

Primary Credit Analysts:

Thomas G Connell
Toronto
(1) 416-507-2501
thomas_connell@
standardandpoors.com

The Role Of Credit Ratings In Corporate Governance

Collectively, the directors of a corporation exercise oversight responsibilities that encompass strategy development, operations, financing activities, human resource management, governance and disclosure practices, and many other dimensions of corporate performance. An essential feature of the director's role is to ensure that acceptable risks are assumed and managed appropriately as part of overall corporate strategy implementation. Risk awareness is at the core of virtually every board activity.

Credit ratings are in essence a risk management tool. The purpose of this article is to highlight a number of different ways in which directors can use this tool to improve the quality of the oversight they conduct in the execution of their board responsibilities. Board members with finance backgrounds may have extensive experience with ratings, while other board members may not be as familiar with them. As described below, there are many instances in which ratings are highly relevant to discussions between board members and company management. This dialogue is most effective if there is a shared understanding of the nature of credit ratings, their functionality, and their limitations.

The first section of this article deals with what a director should know about the rating on the organization of which he or she is a director. The second section focuses on using ratings to understand external credit risks acting on the organization. An appendix includes a selection of questions that can be used to expand the dialogue between directors and corporate managers. This article is intended to promote awareness of useful ways that corporate directors can incorporate readily available and highly relevant ratings information into their decision-making.

What Is A Standard & Poor's Credit Rating?

Before getting into the discussion, it is appropriate to define a credit rating, as provided by Standard & Poor's Ratings Services. (Credit ratings provided by other organizations are broadly similar, although they may differ in some potentially significant respects.) A Standard & Poor's credit rating is a current

Publication Date

Sept. 7, 2006

forward-looking opinion of an obligor's capacity to pay its general financial obligations as they come due (an issuer credit rating), or of its capacity to fulfill the terms of a specific financial obligation (an issue credit rating) (see note 1). Credit rating opinions are expressed using a ratings spectrum or scale ranging from 'AAA' to 'D', which describes creditworthiness relative to other issuers rated on the same scale. Separate rating scales relate to long- and short-term analytical perspectives. Ratings comment on the likelihood of timely payment of principal and interest, and are thus focused on default risk (Standard & Poor's recovery ratings address expectations of post-default recoveries or losses). Ratings are subject to ongoing analytical surveillance, and are adjusted up or down to reflect changes in an issuer's perceived creditworthiness as appropriate.

A rating analysis seeks to incorporate many dimensions of risk that determine a company's creditworthiness; these include commercial and operational risks, considerations of corporate and industry structure, regulatory arrangements and other public policy factors, overall strategy and management effectiveness, along with a financial analysis of historical performance, current position, and outlook. In addition to the assignment of a rating symbol, ratings coverage includes commentary that explains the rating, ongoing reporting that discusses changes to the rating that may occur as circumstances warrant, and additional commentary on industry conditions and topical themes. Ratings are disseminated to capital markets participants who assimilate ratings information into their understanding of an issuer. These participants may be bond investors and other creditors, but equityholders and other stakeholders may also take an interest in ratings.

Corporate Directors And The Company Rating

This section addresses issues relating to the rating on an organization. These are issues about which directors should be well informed because they may tie directly to considerations of risks borne by the company, and to financing the company's strategy.

Most often an organization arranges and maintains ratings coverage to enable ongoing financing activities. Traditionally this has focused on the execution of bond and commercial paper issuance, but ratings coverage encompasses a broad field and also enables issuance of securities such as preferred shares, secured bank loans, hybrid instruments, structured investment products, and even income trust units. The capital markets can be accessed more readily with a rated transaction because the rating and supporting analysis help them come to a view of credit-oriented transaction risks, and the rating may be required to satisfy the investor's risk exposure guidelines. As a general rule, higher ratings entail a lower risk premium, broader market access, and an overall lower cost of funds. Lower or more volatile ratings entail a higher relative cost of financing (although this cost is likely still below the cost of going to the market with an unrated transaction).

