

Credit Ratings



What are Credit Ratings?

- An assessment by professional organisations of an entity's ability to punctually service and repay debt obligations
- Used by investors as indication of likelihood of getting their money back in accordance with the terms on which they invested or the converse risk of default
- Internationally recognised and provide global comparisons of the credit quality of institutions, financial stability of these institutions and whether or not there is a recourse to 'lenders of last resort'
- Organisations use these ratings as an integral part of their credit and investment policy

Why use Credit Ratings?

- Security of funds should be the first priority for Local Authorities
- There is also a duty to balance risk and return
- Enhanced returns should be a secondary priority
- Strong emphasis on Risk Management

Credit Ratings: definitions

Short-term

(Fitch Ratings - Issuer Default Rating)



- Covers obligations which have original maturity < 1 year
- It places greater reliance on liquidity required to meet financial commitments

Long-term

(Fitch Ratings - Issuer Default Rating)



- Generally covers maturities up to 5 years
- Emphasis shifts to assessment of ongoing stability of the institutions prospective financial position

Establishing Credit Criteria

- No combination of ratings can be viewed as entirely fail safe
- One way to determine relative degrees of security is to use matrices based on credit ratings
- Matrices provide a method to decide what levels of credit quality may be appropriate in determining policy
- Combination of ratings and maturity limits are not definitive

Credit Risk Assessment

Rating Agencies

- Fitch
- Standard & Poor's
- Moody's

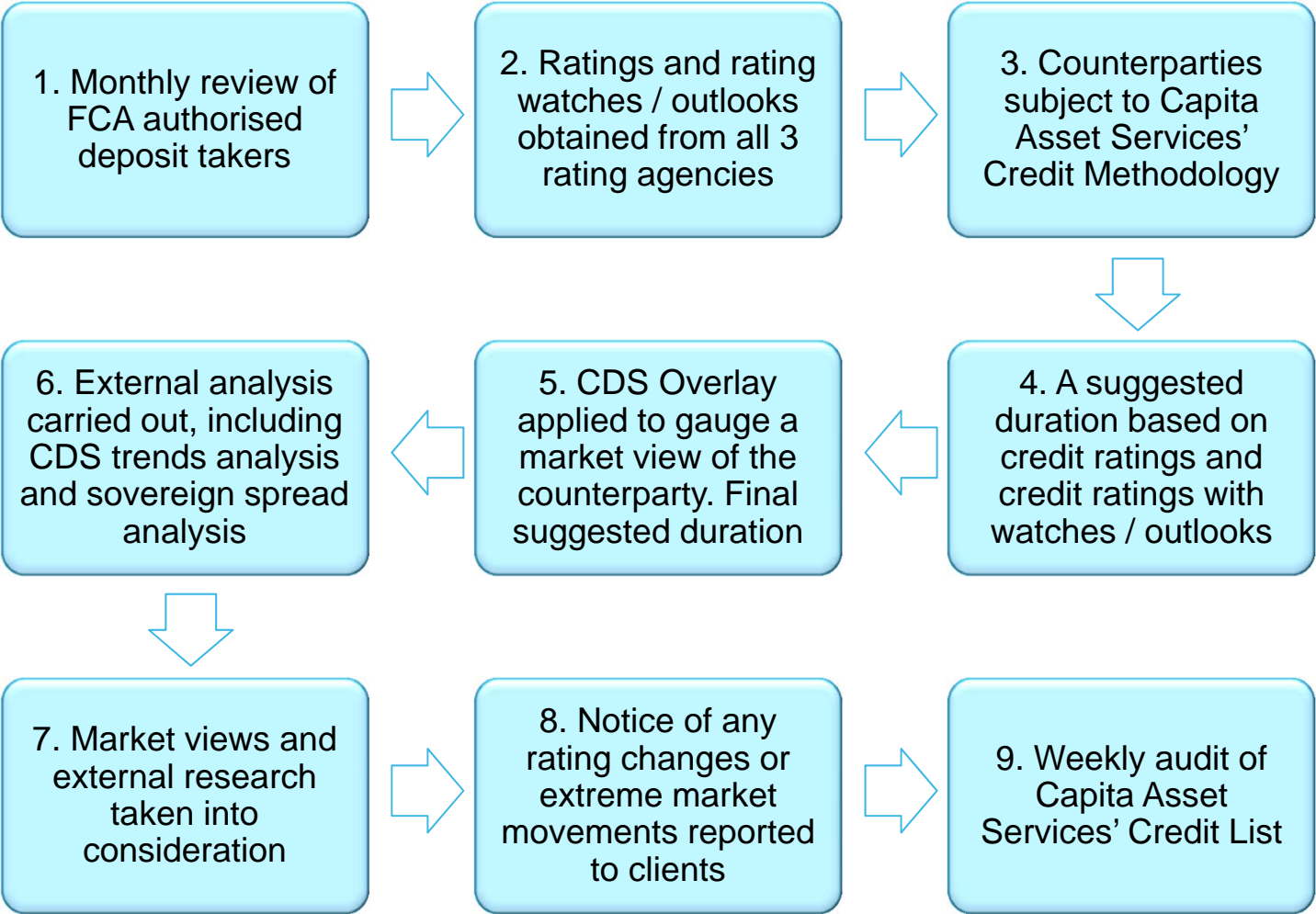
Capita Asset Services' Credit Methodology

