CREDIT RISK AND CREDIT RATING AGENCIES

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Living in a highly dynamic environment, where markets change per seconds, where the rate of performing operations is very high and the transmission of information is very fast, and competition and rules of the game are very tough, if planned to operate as a financial market investor to enable a positive result for business or manage successfully, this requires, first of all, credit risk awareness and management.

Credit risk appears since the moment of holding a simple deposit and it grows in accordance with the speculative degree taken by the form of investment.

A service offered for knowing and identifying credit risk of banks, of securities or insurance companies, of public finances, of restructured finances, in other words, of the whole financial institutions, but at the same time even of sovereign credit authorities of a country, is a rating service provided by the three biggest international credit rating agencies, i.e., Standard & Poor's, Moody's and Fitch.

These agencies have their first footprints at the beginning of XX Century, offering first elements of credit rating to the investing community. The use of symbols and the terminology entered

for credit rating by these agencies were considered practical right from the beginning of their use and have already taken a wide application, as their range is completed, increased and enriched, being ever more adjusted to new developments of different markets.

Credit rating or classification is realized through using a group of letters or a combination of letters and figures. Knowing the technical language is necessary to read and understand credit ratings provided by these agencies for most of the financial institutions all over the world, being banks, securities or insurance companies or sovereign authorities.

As a manager of international reserve, the Bank of Albania is responsible for the management of foreign reserves. Bank of Albania's Supervisory Council approves "The management policy of the international reserves" through fixing the criteria and conditions for investing debt securities, and the permitted credit risk limits to banks and financial institutions with which it cooperates for investments, either in the money market or in fixed-income debt securities market. One of the conditions for investing in debt securities of banks or financial companies is credit rating by the above three agencies.

Under these conditions, it is necessary to know the symbols and the terminology used by these agencies to understand credit ratings and the risk accompanying an instrument, a debt security, a bank or a financial institution.

WHAT DOES "RATING" MEAN?

The three agencies, the Fitch, Moody's and Standard & Poor's define the credit rating of banks or of various financial companies as an opinion about creditworthiness of the overall solvency of a borrower or of a specific class of financial obligations, or a specific financial program (including ratings on medium term note programs and commercial paper programs). The rating is not a recommendation to purchase, sell or hold a financial

obligation, in as much as it does not comment as to market price or suitability for a particular investor.

PROVIDING A "CREDIT RATING"

Issue credit ratings are based on qualitative and quantitative bases, following a specific methodology in accordance with the criteria and profile or selected statistical, mathematical or computer pattern the agencies use. They go beyond the assessment of reports or indicators expressed in the language of numbers, meaning that a rating assesses at the same time the invisible strengths and weaknesses of banks and other institutions.

The currency in which the payment will be effected is a key factor of analysis. So, the borrower's capacity to settle the obligations in foreign currency is frequently lower than the capacity to repay obligations in local currency, due to the capacity of sovereign government, which is relatively lower for foreign currency debt than for domestic currency debt.

The three credit rating agencies provide their default risk rating in terms of non-repayment capacity of the issue or issuer. Groups of letters or combinations of letters and figures, which contain a well-established denotation, comprise the symbols they use for credit ratings.

TYPES OF CREDIT RATING

Credit ratings can be either long-term or short term. Short-term ratings are done mainly for those obligations or instruments that are considered as short-term in the relevant markets. In the U.S. for example, this means obligations with an original maturity of no more than 365 day- including commercial papers.

Such a rating is done even to long-term obligations or instruments as well (resulting to dual rating), so that debt

assessment be as accurate and coherent as possible, and under constant attention.

Long-term notes are defined through long-term rating.

Below are given the definitions of symbols and terms used by these agencies for credit rating of financial institutions and a summarized table of the various symbols they use.

LONG-TERM ISSUE CREDIT RATINGS

Investing category

AAA or Aaa

The highest credit rating

Rating in "AAA" or "Aaa" category denotes the lowest credit risk. Such a rating is assigned in specific cases, when the capacity to timely meet the financial commitments on an obligation is extremely strong. This category constitutes the best rating assigned by the agencies.

AA or Aa

A very high credit rating

The "AA" rating denotes a very low credit risk. It indicates a very strong capacity to meet the financial commitments in due time. This capacity is not very susceptible to changes in circumstances and economic conditions.

A

High credit rating

"A" rating denotes low credit risk. It denotes a strong capacity to timely meet its financial commitments. However, this

capacity is more susceptible to changes in the circumstances or economic conditions than the capacity mentioned in higher rated categories.

BBB or Baa

Good credit rating

The "BBB" or "Baa" rating denotes that there exists a low degree of credit risk. It indicates a sufficient degree of capacity for the timely payment of financial commitments, but adverse economic conditions or changing circumstances are more likely to affect this capacity. This is regarded as the lowest degree of investing category.