The rating assigned to a company has implications for the financing avenues open for that issuer. The following table provides some indications of relative market access based on market observations:

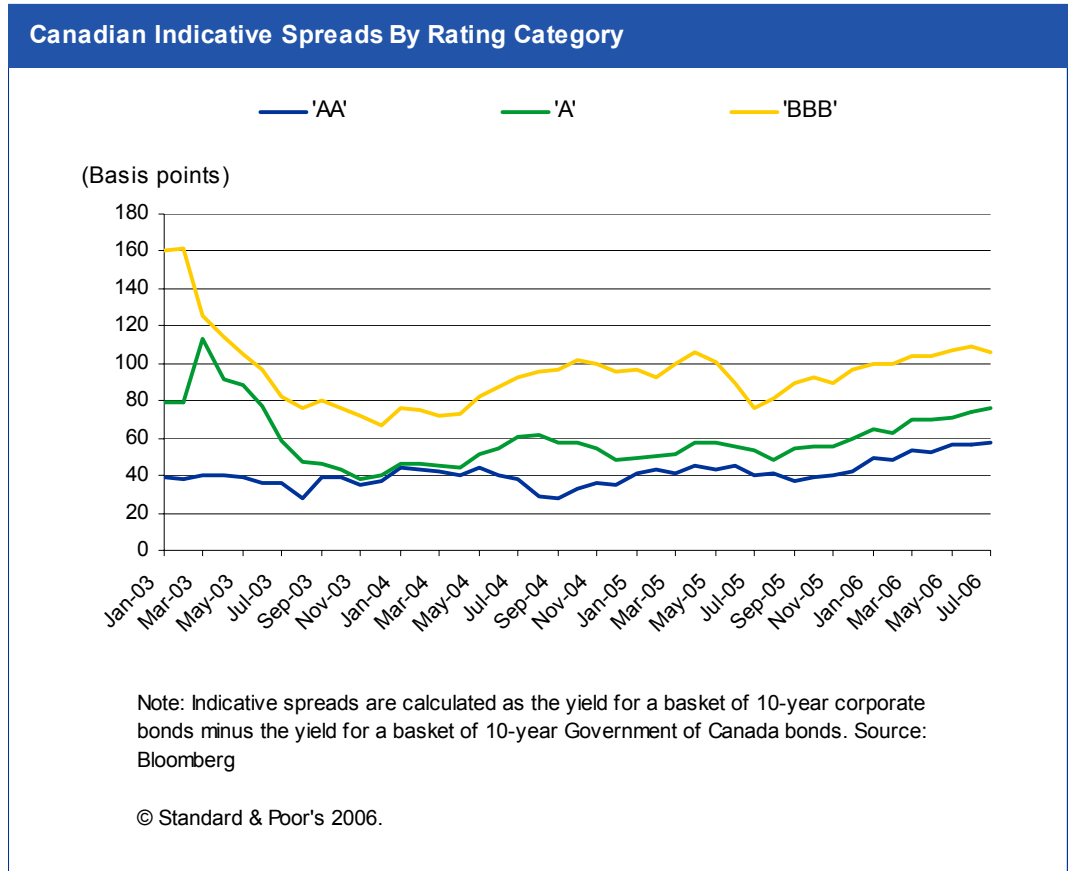
| Indicative Current Market Access For Canadian Issuers | | | | |
|--|--|--|---|--|
| By rating level and financial instrument | | | | |
| | 'BB-' and below <i>Low to Middle Speculative Grade</i> | 'BB' to 'BBB -' <i>Borderline Speculative/Investment Grade</i> | 'BBB' to 'A+' <i>Middle Investment Grade</i> | 'AA -' to 'AAA' <i>High Investment Grade</i> |
| Bonds | Access to U.S. or private placement markets | Access to U.S., private placement, and possibly public Canadian markets (short maturities) | Access to public Canadian market for long maturities, as well as to crossborder markets | Strong access to Canadian and crossborder markets |
| Commercial Paper | Minimal access to CP market | Minimal access to CP market | Graduated access to domestic and other markets | Extensive access to domestic and other markets |
| Bank Loans | Access to secured loan market | Access to secured loan market | Strong domestic access on unsecured basis | Very strong domestic access on unsecured basis |
| Preferred Shares | Minimal access to Canadian preferred market | Minimal access to Canadian preferred market | Graduated access to Canadian market | Extensive Canadian market access |

© Standard & Poor's 2006.