- Overlay Credit ratings with the use of Credit Default Swaps

Creditworthiness: Capita Asset Services Methodology

- Mathematical and transparent in its approach.
- A system which assigns values to ratings from all 3 agencies and integrates them accordingly.
- The scoring starts from 1 for the highest ratings and increases in an ascending manner.
- The ratings are then calculated and a final score is assigned to each institution.
- This score is then compared to pre-assigned bands and a colour is derived from this.

Capita Asset Services Credit Procedure



Capita Asset Services Credit Methodology – An Example

Stage 1: Obtain Credit Ratings

Barclays			
	Fitch	Moody's	S&P
Long Term	A	A2	A
Short Term	F1	P-1	A-1

- Subscriptions to all 3 ratings agencies
- Use a full 2 way approach where possible

Capita Asset Services Credit Methodology – An Example

Stage 2: Score the counterparty

	Fitch	Score
Long Term	A	6
Short Term	F1	2

	Moody's	Score
Long Term	A2	6
Short Term	P-1	2

	S&P	Score
Long Term	A	6
Short Term	A-1	2

Long Term Ratings					
Fitch		Moody's		S&P	
Rating	Scoring	Rating	Scoring	Rating	Scoring
AAA	1	Aaa	1	AAA	1
AA+	2	Aa1	2	AA+	2
AA	3	Aa2	3	AA	3
AA-	4	Aa3	4	AA-	4
A+	5	A1	5	A+	5
A	6	A2	6	A	6
A-	7	A3	7	A-	7
BBB+	8	Baa1	8	BBB+	8
BBB	9	Baa2	9	BBB	9
BBB-	10	Baa3	10	BBB-	10

Short Term Ratings					
Fitch		Moody's		S&P	
Rating	Scoring	Rating	Scoring	Rating	Scoring
F1+	1	-	-	A-1+	1
F1	2	P-1	2	A-1	2
F2	3	P-2	3	A-2	3
F3	4	P-3	4	A-3	4

Capita Asset Services Credit Methodology – An Example

Stage 3: Calculate the credit score

	Fitch	Score
Long Term	A	6
Short Term	F1	2

	Moody's	Score
Long Term	A2	6
Short Term	P-1	2

	S&P	Score
Long Term	A	6
Short Term	A-1	2

Calculation	
Long Term Average	$(6+6+6) \div 3 = 6$
Short Term Average	$(2+2+2) \div 3 = 2$
Total score	$6 + 2 = 8$

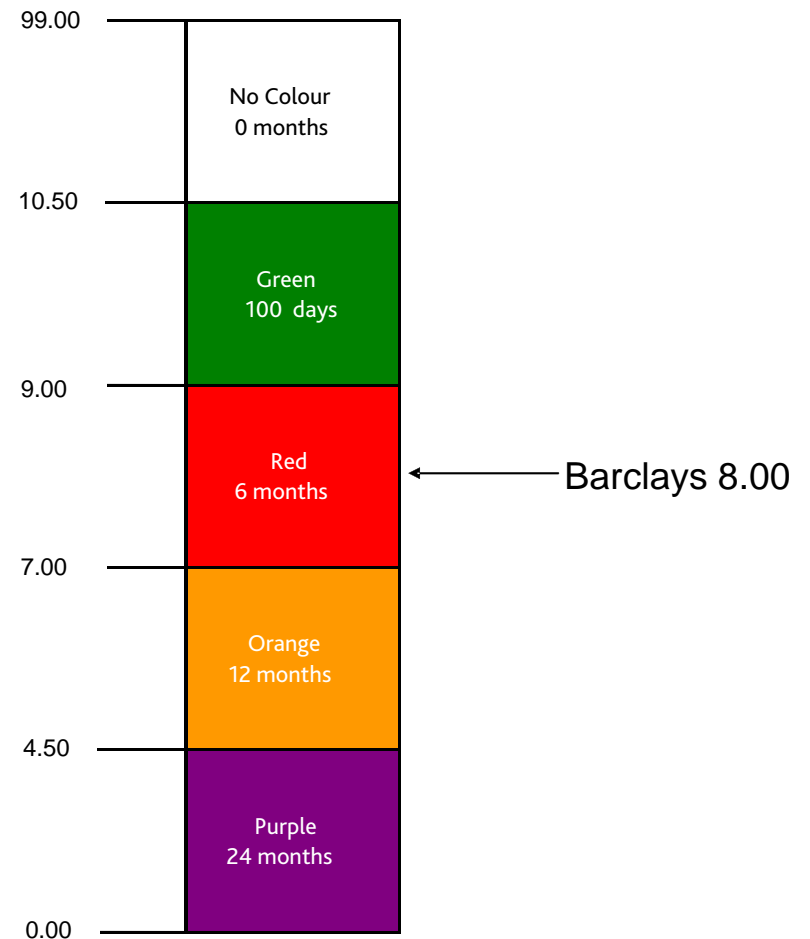
- The credit score is a summation of the averages of the scores for each rating component (i.e. Long and Short Term) from each credit rating agency.
- If a rating component is missing e.g. there is no Long Term rating from **any** of the 3 agencies, then the counterparty is not penalised.

