How Rating Agencies Achieve Rating Stability

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Abstract

Surveys on the use of agency credit ratings reveal that some investors believe that rating agencies are relatively slow in adjusting their ratings. A well-accepted explanation for this perception on the timeliness of ratings is the agencies' "through-the-cycle" methodology. According to Moody's, "through-the-cycle" ratings are stable because these ratings are intended to measure the default risk over long investment horizons and because these ratings are changed only when the agencies are confident that observed changes in a company's risk profile are likely to be permanent. To verify this explanation we compare a financial ratio-based (credit scoring) agency-rating prediction model to (credit scoring) default-prediction models of various time horizons, and we examine the rating migration practices.

By varying the time horizon in the estimation of the default-prediction models, we searched for a best match with the agency-rating prediction model. Consistent with the agencies' stated objectives, we conclude that agency ratings are long-term focused. In contrast to the one-year default prediction models, agency ratings place lower weight on the short-term indicators of credit quality.

We also demonstrate that the agencies' focus on long investment horizons only partly explains the relative stability of agency ratings. The other aspect of the "through-the-cycle" rating methodology - the agencies' rating migration policy - is a second, even more important factor underlying the agency-rating stability. We find that a rating migration is triggered when the difference between the actual agency rating and the rating predicted by the agency-rating model exceeds a certain threshold level. If triggered, ratings are only partly adjusted by agencies, which is consistent with the known serially dependency of agency rating migrations.