Speculative category

BB or Ba

Speculative

The "BB" or "Ba" indicates that there exists the likelihood of credit risk rise, particularly in the case of adverse economic circumstances over time. However, the business and financial alternatives are likely to enable the fulfilment of financial commitments. This category constantly reflects uncertainty or major exposure to adverse conditions, which may put into question the meeting of commitments.

B

Very speculative

The "B" category denotes that currently there exists a significant degree of credit risk. However, a limited margin of safety remains. Financial commitments are currently being met, but the capacity for continued timely payments is contingent upon a sustained, favourable business and economic environment.

CCC, CC, C or Caa, Ca, C

High degree of nonpayment risk

Nonpayment is currently probable. The capacity to meet its financial commitments is totally dependent upon favourable business, financial and economic conditions. In the event of adverse business, financial or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation.

"CCC" or "Caa" rating is CURRENTLY VULNERABLE TO NONPAYMENT; "CC" OR "CA" RATING IS CURRENTLY HIGHLY VULNERABLE TO NON-PAYMENT.

DDD, DD, D

In payment default

The issue or issuer rated in this category is extremely speculative and its value can not exceed the value obtained from any possible liquidation or re-organization process.

So, institutions rated as "DDD" have the highest likelihood to continue the activity and recover, and there can be included or not the possibility of a re-organization process.

The institutions rated as "DD" and "D" are in fact undertaking formal re-organization or liquidation process. The "DD" rating means more likelihood to meet the unsettled obligations to a greater extent, whereas the "D" rating represents the lowest likelihood to re-pay all obligations.

THE EQUIVALENCE OF SYMBOLS FOR LONG-TERM ISSUE CREDIT RATINGS

Fitch	Standard & Poor's	Moody's
AAA	AAA	Aaa
AA+	AA+	Aa1
AA	AA	Aa2
AA-	AA-	Aa3

A+	A+	A1
A	A	A2
A-	A-	A3
BBB+	BBB+	Baa1
BBB	BBB	Baa2
BBB-	BBB-	Baa3
BB+	BB+	Ba1
BB	BB	Ba2
B-	B-	Ba3
B/B+	B/B+	B1
CCC	CCC	Caa
CC	CC	Ca
C	C	C
D	D	D
NR	NR	NR

SHORT-TERM ISSUE CREDIT RATING

Relative to the short-term issuer credit ratings, the three agencies use different symbols to indicate the degree of credit quality.

Standard & Poor's

A-1

An obligor rated 'A-1' has STRONG capacity to meet its financial commitments. It is rated in the highest category by Standard & Poor's.

A-2

An obligor rated 'A-2' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligors in higher rating categories. However, the obligor's capacity to meet its financial commitment on the obligation is SATISFACTORY.

A-3

An obligor rated 'A-3' exhibits ADEQUATE capacity to meet its financial obligations. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened

capacity of the obligor to meet its financial commitment on the obligation.

B

An obligor rated 'B' is regarded as VULNERABLE and as having significant speculative characteristics. The obligor currently has the capacity to meet its financial commitments; however, it faces major ongoing uncertainties, which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.

C

An obligor rated 'C' is CURRENTLY VULNERABLE to nonpayment and is dependent upon favourable business, financial and economic conditions for the obligor to meet its financial commitment on the obligation.

FITCH

F1

Strong

Indicates THE STRONGEST intrinsic capacity for timely payment of financial commitment on the obligation. This category may be accompanied by "+" to indicate any exceptionally strong credit feature.

F2

Moderately strong

Indicates a SATISFACTORY capacity for timely payment of financial commitment. However, the margin of safety is not as great as in the case of the higher ratings.

F3

Moderate

Indicates an ADEQUATE capacity for the timely payment of financial commitment on the obligation. However, such capacity is more susceptible to near-term adverse changes and could result in a reduction to “vulnerable”.

B

Speculative

Indicates MINIMUM capacity to meet short-term obligations and vulnerability to adverse changes in financial and economic conditions

C

High nonpayment risk

Nonpayment of obligation is a real possibility. Capacity to meet financial commitment on the obligation is solely reliant upon a sustained, favourable business and economic environment.

D

In default

Indicates actual or imminent payment default.

Moody’s

Moody’s uses the Prime Rating System for short-term credit rating.

P-1 (Prime-1)

Issuers rated P-1 (or supporting institutions) have a superior

ability for repayment of short-term debt obligations. It is presented as the highest rating for short-term credit.

P-2 (Prime-2)

Issuers or (supporting institutions) rated Prime2 have a strong ability to repay short-term debt obligations, however to a lesser degree compared to the first category. Earnings trends and coverage ratios, while sound, may be more subject to variation with the passing of time and upon changes of economic conditions.

P-3 (Prime-3)

Issuers or (supporting institutions) rated Prime-3 have an acceptable ability for repayment of short-term debt obligations. The effect of industry characteristics and market compositions may be more pronounced. Variability in earnings and profitability may result in changes in the level of debt-protection measurements and may require relatively high financial leverage.

