Pittsburgh Graduate School of Library and Information Science and earned her MBA while working as the business librarian for the Graduate School of Business at Rutgers University. She worked in public, community college, college, and university libraries before going to Salomon Brothers in 1986. Salomon Brothers is one of the largest investment banks in the United States and has traditionally been known as the "Bond House." Ms. Klusek works as a research associate in the firm's Investment Banking Library which has a staff of sixteen, including five librarians, servicing the information needs of the Salomon Brothers New York City headquarters as well as the regional and worldwide branches.

The second was Steve Lubetkin, a veteran of more than eighteen years in corporate and financial communications and print and broadcast journalism, during which time he earned the designation "Accredited in Public Relations" (APR) from the Public Relations Society of America. He has a B.A. in Spanish and Philosophy from Monmouth College and an M.B.A. from the University of Phoenix. At Standard & Poor's, he has led the rating agency's expansion of credit quality seminar programs offered to bond issuers, investors, and financial intermediaries. In his position at Standard

& Poor's Ratings Services he is both the director of their research library and the director of Global Ratings Development. He is an active Internet user and co-chair of Standard & Poor's World Wide Web task force, which is developing Standard & Poor's presence on the Internet. He has published articles on ratings, financial communications, and public relations in *Financial Communications Report*, *Standard & Poor's CreditWeek*, *PR Tactics*, *The Public Relations Strategist*, and SLA's *Business and Finance Division Bulletin*.

Their papers published here are drawn from the presentations they made at the ALA Annual Conference program for Business and Reference Services on July 8, 1996, including information taken from their overheads and from answers to audience questions. Supplemental materials that were distributed at the program or prepared since then have also been included as separate chapters.

We are pleased to have this opportunity to share the contents of our program with our library colleagues outside the confines of the Annual Conference and hope it is both useful and timely.

LYDIA E. LAFARO
Chair, BRASS 1996 Program Planning Committee

CHAPTER 2

Bond Ratings

Steven L. Lubetkin, APR

How Did Ratings Start?

How did bond ratings get started? It was not actually ratings in the very beginning. It was an idea, it was a concept—"The investor's right to know." And the man who came up with it was Henry Varnum Poor. Henry, back in the 1860s, started compiling financial data on the railroads and canals in the United States, which at the time were the principal engines of the industrial revolution. There was no information, but there were lots of people who wanted to invest in them. Meanwhile, unscrupulous operators were literally printing stock and bond certificates overnight, creating fictitious railroads and fictitious canal companies into which investors were dumping their money. It is reminiscent of some of the speculative Internet stocks today. So Henry Varnum Poor came up with a way to get financial information together for investors. He started compiling it. The companies were not very happy with this information being disclosed. Many of them would not cooperate with him, but the investors found it to be a very useful tool and for a number of years Henry updated the *Directory of Railroads, Canals and Steamship Lines in the United States*. It has been reprinted and many libraries may even have one of the replica editions on their shelves.

The successor to Henry Poor's work was Poor's Publishing, which collaborated with John Moody on investment publications and index cards with investment information. These were sold on the street by runners to the various brokers. At some point, John Moody and Poor's Publishing went their separate ways. John Moody went out on his own and produced the *Moody's Investor's Manual*, which to this day continues to be a very important source of information. Poor's Publishing went on to compete with Moody's, began publishing bond ratings around 1920, and in 1941, it merged with the Standard Statistical Bureau to create today's Standard & Poor's. There have been many newer entrants into the rating business in recent years, such as the well known Fitch Investor Service. Fitch has become much more aggressive and has assumed a higher profile. Then there is also Duff and Phelps which continues to be very active in the ratings area. Meanwhile IBCA in the United Kingdom is starting to make inroads in the U.S. and other markets, although it is much more

prominent in Europe. In Canada, there are two major bond rating services, Dominion and CBRS which is Canadian Bond Rating Service.

There are also rating services developing in some emerging markets. Countries are seeing the enormous liquidity in the U.S. capital markets, and they want to copy that in their own markets. They have concluded that having third parties make independent assessments of creditworthiness is a critical feature for their capital systems. It is a linchpin to achieving that kind of liquidity in their markets. So they are coming to the United States for technical assistance in designing a rating methodology for their markets. The big question for emerging markets is whether they are going to control rating agencies through the government or they are going to allow independent private companies to be set up with some regulatory oversight? It is one thing to have regulatory oversight; it is quite another thing to have the government actually dictating the ratings to the individual entities that are issuing bonds. Standard & Poor's has had technical assistance relationships with several rating agencies in these markets overseas. One of these relationships has been with a rating agency in India called CRISIL (Credit Rating and Information Services of India, Ltd.). In Thailand, it has been with the Thai Rating and Information Service (TRIS); and in Mexico, with a firm that Standard and Poor's acquired several years ago, Calificadora de Valores (CAVAL), the leading rating agency in Mexico.