It should be noted that the accessibility of different financing channels tends to ebb and flow in response to an array of relevant variables, such as the debt maturity being offered in light of interest rate expectations, the anticipated liquidity of a given issue, and overall market sentiment toward a particular issuer or sector.

As transparent risk benchmarks, ratings help investors define and manage their risk allocations. In this manner, ratings are an important reference in the market pricing of risk. Chart 1 quantifies the interaction between rating levels and funding costs. This chart shows that the market pricing of risk is a dynamic process and that the risk premium embedded within borrowing costs at each rating level is continually being re-evaluated (see note 2). For a company's directors, understanding the relationship between ratings and the market pricing of risk is a prerequisite for reaching conclusions about the feasibility of a borrowing program, and about the overall ability to finance corporate strategy implementation. It is worth pointing out there have been many historical intervals in which credit spreads (that is, the risk premium over a benchmark risk-free issue) have exhibited more dispersion and more volatility than are represented in the period described by chart 1; the current market conditions favorable to issuers should not be taken for granted.

Chart 1



Ratings' influence extends to other financial contracts

Looking more broadly, we note that ratings frequently influence the terms on which organizations can execute financial counterparty arrangements such as hedges and other financial contracts, long-term commodity contracts, and leases. An organization's rating level will often dictate whether it needs to post security for such transactions, or whether it can find willing counterparties at all.

Depending on the level of the rating and in conjunction with prevailing market conditions, certain financing options will be open to an organization, while others will be precluded. Awareness of the organization's current credit standing, and understanding the commensurate scope of financing options available (for a given rating level) are highly germane to a director's oversight of corporate strategy implementation. The well-established connection between ratings and the market pricing of risk underscores the relevance of ratings to many strategic corporate decisions.

Because ratings often influence the range of financing options available, the director may take an interest in how corporate executives are managing the organization's credit profile and, by implication, the ratings. Many rating-relevant factors are largely beyond the control of management (in the short term in particular), such as the businesses the company is in, the markets in which it operates, and the age and condition of its assets. Other variables are clearly under management control, such as strategic risk appetite, rate of diversification or expansion, capital structure, and dividend payout strategy. The ratings on an organization are informed by an appraisal of these and other factors, both under management control and otherwise. By acquainting themselves

with the rating commentary on the organization, as well as with management's reporting on rating agency discussions, directors can incorporate a current understanding of the organization's credit standing into their ongoing appraisal of the risks and feasibility of their organization's strategy.

Beyond considerations of access to financial markets, ratings are a source of information on an organization's overall credit risk profile, particularly as compared with peer organizations from a benchmarking perspective. Directors may use this information to consider risk in absolute terms, such as the company's use of leverage, or credit risk relative to peer organizations. The reasons that a peer might be rated higher or lower than the organization reflect a combination of the organization's inherent attributes and its deliberate strategic positioning, either of which should be of interest to directors.

Ratings continuity and feedback provide advantages

Ratings are not static measures, and directors might be particularly interested in recent or prospective changes to the rating on the organization. Ratings are changed as appropriate to ensure they provide a reasonable ongoing reflection of the organization's risk profile and expected future performance. Rating changes may reflect a response to market conditions, the actions of competitors and other external parties, or developments within the organization. In any case, these changes provide coherent feedback to directors on the relative position of the company and the results of its management and execution, along with related implications for continuing market access. This feedback is "coherent" because, unlike share or bond price movements for example, a rating change will have explicitly stated cause and effect and there is a continuity to the ratings coverage narrative over time. In contrast, the "noise" of financial markets can obscure the interpretations of share price or credit spread movements. And instead of waiting for the next rating action, an organization can opt to discuss with the ratings analysts, in confidence, the potential ratings impact of strategic options before any steps are taken. Ratings feedback on strategic corporate options is available on an informal basis, as well as within a formal framework to highlight anticipated rating outcomes for strategic options under board consideration.

Rating changes are significant to the rated issuer because they can have implications for future market access and hence execution of financing strategies, or the terms on which financing can be obtained. In certain instances, the preservation of ratings at a particular level may be viewed by a company as critical to successful strategy implementation, and potentially an intrinsic part of the company's business model. Rating changes may also have an effect on an issuer's liquidity position should the rating changes trigger collateral provisions in counterparty agreements, for example. In some cases, liquidity difficulties can severely compound underlying challenges an issuer may be experiencing. (Rating analytics attempt to factor-in disproportionate and recursive exposure to prospective rating changes.)

