A HIDDEN influence?

OWAIN ap GWILYM provides insight on the potential negative consequences of unsolicited sovereign ratings.

Events during the global financial crisis triggered increased attention on the major international credit rating agencies (CRAs). The industry is dominated by Fitch Ratings, Moody's Investors Service and Standard & Poor's (S&P). Numerous criticisms have been levelled at these CRAs' influence in financial markets, including a perception that downgrades of European sovereign debt worsened the Eurozone crisis.

ADDRESSING THE ISSUES

EU regulatory changes have sought to address the credit rating industry's perceived lack of transparency, lack of competition and conflicts of interest. Within Europe, oversight of the credit rating industry now rests with the European Securities and Markets Authority (ESMA).

Unsolicited ratings are one of the most controversial features of the credit rating business. These are ratings which the CRA decides to release, i.e. without the involvement of the debt issuer. In contrast, in the case of a solicited rating, the debt issuer pays the CRA for the rating service. Academic research finds that these banks and these corporates which are rated on an unsolicited basis have significantly lower ratings than they would achieve if they solicited the rating.

Concerns exist that unsolicited ratings are biased downward because CRAs are not compensated for their service and therefore rate the issuers on a more conservative basis. This is worthy of attention, because both solicited and unsolicited ratings have been permitted for some regulatory uses. This is especially a concern when it is unclear whether a rating has solicited or unsolicited status.

RATINGS IN PRACTICE

Recent research at Bangor Business School has linked three features of credit rating practice. First, one impact of the new EU regulatory regime was to reveal which governments' ratings are produced under solicited and unsolicited arrangements. Second, does the well-known downward bias of unsolicited ratings apply at the government level? This question has not been considered in prior academic research. Third, there exists a ceiling effect whereby bank ratings very rarely exceed the rating of their sovereign government (termed the sovereign rating ceiling effect). For most countries (but not USA), banks are much more likely than corporates to be rated equal to, or near, the sovereign ceiling level.

These three features interact to generate a crucial question for banks: does the conversion of a sovereign rating to unsolicited status induce lower bank credit ratings than would otherwise prevail if the government engaged with the CRA on a solicited basis? Historically, many developed country sovereign ratings were at the top AAA level, which would perhaps have limited the importance of this question. However, in the current post-crisis global economy, many developed countries' government debts are rated below the top level. In this scenario, bank ratings in a wide range of countries can potentially be affected by downward-biased unsolicited sovereign ratings. (See fig 1).

Fig 1: Examples of S&P sovereign ratings below AAA (at 1 June 2016):

Austria AA+	**Belgium** AA	**China** AA-	**Finland** AA+	**France** AA
Ireland A+	**Italy** BBB-	**Japan** A+	**Spain** BBB+	**USA** AA+

WEIGHING UP RISKS

For banks, sovereign debt ratings are important in several respects. Many rating actions on banks are closely attached to the rating actions on the sovereign's debt. One can observe many recent cases e.g. in Brazil, Ireland, Italy, Russia and Spain. 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 from government guarantees and lower bank ratings.

The close interconnections between banks and sovereigns were prominent in the financial crisis period and many policy and regulatory changes have aimed to reduce the potential for sovereign-bank contagion effects. The Bank for International Settlements recently showed that a large proportion (30%) of the spread on bank bonds (between the bond yield and the swap rate of similar maturity) reflected the conditions of the sovereign.

The research underlying this article draws from events where S&P converted the status of sovereign ratings to unsolicited. This predominantly occurred in February 2011, shortly after the EU's disclosure requirements were implemented. The research involved 147 S&P-rated banks incorporated in 42 countries (13 with unsolicited sovereign ratings and 29 with solicited sovereign ratings) to investigate the consequences of such conversions.

These banks are located in Europe, Asia-Pacific and Latin America. Around 20% of the bank ratings are equal to the sovereign rating and very few are above this ceiling. In considering the potential impact of unsolicited sovereign ratings, the research strongly endeavours to rule out the possibility of sample selection bias or that any observed phenomenon arises from events other than the adoption of EU disclosure rules for CRAs. (See fig 2).

THE IMPACT AND IMPLICATIONS

The research results strongly suggest that the disclosure of unsolicited sovereign status adversely influences bank ratings through the sovereign rating ceiling effect. Banks in countries converted to unsolicited status are more likely to be downgraded and less likely to be upgraded compared with banks in sovereigns which retained solicited ratings at all times. A reduced information flow from governments under the unsolicited status might justify lower sovereign ratings. Nevertheless, such an effect has a potential negative impact on the funding costs of banks in that country. Therefore, banks could face a financial penalty arising from their government's decision not to solicit a credit rating.

This seems to be a counter-productive approach by governments because any negative impact on bank ratings will inevitably influence funding and lending practices and therefore the wider economy. The cost for a government to solicit a rating is minimal relative to such potential for negative economic outcomes. Banks should also consider whether their international counterparties' rating levels are affected by an unsolicited sovereign rating.

These findings have policy implications for regulators and banks, since there are potential costs to the institutions and the wider economies through this rating ceiling effect. There is an apparent unforeseen consequence of regulation, which suggests a need for greater awareness of CRAs' methods when designing future regulation. Policymakers should take a closer look at unsolicited sovereign ratings and their implications.

Fig 2: S&P sovereign ratings with status converted to unsolicited:

2011: Argentina, Australia, Belgium, Cambodia, France, Germany, India, Italy, Japan, Netherlands, Singapore, Switzerland, Taiwan, UK, USA.		
2013: Turkey	**2014:** Portugal, Sweden	**2015:** Saudi Arabia
All other S&P sovereign ratings had solicited rating status as at November 2015.		

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