What's an NRSRO?

It is important to remember that rating agencies in the U.S. are officially sanctioned as Nationally Recognized Statistical Rating Organizations or NRSRO's. This is a designation that is written into the securities laws in the United States. Back in the 1930s and 1940s, when the securities markets were coming under increasing regulation because of all of the abuses of the 20s and 30s, the securities regulators wrote into the law that securities issued in the U.S., debt securities, had to be rated by one of these NRSRO's. For many years, Standard & Poor's and Moody's were the primary organizations to which this applied. Now, as noted earlier, there are new ones that have come along in recent years. In the U.S., there are six rating agencies that are officially sanctioned by the government. These are Standard & Poor's, Moody's, Duff and Phelps, IBCA, Fitch and Thomson BankWatch. The last one is an NRSRO in the U.S. for banks. The other rating agencies are designated to rate anything.

What Do Rating Agencies Do?

What do rating agencies do? They offer an opinion. They analyze the creditworthiness of a company and give an opinion on the likelihood that it will pay its debt in a timely fashion. Except in the case of hybrid bonds, they are looking at two components. They are looking at principal and interest and they are looking at both of those things being paid on a timely basis. Sometimes the

terms of the instrument itself can govern whether that payment is on a regular time schedule or whether it is tied to other market forces.

In recent years, investment banks have become very creative in designing bonds and bond-like instruments that look like they're going to pay in a certain way, but may not, depending on how things turn out in the market. This is particularly true if they are linked to an index. In some cases, there have been relationships to an index where if the interest rates rose three percent, then the value of the bond declined 20 percent because of the way the formula was written. So it is something that has become very complex and investors have to be very careful about it.

Ratings themselves are a shorthand expression that describe the credit risk. The "Rating Categories" section later in this chapter will describe the levels of risk associated with the different rating classifications that make up this system of shorthand expressions, but first it is interesting to note how amazingly pervasive the whole concept of ratings has become in general usage every day. It proves that people pay attention to ratings even though they may not fully understand them.

Take this example. A few years ago the Mets had a player by the name of Bobby Bonds. At one point, he fell out of favor with the Mets' management and the headline on the sports page in *The New York Daily News* was "Mets Downgrade Bond's Rating". It is mind-boggling how ratings have just become part of our everyday culture.

Here is another example. Last season there was an episode of "Law and Order"—it is a crime drama that takes place here in New York City—set on Wall Street. The police were investigating a case where the bond trader had been making some fake trades in bonds and he was suspected of murdering his boss. The police were interviewing a woman who worked with the suspect. They asked about her relationships with the men at her place of business and she said to the detectives, "There are only two types of men who work on Wall Street—standard and poor."

The Rating Process

Rating Request

The details of the rating process differ from agency to agency. At Standard & Poor's it usually starts with a bond issuer requesting a rating since the agency prefers to work with the cooperation of bond issuer in order to obtain the most information possible about their management, their strategies, their plans and their financial performance and condition overall.

Issuer Meeting

The next step is an issuer meeting where a team of analysts meets with the issuer's management. The analysts are experts in the particular sector that the issuer works in, whether it is a governmental, corporate, banking or other institutional type. They meet with the issuer's management, gather all of the information, and then when they have collected enough, they discuss it amongst themselves at what is called a rating committee meeting.

Rating Committee Meeting

The committee is composed of any number of Standard and Poor's analysts, including several senior analysts. The committee also includes people who have particular expertise. For example, when doing a rating on an insurance company, there have to be people who are expert not only in insurance company finances, but also people who know something about real estate finance because a big portion of insurance company investments tends to be in real estate. Or the committee might include analysts who have particular expertise in bonds of other institutions, because insurance companies also hold bonds from other issuers in their portfolios. So the committee process brings together experts in all areas relating to the issuer's business. It is very much a collaborative effort, though it does include an adversarial component when they reach the point at which the lead analyst who is presenting the credit has to defend his or her position to his or her peers as they play devil's advocate.

Notification and Appeal

Once the rating decision is made, Standard and Poor's notifies the bond issuer. The issuer does have the right to appeal the rating by providing additional information that may not have been considered or that the issuer feels did not receive adequate consideration during the rating committee process.

Dissemination

After the appeal is concluded, Standard and Poor's disseminates the rating through the news wire services. This is done through Standard and Poor's own internal wire service (CreditWire), which is not only sold to subscribers but is also used to feed the major wire services, in the interest of full disclosure, and those wire services in turn feed the other news organizations.