Directors should also recognize that there are limits to the significance of the feedback embodied in the ratings. Directors and managers need to implement strategies that optimize outcomes across a wide range of stakeholders, with obvious emphasis on equityholders as a primary constituency. Ratings are provided primarily as an opinion on the credit risks that bondholders and other creditors assume in taking on exposure to the organization. While a high rating might secure advantageous debt funding costs and other benefits, it likely imposes economic costs arising from, for example, an overall higher proportion of balance-sheet equity consistent with the high rating. For many companies, an efficient or optimal rating is one that is sustainable across a range of future scenarios, that preserves cost-effective access to debt markets, and that employs financial leverage in a way that will allow the company to meet the evolving expectations of equityholders. The question of an optimal rating can only be addressed by the board and management taking into account the circumstances of a given company and the board's risk tolerance. It is not unusual for a corporation to identify a

particular rating level that it will seek to maintain as part of a multidimensional scorecard of corporate performance. But the target rating should not be viewed as a desirable objective for its own sake. Ultimately, the most appropriate approach is to operate for the good of the business as the board and management see it, taking a pragmatic view of the role of ratings in the issuer's strategic positioning.

Corporate Directors, Counterparty Risks, And Ratings

In addition to the information that ratings can tell a director about his or her own organization, they can also serve to characterize and reflect its external risk exposures and tolerances. Directors have a role in understanding, confirming, and supervising the organization's risk exposures and management, and should have a clear understanding of the functionality of ratings in this respect.

There are a number of categories of exposure for which the credit risk dimension can be reflected in counterparty or instrument ratings. These include:

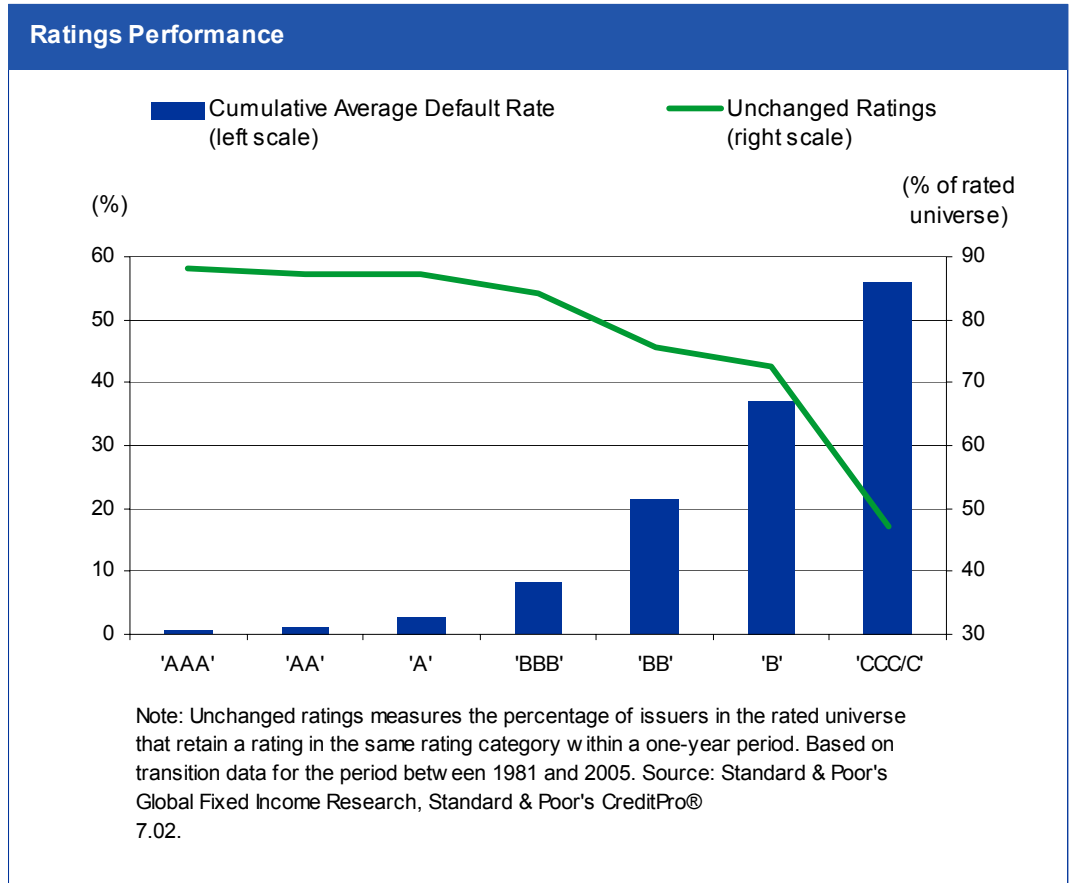
- Fixed income portfolios;
- Financial contract counterparties;
- Long-term off-take or commodity purchase/sale agreements;
- Trade counterparties (major suppliers and customers);
- Tenants and leaseholders;
- National and local government ratings for plant siting or inward investment decisions; and
- Financing structures established for risk-transfer purposes.