Capita Asset Services Credit Methodology – An Example

Stage 4: Determine Duration

	Lower Boundary	Upper Boundary
P	0	4.5
O	4.5	7
R	7	9
G	9	10.5
N/C	10.5	99

- The score for the counterparty is then measured against pre-determined bands (which have been historically back tested) to determine what colour the counterparty will take (see above)
- There are currently 5 colour bands, with each band relating to a duration.
- In the case of Barclays, we can see that a score of 8.00 falls into the Red band giving it a credit rating suggested duration of 6 months.



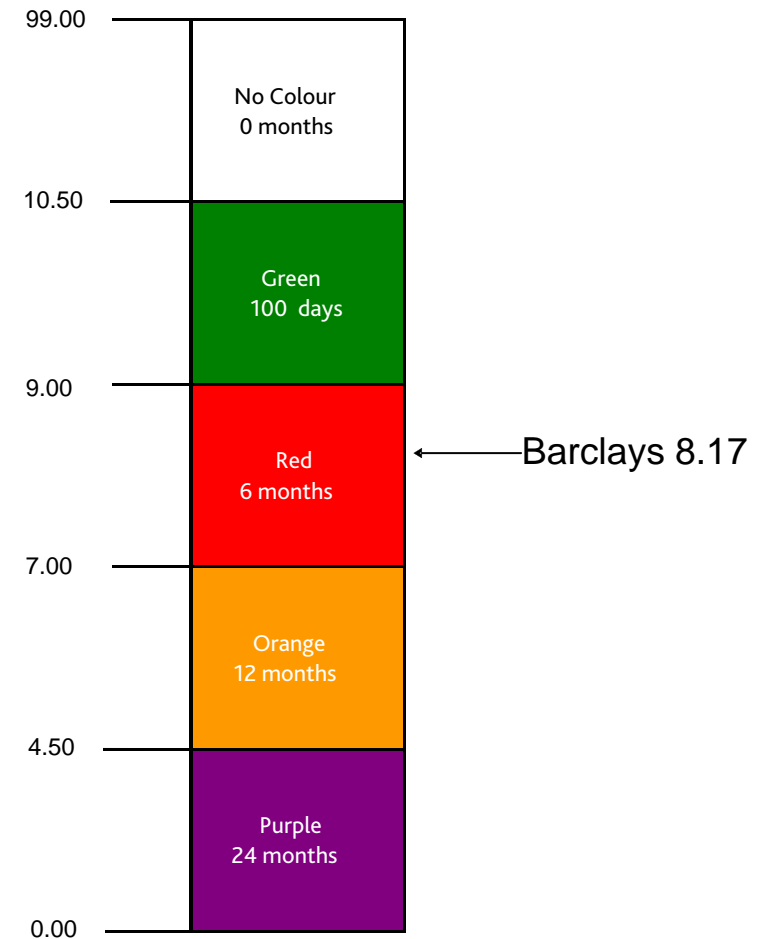
Capita Asset Services Credit Methodology – An Example

Stage 5: Watch/Outlook Adjusted Duration

Status	Effect on Credit Score
Negative Watch	+1/2
Negative Outlook	+1/4
Positive Watch	- 1/2
Positive Outlook	- 1/4
Under Review for Possible Downgrade	+1/2
Under Review for Possible Upgrade	- 1/2

Barclays - Watches and outlooks			
	Fitch	Moody's	S&P
Long Term	Stable Outlook	Negative Outlook	Negative Outlook
Short Term			