Surveillance

The rating process does not end here. There is still a very important and final step, conducting surveillance. This means staying on top of the financial performance of the issuer, to make sure that they continue to perform in accordance with what they have stated, and in accordance with Standard & Poor's expectations of how they will perform over the course of the bond's life.

Definition of a Rating

A rating is defined as a current assessment of the creditworthiness of an obligor with respect to a specific obligation. There are three main factors considered in determining a rating. The first is the likelihood of default, that is, the capacity and willingness of the obligor to pay the interest and

repay the principal in accordance with the terms of the obligation. The other two are the nature and provisions of the obligation and the protection afforded the lender in bankruptcy.

Rating Categories

As stated earlier, there are a variety of rating categories as demonstrated in the figure below. The distinction between "investment grade" and "speculative grade" bonds arose because of regulatory requirements that limit the types of instruments in which banks and other financial institutions can invest. These are generally the instruments in the "AAA" to "BBB-minus" Standard & Poor's rating categories. Investment grade is simply a shorthand way of saying those are the instruments that qualify for investment by those institutions subject to the federal restrictions.

Speculative grade or high-yield or, as they are popularly known, "junk" bonds are anything below that. These are the companies that exhibit weaker, not necessarily bad, credit quality; although with those in the CCC and the D categories down at the lower right of Figure 1, the financial situation is very weak. These are companies that have higher than normal credit leverage. This may be an indication that they have more bonds outstanding than the BBB companies or that they are growing companies. It doesn't necessarily mean that they are bad companies, but it does mean that their financial performance is weaker.

CAPACITY TO PAY INTEREST & PRINCIPAL IS			
Investment-Grade		**Speculative-Grade**	
AAA	Strongest	BB+	
		BB	Least Speculative
AA+		BB-	
AA	Very Strong		
AA-		B+	
		B	Speculative
A+		B-	
A	Strong		
A-		CCC	Highly Speculative
		CC	
BBB+			
BBB	Adequate	C	Non-Paying Income Bonds
BBB-			
		D	In Default

FIGURE 1 Standard & Poor's Rating Categories

New Rating Services

The markets are expanding and there is growing demand for new rating services. For example, Chapter One elaborated a bit on the different types of bonds including asset-backed bonds, among which there are those based on lottery winnings. These are part of a new category of assets that are being used to securitize bonds. Even assets like health club memberships could be used as collateral for bonds. That has not happened yet but people are exploring it and the way it might work. Actually, it is not as strange as it sounds. It simply takes a pool of receivables and uses them as the cash flow collateral for the bond itself. In the case of lottery winnings, the cash flow collateral is a stream of future income. So it is not that strange, although some of the things that people have looked at securitizing sound strange at first.

Another one that has recently gotten a lot of attention is viatical settlements. These are insurance settlements for terminally ill people where the terminally ill patient wants to get access to the life insurance benefits before the time that those benefits would normally be paid. They may need the cash to pay medical expenses or to engage in activities that they want to pursue in the limited time they have left. There are companies that will pay terminally ill patients a present value cash settlement in return for becoming the beneficiary on their insurance policy. These firms will continue to pay the premium on the policy and the policies then go into a pool which is used to securitize bonds. It is actually a win-win situation. The advocates for many terminally ill patients, particularly AIDS patients, have really pushed this kind of issue where the insurance companies were unwilling to take the risk at first.

Asset-backed bonds based on auto loans and credit cards were also mentioned in Chapter One. If you wonder why you are getting so many solicitations for credit cards in the mail, it is because there is a financial machine that needs to be fed. It is the securitization of credit card receivables into bonds which is spurred on by the demand of investors who want the yields that these bonds will pay. The bonds have very high credit quality because, not only are they backed by the collateral of the credit card receivables themselves, but the banks know within decimal points how many of them are going to default. The percentage is really very small. Between four and five percent of credit cards actually default and do not pay. So they know how big a pool they need to have and they know how much additional cash they need to put into it. It is a very attractive proposition. Credit becomes freer and more available and both consumers and the credit companies are happy.

Counterparty Ratings

There are some other new types of services that Standard and Poor's is providing, such as counterparty ratings in the derivatives world. Derivatives or hybrids or whatever you want to call them are basically instruments that are based on other instruments. For instance, a stock option is a derivative because it is based on the price of the underlying stock it represents. The price of the option fluctuates depending on the price of the stock and how close you are to the expiration date of the option.

Derivative Product Companies

There are many other kinds of derivatives, too many to go into here. They have proliferated to such an extent that there are now companies set up as highly capitalized, high credit quality subsidiaries to handle them. They are called derivative product companies. They get ratings from Standard & Poor's and the other rating agencies as counterparties. The rating assures investors engaging in these various derivatives transactions—in essence, trading their interest streams for another entity's interest streams—that the counterparty they are trading with has very high credit quality and will honor the obligation when it comes time to actually transfer the money in both directions.