If we delve further into the risk management landscape, ratings are a relevant diagnostic for structured efforts to manage or reallocate risks. This might pertain to risks associated with hedging programs for interest rates, currencies, etcetera, as well as risk transference via synthetic securities, such as for financial institutions in light of capital relief under capital adequacy guidelines applied to rated exposures.

Credit exposure policies are an important element of an enterprise risk management framework. Such a framework typically incorporates clear exposure limits, reporting requirements, channels for approvals and exceptions, requirements for security commitments or capital allocations commensurate with credit risk assumed, and the specification of roles and responsibilities encompassing corporate staff, management, and board members.

The usefulness of ratings in these situations is based on the information they provide in terms of probability of default and other business impacts (such as losses) arising from credit defaults or other related forms of non-performance such as the failure of a commercial counterparty. Historical information on ratings transitions and default rates provides ongoing validation for the effectiveness of ratings as a predictor of default. Chart 2 illustrates the cumulative default probabilities associated with different credit rating grades, based on transition data for the period between 1981 and 2005.

Chart 2



The methodological framework used to assign ratings is not static. In fact, rating methodologies are continually evolving to adapt to the changing business and operating environments faced by companies. There is a continuity of purpose, however, as ratings are assigned to assess the relative credit strength of borrowers. For this reason, default frequencies by rating category show substantial consistency over time.

Bond portfolios and ratings

One of the most widespread applications of ratings as a risk management tool is to define the credit risk exposure limits for a bond portfolio. An investment policy indicates what proportion of the portfolio could consist of securities with a particular rating level. Typical Canadian pension investment guidelines set eligible investment thresholds within either the 'A' or 'BBB' rating categories. The purpose of such a policy is to limit the losses due to credit defaults to an acceptable level, while allowing the board to evaluate fund manager performance with reference to the quantity of credit risk assumed (pre-empting any temptation to the fund manager to improve performance by simply assuming excessive risk).

There is no single correct answer for exactly where portfolio credit risk tolerances should be set. To a great extent, they will be a function of an organization's overall investment objectives, and the company's experience managing credit exposures and incurring or avoiding losses. The annually updated ratings default and transition studies from Standard & Poor's can assist an organization that is approaching default exposure tolerances quantitatively (see commentaries "Annual 2005 Global Corporate Default Study And Rating Transitions"

published Jan. 31, 2006, and "Canadian Ratings Performance 2005: Scarcity Of Defaults Persists" published April 26, 2006, on RatingsDirect). By examining the cumulative default and transition performance of respective rating categories over economic and credit cycles, boards can make informed decisions about suitable investment thresholds. Ultimately, investment policy decisions will reflect a risk-return trade-off dictated by the objectives of the organization in the context of the market environment.

Rating-oriented investment policies can refer to one or to multiple ratings providers. Policies that refer to a rating from a single source have the benefit of comparability of risk levels across different investments. The downside of this approach is that it excludes from formal consideration in the investment decision the significance of other rating perspectives that may be available. On balance, investment decisions benefit if more sources of risk information are considered in the decision process (see note 3). It is not uncommon, however, for rating agencies to arrive at different rating opinions on the same transaction. A requirement that a security have two or more ratings that meet a stated threshold can help to ensure that the embedded risk of a portfolio is not understated. An investment policy that considers more than one rating subjects the issuer to additional scrutiny and analysis, and provides the investor with the benefit of a second opinion. Requiring two or more ratings on an eligible investment also reduces the opportunity for an issuer to furnish only the rating that puts it in the most favorable analytical light.

