How rating agencies read Europe's DEBT CRISIS

The credit rating agencies came under critical scrutiny during the debt crisis. OWAIN GWILYM looks more closely at the story behind the headlines.

The recent European debt crisis triggered increased attention on the credit rating agencies (CRAs). Criticism of them focused on a perception that downgrades of European sovereigns led to unjustified higher borrowing costs and worsened the crisis. Others might argue that CRAs' actions lagged behind market indicators.

Recent changes to the regulation of CRAs have sought to address lack of transparency and competition in the rating industry, conflicts of interest and rating shopping. Perhaps most importantly, there was a perceived over-reliance on credit ratings, leading to mechanistic market reactions.

The independence of CRSs is critical to their credibility in the financial markets, and market discipline has been their preferred means to be monitored. However, a formal European Union regulation in December 2009 brought all CRAs operating in the EU under legally binding rules.

Responsibility for their oversight now rests with the European Securities and Markets Authority (ESMA) whose most recent report identifies progress by CRAs in meeting regulatory requirements on integrity, transparency and disclosure of methodologies. ESMA believes that improvements are still necessary in the areas of conflict of interest, application and presentation of rating methodologies, the monitoring of ratings, and the reliability of IT infrastructures.

Most attention on CRAs during the European debt crisis focused on sovereign ratings. These represent assessments of the ability and willingness of governments to meet their financial obligations, have a strong influence on borrowing costs, and are an important stimulus for enhancing the capability of governments and private sectors to access global capital markets.

> "THE DEBT CRISIS REPRESENTED A SIGNIFICANT CHALLENGE TO CREDIT RATING AGENCIES IN DECIDING THE TIMING AND EXTENT OF DOWNGRADES TO SOVEREIGN AND BANK RATINGS."

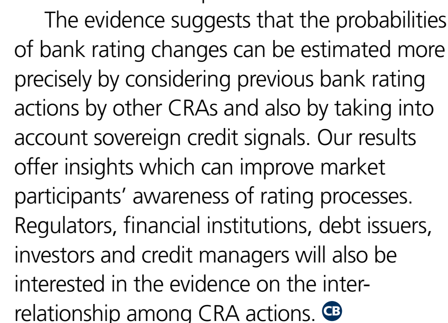
One focus for recent research at Bangor Business School is the link between sovereign ratings and bank ratings. Sovereign ratings typically represent a ceiling for the ratings assigned to corporates and financial institutions within a given country.

There have been close interconnections between financial institutions and sovereigns during the financial crisis. The deterioration in European sovereign creditworthiness had an adverse impact on banks' funding costs and market access, including for banks in France, Germany and the UK.

Many banks were heavily exposed to the sovereign debt of their own country. For example, the exposure of Greek banks to Greek sovereign debt represented 212 per cent of their Tier 1 capital in 2011, while in Italy, Portugal and Spain, the equivalent figures were 161 per cent, 130 per cent and 152 per cent. There are several channels through which sovereign risks affect bank risks, including direct losses on sovereign debt holdings, lower collateral values for wholesale and central bank funding, reduced benefits that banks derive from government guarantees and lower bank ratings.

On the latter point, there are examples where the CRAs explicitly link bank downgrades with prior sovereign rating actions. For example, when Moody's downgraded 28 Spanish banks' ratings on 25 June 2012, they stated that the "actions follow the weakening of the Spanish government's creditworthiness, as captured by Moody's downgrade of Spain's government bond ratings … on 13 June 2012".

The debt crisis represented a significant challenge to CRAs in deciding the timing and extent of downgrades to sovereign and bank ratings – for example, establishing the influence of explicit and implicit government guarantees to countries' banking sectors. CRAs



dealt with the issues differently, leading to differences in the timing of rating actions and a preponderance of split ratings (differences of rating opinion across CRAs). Among the themes addressed in our research, we assess the reaction of bank ratings to sovereign credit signals and analyse the lead-lag relationship in bank ratings across CRAs.

During 2006-2012, average ratings for leading European banks were lower than the average sovereign ratings by at least two notches on the rating scale, with more than 83 per cent of the daily bank ratings observations below the sovereign ceiling. We observe differences in opinion and timing of bank and sovereign rating actions across CRAs, with Moody's (S&P) broadly tending to be the most generous (harshest) CRA.

The research shows that bank ratings are frequently constrained by the sovereign ceiling, thus highlighting the importance of sovereign ratings for banks. Differences are identified across the CRAs in their policies regarding the attachment between sovereign and bank credit actions. We find that multiple-notch sovereign downgrades by S&P have the strongest impact on bank rating downgrades. Banks in Greece, Italy, Portugal and Spain are more affected by sovereign credit signals than banks in other European countries. This is consistent with the situation that the exposures of banks in these four countries to the sovereign debt of their own country were very substantial.

Further, we find evidence of interdependence in bank rating actions across CRAs. Banks which are downgraded by one CRA have a significantly increased probability to experience harsher (more than one-notch) subsequent downgrades by one of the competing CRAs. S&P shows the greatest tendency to be a 'first mover' in bank downgrades. Moody's is more cautious but can then take decisive action, as evidenced by its frequent use of multiple-notch downgrades. There are differences in rating policy with Moody's applying greater rating stability than the other leading CRAs. Different users of ratings will have different preferences across these different CRA policies.

The evidence suggests that the probabilities of bank rating changes can be estimated more precisely by considering previous bank rating actions by other CRAs and also by taking into account sovereign credit signals. Our results offer insights which can improve market participants' awareness of rating processes. Regulators, financial institutions, debt issuers, investors and credit managers will also be interested in the evidence on the inter-relationship among CRA actions.

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