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Investors value accuracy ahead of stability

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From Prof Stuart M. Turnbull and Mr Lee M. Wakeman.

Sir, When John Moody successfully re-entered the financial markets exactly 100 years ago, he offered investors detailed analyses of railroad securities and then summarised his conclusions with the now famous letter ratings. On this anniversary, we applaud Deven Sharma's intention to provide more information underlying a corporation's rating ("**Investors require consistency when it comes to credit ratings**", Insight, October 2), but wish that Standard & Poor's would include a specific time dimension in the rating process.

Corporate bond prices incorporate an implicit default term structure. This term structure is made explicit in the credit default swap market, with price quotes for one to 10-year protection. In general, these premiums rise as the maturity of the insurance contract increases from one to 10 years, reflecting an increased marginal annual probability of default. But there can be exceptions. For example, in December 2002, US dollar CDS default insurance premiums for Xerox senior debt (modified restructuring) were quoted as 18 per cent, 11.5 per cent and 10.5 per cent a year for one, three and five years respectively, reflecting the market's belief that if Xerox survived a difficult next year, it would have a much better chance of surviving for five years.

Mr Sharma states that "investors want credit ratings to be relatively stable". We believe that investors will value accuracy more highly than stability since, as conditions in the economy change, survival probabilities change. Standard & Poor's annual default tables show this quite clearly; defaults from lower rating grades in bad years can be four times higher than defaults from the same grades in good years.

If the rating agencies published, and kept current, term structures of survival probabilities, investors would be able to compare directly the risk of default for various maturities across corporate and municipal bond markets.

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