A common fallacy

Although ratings from different rating agencies may be analogous to some degree, it is a fallacy to assume that they are directly comparable. Ratings from different sources differ with respect to basic rating symbols and definitions, analytical criteria, sector- and issuer-specific analytical judgments, and historical ratings transition performance.

There are some analytical issues on which rating agencies differ dramatically. This would occur where different approaches are used on specific ratings criteria questions, such as: requirements for liquidity backup; credit given to a bankruptcy remote special-purpose vehicle to isolate issuer cash flows; or the credit implications of holding company structures. The extent of the resulting ratings divergence may not be apparent at all, because an issuer might choose to avoid one or more rating agencies known to take a more conservative approach with a particular risk factor relevant to that issuer. As a result, it is possible that the same issuer would get an "eligible" rating from one rating agency, while another rating agency would assign a much lower rating (had it been asked to do so). The board should give careful consideration to what constitutes investment policy compliance in light of different rating agency approaches to certain fundamental credit risk factors.

In light of complexities arising from single ratings, split ratings, or dynamic ratings, an effective investment policy should place an emphasis on the exercise of informed judgment on the part of the investment manager. There is an onus on the investor to exercise good judgment in comparing in-house views with ratings-related risk analytics, taking appropriate account of differences between rating agency methodologies. Investment programs are best served when rating agency analysis supplements in-house efforts rather than being viewed as a substitute for those efforts. Standard & Poor's publishes extensive rating criteria documentation, and annual ratings performance studies that will allow boards to make appropriate decisions about the confidence that can be placed in ratings from Standard & Poor's.

Reasons For Board Members To Stay Informed

Some boards are extremely well informed about the ratings on their own organizations, as well as the policies used to manage external credit exposures. But for many boards, ratings issues are viewed as technical matters of

concern to the CFO, treasurer, or investment staff. While day-to-day management of ratings and credit issues is best left to finance and investment staff, a board member has many compelling reasons to develop an understanding of the nature of ratings, and how they apply or are used by his or her own company. This acknowledges:

Ratings can provide a clear indication of the ability of a company to attract capital, as a fundamental requisite for continuing corporate strategy execution;

- Ratings can provide dynamic feedback to a board with respect to the impact of external developments on the company;
- At a strategic level, the company may undertake to manage its credit profile to optimize variables such as funding cost and use of leverage to enable long-term attainment of strategic goals; and
- Ratings are an effective source of information on investment and counterparty credit exposures, but should supplement and not replace thoughtful judgment and oversight of risk exposures and tolerances.

Thoughtful attention to the ratings on a company, its counterparties, and its investments will provide board members with an enhanced understanding of risks critical to the continuing success of the organization and its strategy.

Notes

Note 1

Ratings are opinions, and therefore should not be regarded as verifiable statements of fact, and Standard & Poor's does not perform an audit in connection with any credit rating. Credit ratings do not comment on the market price of a security or its suitability for any investor; accordingly, ratings are not recommendations to purchase, sell, or hold a financial obligation. In general, credit ratings are requested by issuers, and are based on current information furnished by the obligors or obtained by Standard & Poor's from other sources it considers reliable. (For a more detailed description, please see "Standard & Poor's Ratings Definitions".)

Note 2

The effect of rating agency announcements on bond prices is a research topic that has historically received much attention. Some of the more recent literature focuses on the linkage between ratings announcements and the effect on the credit default swap market. The Bank for International Settlements published a useful summary of this topic in an article titled "The price impact of rating announcements: evidence from the credit default swap market", BIS Quarterly Review, June 2004.

Note 3

The vast majority of Canadian financial market participants prefer securities to be rated by more than one rating agency. Indeed, more than 99% of the market value of bonds meeting non-ratings eligibility criteria for the S&P/TSX Canadian Bond Index portfolio are rated by two or more rating agencies. A comparison of rating agency coverage, however, reveals that only one-quarter of these bonds (on a market value basis) have been assigned ratings that are nominally equivalent. The majority of securities, therefore, receive different ratings treatment by each agency and typically the difference between agencies is one or two rating notches.