Corporate Credit Assessments

Standard & Poor's is also starting to do corporate credit assessments, referred to as corporate credit ratings. These are done for companies without publicly traded outstanding debt that are coming in for a credit rating from Standard & Poor's . They do this because they think the rating conveys important additional information they want their creditors to see, whether they are trying to negotiate a lease for a new office building or buy some equipment, and they need the bank to be comfortable with their credit rating.

Private Placement Ratings

Private placement ratings are a very active market. There are two basic types. One is true private placements where the debt is actually placed privately and there is never any public discussion of it. The company issues it; it is immediately sold to another company or a sophisticated institutional investor. Typically, an insurance company will buy these kinds of issues. But often, they want to have a rating on it because they need to make sure in their own auditing process that they are comfortable with the risk that they are taking.

There is another kind of private placement which is not as private and is called a Rule 144A transaction. It is named after the securities law provision that allows it to exist. Transactions of this type might be described as semi-private. They are made public in a limited way, but there are great restrictions on who they can be sold to in the secondary market, and most private investors do not deal in those kinds of transactions.

Project Finance

Project finance is a new, emerging area. In the emerging markets where there are infrastructure issues, there are roads that need to be built and bridges and airports and all kinds of pipelines and energy projects. The project developers are coming to the rating agencies for ratings on those kinds of issues. There are many factors that have to be taken into account, including the technology being used if it is an energy-generation project, the experience of the operator, and whether they have experience working with this type of technology. A lot of these are very risky projects. Standard and Poor's assesses the risk in a variety of ways, such as, looking at the contracts

that an energy generator has with existing utilities to see if circumstances might make it a high-cost producer so that the utilities will not buy its electricity if the market turns against it.

"r" Subscript

All of these new issues have led to some new risks and that is what brought about the "r" subscript. Around 1994, Standard & Poor's started becoming concerned that the traditional ratings, the letter-grade ratings, were not adequately reflecting the risks that some of these instruments contained because many of the risks weren't just credit risks. There were a great number of issues, particularly from some of the government-supported enterprises, the Fannie Maes and the Ginnie Maes, where the notes themselves had components that caused them to fluctuate in value or fluctuate in the timeliness of the payments for reasons other than credit risk. If it is a Fannie Mae, it is going to be a AAA-rated instrument. But because of the way the note was structured, if the markets went up, the note might go down. Standard and Poor's became very concerned about this in view of the large quantity of them, so they created a subscript, a "rating highlighter", called the little "r." When it is appended to a rating, it is a flag to look for more information in the rating write-up in one of the publications or on the wires to see why we assigned that "r" subscript.

Bank Loan Ratings

Standard & Poor's is also doing bank loan ratings. Banks sell loans amongst themselves or trade them because they want to hold different pieces of their portfolio. The companies want to have some measure of credit quality, and Standard and Poor's has been working closely with the banking industry to come up with a methodology and a comfort level for them with the rating approach. The resulting ratings on the bank loans means they are traded more freely in the secondary market. It opens up transparency in the market; it opens up the liquidity.

Municipal Disclosure

This year the market saw an increased requirement for disclosure by state and local governments about the events that may have an impact on their credit quality. There were problems with the derivative investments in Orange County and in other municipal government portfolios and so one of the outgrowths of that is increased oversight, increased regulation. Municipal issuers are now required to disclose through a NRMSIR (Nationally Recognized Municipal Securities Information Repository), a very specific list of eleven kinds of events that are considered material events for municipal governments. They are required to make an announcement when those things happen, which can be anything from a change in their financial performance to the fact that someone was elected to the board or they have to change their name. So Standard & Poor's is now working with J. J. Kenny, one of its sister companies, on a service that looks at these events and determines whether it is important or not important, in the context of the overall credit quality. Some of these events are very routine disclosures that are simply required now, but there are others that have a serious impact and bear watching.

Claims-Paying Ability Ratings

Claims-paying ability ratings are the ratings assigned to insurance companies. These are ratings that assess the ability of the insurance company to pay its claims. It is important to distinguish between claims-paying ability and willingness to pay. The rating is only looking at the financial ability of the company to pay.

Conclusion

In conclusion, the demand for new ratings and new rating categories and new flavors is increasing. All of the bond agencies are aggressively competing; we are all trying to offer more and better services. The bottom line on ratings is that they are good for investors because they provide more transparency, more information on the market.

It goes back to the same idea that Henry Poor came up with 136 years ago when he said the investor has a right to know. With more complexity in the market for both the investor and the business librarian, the new ratings continue the tradition of providing unbiased assessments from which the public can make informed decisions. It is an exciting time of rapid change in the financial industry, calling for evermore specialized rating services.