NP (Not Prime)

Issuers rated Not Prime do not fall within any of the Prime rating categories.

OTHER RATING SYMBOLS AND CATEGORIES

Plus (+) or Minus (-)

The ratings from 'AA' to 'CCC' may be modified by the addition of plus or minus sign to show the relative standing within the major rating categories.

Numerical modifiers - 1, 2, 3

Moody's applies numerical modifiers 1, 2 and 3 in each generic rating classification from "Aa" through "Caa". The

modifier 1 indicates that the issuer is in the higher end of its letter rating category; the modifier 2 indicates a mid-range ranking and the modifier 3 indicates that the issuer is in the lower end of the letter rating category.

R

An obligor rated 'R' is under regulatory supervision owing to its financial condition, a period during which the supervisory regulators may have the power to favour one class of obligations over the others or pay some obligations and not the others.

SD and D

An obligor rated "SD' (Selective Default) or 'D' (Default) has failed to pay one or more of its financial obligations when it/ they came due.

Credit rating agencies assign a 'D' rating when they believe that the default will be a general default and that the obligor will fail to pay all substantially obligations as they come due. 'SD' rating is given when these rating companies believe that the obligor has selectively defaulted on a specific issue or class of obligations but it will continue to meet its payment of obligations on other issues or classes of obligations in a timely manner.

N. R.

An issuer designated N.R is not rated.

'Pi' rating definition

Ratings with "pi" subscript are based on an analysis of an issuer's published financial information as well as additional information in the public domain. They do not, however, reflect in-depth meetings with an issuer's management and are, therefore, based on less comprehensive information than ratings without 'pi' subscript. Ratings with 'pi' subscript are received annually based on a new year's financial statement. Outlooks

are not provided for ratings with a 'pi' subscript, nor are they subject to Potential Credit Watch listings.

Ratings with 'pi' subscript generally are not modified with '+' or '-' designations. However, such designations may be assigned, when the issuer's credit rating is constrained by sovereign risk or the credit quality of a parent company or affiliated group.

Outlook Rating

Rating outlook assesses the potential direction of a long-term credit rating over the intermediate to long term. In determining a rating Outlook, consideration is given to any changes in the economic and/or fundamental business conditions. An outlook is not necessarily a precursor of a rating change or future Credit Watch action.

· Positive means that a rating may be raised.
· Negative means that a rating may be lowered.
· Stable means that a rating is not likely to change.
· Developing means that a rating may be raised or lowered.
· N.M. means not meaningful.

Credit Watch

Credit Watch highlights the potential direction of short- or long-term rating. It focuses on identifiable events and short-term trends that cause ratings to be paced under special surveillance by the analytical staff.

These may include recapitalizations, voter referendums, and regulatory action or anticipated operating developments.

Ratings appear on Credit Watch when such an even or a deviation from an expected trend occurs and additional information is necessary to evaluate the current rating. A listing, however, does not mean a rating change is inevitable and, whenever possible, a range of alternative ratings will be shown. Credit Watch is not intended to include all ratings under review

and rating changes may occur without the ratings having first appeared on Credit Watch.

The 'positive' designation means that a rating may be raised; a 'negative' designation means that a rating may be lowered; and 'developing' means that a rating may be raised, lowered or affiliated.

Dual ratings definitions

Rating agencies assign 'dual' ratings to all debt issues that have a put option or demand feature as part of their structure. The long-term debt rating symbols are used for bonds to denote the long-term maturity and the commercial paper rating symbols for the put option.

'r'

This symbol is attached to the ratings of instruments with significant non-credit risk. It highlights risk to principal or volatility of expected returns, which are not addressed in the credit rating.

Examples include obligations linked or indexed to equities, currencies, or commodities, obligations exposed to severe prepayment risks.

Withdrawn

A rating is considered withdrawn when the agency terms the information submitted for rating as insufficient or in the cases when the obligation is matured, is called (or has a calling feature) or is refinanced.

Rating Alert

Fitch provides a similar rating to that of Standard & Poor's Credit Watch. Ratings are placed on Rating Alert to notify the investors that there is a reasonable probability of a rating change

and the likely direction of such a change. These are designated as:

"Positive", when indicating a potential upgrade;
"Negative' when designating a potential downgrade; or
"Evolving" if ratings may be raised, lowered or maintained.

Rating Alert is typically resolved over a relatively short period. Concluding this introduction and taking into account the Bank of Albania's objectives, the rise in the number and types of instruments where it may invest and the financial institutions it may co-operate to reach this end, is highlighted as a possibility. Knowing this language is necessary to read and understand credit ratings provided by these agencies for the majority of financial institutions worldwide, either banks or security companies. Knowing, using and updating them may be regarded as another possibility for successful management of credit risk relative to the Bank of Albania's managed reserve.

Other correspondent central banks use the services offered by these agencies depending on the criteria and information they require to have under disposal. However, the tendency of these banks is that they use credit rating services from at least two of these agencies.

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