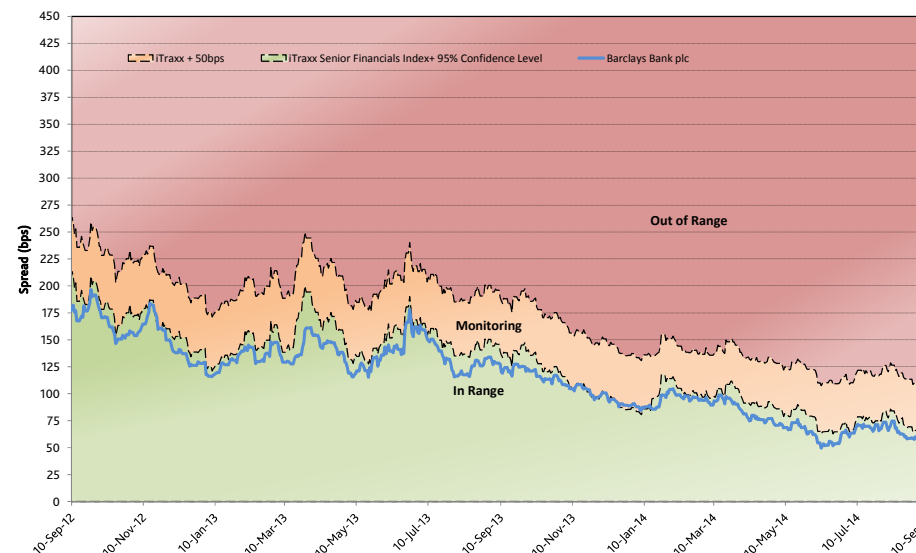
- As Barclays has 2 negative outlook status' the credit score is increased by 1/6 point bringing the score to 8.17 and it therefore remains in Red.



Capita Asset Services Credit Methodology – An Example

Stage 6: CDS Overlay

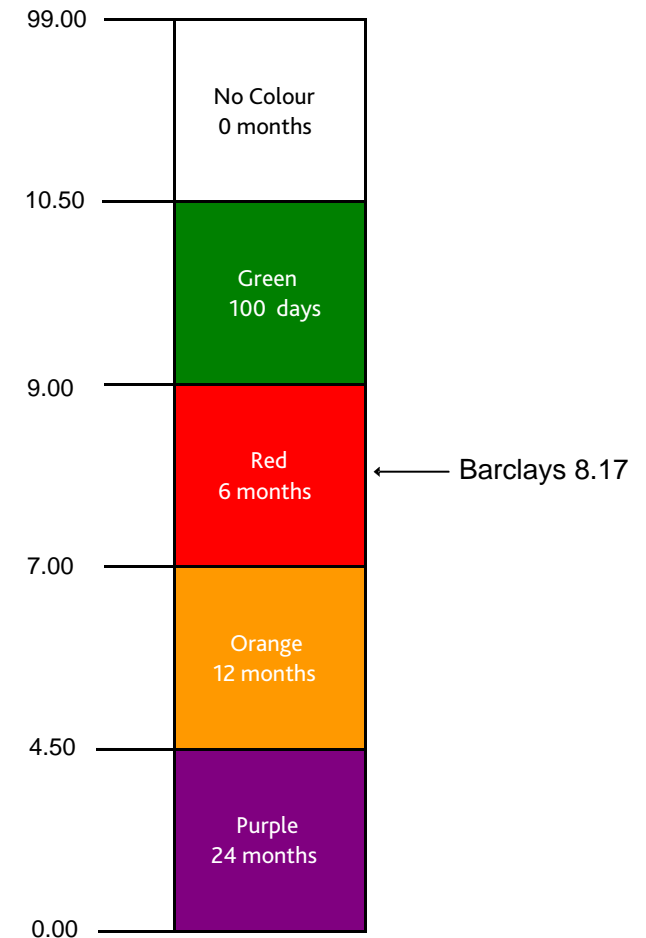
- The final layer to be considered is that of the CDS spread (if available). The CDS spread gives a market sentiment of the credit risk surrounding a particular institution.
- This CDS spread is then compared to an iTraxx benchmark. The iTraxx benchmark gives an indication of the average CDS spread for financial institutions.
- An upper band is produced based either on a fixed spread of 50bps above the iTraxx benchmark or based on a volatility measure.



Capita Asset Services Credit Methodology – An Example

- As Barclays is in “In Range” i.e. its CDS spread is below the iTraxx we maintain its suggested duration at Red – 6 months.
- This is illustrated below:

Stage	Colour	Duration
Credit Ratings	Red	6 months
Outlooks/Watches	Red	6 months
CDS Spreads	Red	6 months



Capita Asset Services Credit Methodology – An Example

- **When the iTraxx is below 100 :**
- 0-100 No Change. (“In Range” status)
- Above 100-150 Duration reduced by one period (“Monitoring” status)
- Above 150 Duration changed to “No Colour”. (“Out of Range” status)

- **When the iTraxx is above 100 :**
- Below iTraxx No Change. (“In Range” status)
- Up to iTraxx+50bps Duration reduced by one period. (“Monitoring” status)
- Over iTraxx+50bps Duration changed to “No Colour”. (“Out of Range” status)

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