Seven Ratings-Related Questions That Directors Can Ask Their CFO Or Treasurer

1. What ratings have been assigned to our company, and what are the top concerns highlighted by each of the ratings teams that cover us?
2. What ratios are rating agencies focused on most closely, and what are some identified trigger points that would lead to a rating upgrade or downgrade?
3. How much tolerance on key variables (leverage, profitability, acquisitions, project management) is built-in to our ratings?
4. Is there any divergence in views among different rating agencies (including any that might not have relationships), or between ratings and market sentiments?
5. What is the appropriate rating to balance shareholder objectives, effective execution of plans, cost of equity, and manageability of financial risks?
6. How would our business model and/or strategy implementation be affected by a rating downgrade?
7. Is there currently any information that will surprise the rating agencies once we disclose it to them?

Seven Ratings-Related Questions That Directors Can Ask Their Chief Investment Officer

1. How are credit ratings incorporated in our investment policy guidelines, and how does our in-house analytical work factor-in rating agency analytics?
2. What is the analytical basis for our current eligible investment rating threshold; what is the resulting degree of default risk incorporated in our portfolio?
3. Based on the ratings distribution of our current holdings, what level of defaults should we expect in a credit cycle downturn?
4. How does our investment process handle issuers which, based on internal research, we feel are over- or under-rated by the rating agencies?
5. Have we established in-house positions on certain credit risks that may be approached in distinctly different ways by respective rating agencies?
6. Are there portions of our bond or money market portfolio that are covered with only a single rating, and does this reflect any underlying analytical considerations?
7. Do we have a consistent process for handling split ratings in our eligible investment framework?

Published by Standard & Poor's, a Division of The McGraw-Hill Companies, Inc. Executive offices: 1221 Avenue of the Americas, New York, NY 10020. Editorial offices: 55 Water Street, New York, NY 10041. Subscriber services: (1) 212-438-7280. Copyright 2006 by The McGraw-Hill Companies, Inc. Reproduction in whole or in part prohibited except by permission. All rights reserved. Information has been obtained by Standard & Poor's from sources believed to be reliable. However, because of the possibility of human or mechanical error by our sources, Standard & Poor's or others, Standard & Poor's does not guarantee the accuracy, adequacy, or completeness of any information and is not responsible for any errors or omissions or the result obtained from the use of such information. Ratings are statements of opinion, not statements of fact or recommendations to buy, hold, or sell any securities.

Standard & Poor's uses billing and contact data collected from subscribers for billing and order fulfillment purposes, and occasionally to inform subscribers about products or services from Standard & Poor's, our parent, The McGraw-Hill Companies, and reputable third parties that may be of interest to them. All subscriber billing and contact data collected is stored in a secure database in the U.S. and access is limited to authorized persons. If you would prefer not to have your information used as outlined in this notice, if you wish to review your information for accuracy, or for more information on our privacy practices, please call us at (1) 212-438-7280 or write us at: privacy@standardandpoors.com. For more information about The McGraw-Hill Companies Privacy Policy please visit www.mcgraw-hill.com/privacy.html.

Analytic services provided by Standard & Poor's Ratings Services ("Ratings Services") are the result of separate activities designed to preserve the independence and objectivity of ratings opinions. Credit ratings issued by Ratings Services are solely statements of opinion and not statements of fact or recommendations to purchase, hold, or sell any securities or make any other investment decisions. Accordingly, any user of credit ratings issued by Ratings Services should not rely on any such ratings or other opinion issued by Ratings Services in making any investment decision. Ratings are based on information received by Ratings Services. Other divisions of Standard & Poor's may have information that is not available to Ratings Services. Standard & Poor's has established policies and procedures to maintain the confidentiality of non-public information received during the ratings process.

Ratings Services receives compensation for its ratings. Such compensation is normally paid either by the issuers of such securities or by the underwriters participating in the distribution thereof. The fees generally vary from US\$2,000 to over US\$1,500,000. While Standard & Poor's reserves the right to disseminate the rating, it receives no payment for doing so, except for subscriptions to its publications.

Permissions: To reprint, translate, or quote Standard & Poor's publications, contact: Client Services, 55 Water Street, New York, NY 10041; (1) 212-438-9823; or by e-mail to: research_request@standardandpoors.com.