# What the ratings agencies are really good at

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The Global Financial Crisis was a disaster for ratings agencies such as S&P and Moody's – and for the thousands of investors who relied on their ratings on CDOs and other complex securities. So much so, that many commentators now dismiss their work as totally lacking credibility.

However, this overlooks the fact that over the course of the GFC, the heart of the ratings agencies business – assessing the credit worthiness of companies – performed magnificently.

To make this assessment, I compared average historical failure rates for companies with various ratings with the five-year failure rates of companies post 2006. I used the 5-year failure rates because it gives a better indication of the rating agencies predictions – can they forecast a failure just before it happens, or can they predict likely failure rates years in advance? Clearly the later is a much better result for investors.

Given that a credit rating is an assessment of how likely a company is to fail – not whether it WILL fail – what we should expect to see from a high-quality ratings approach are failure rates that steadily increase as ratings become lower. Ideally, actual failure rates should be consistent with past failure rates, or even somewhat higher than average given that 2006 to 2011 was an unusually stressful period economically.

And that's exactly what we see. Running down the list of five-year failure rates from 2006 to 2011 in Figure 1 below, we see a steady increase. Each step down in ratings saw a step up in failures. Furthermore, the quantum of failures was remarkably consistent with the long-run averages.

In a way, this is quite remarkable. The agencies – Moody's, in this case – effectively predicted in 2006 how likely failure was for a whole range of different companies over the next five years, and broadly got it right.

Far from being hopeless, the ratings agencies do a wonderful job of assessing companies.

## Figure 1: Moody's company ratings – forecast failure vs actual

| Original rating | Cumulative five-year failure rate (avg) | |
|---|---|---|
| | 1970 – 2006 | 2006 – 2011 |
| Aaa | 0.1% | 0.0% |
| Aa | 0.3% | 0.2% |
| A | 0.7% | 1.3% |
| Baa | 1.6% | 2.1% |
| Ba | 8.3% | 8.9% |
| B | 22.1% | 20.3% |
| Caa_C | 35.3% | 37.5% |
| Inv Grade | 0.9% | 1.3% |
| Spec Grade | 18.9% | 19.4% |

Source: Moody's, farrelly's analysis.

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