A highly relevant BAROMETER

Since the financial crisis, policy-makers and regulators have sought to weaken the contagious effects of the close inter-connections between banks and sovereigns. OWAIN ap GWILYM discusses the impact on the way ratings agencies assess creditworthiness.

Recent events, including the ongoing Eurozone debt crisis, have focused increasing attention on the major international credit rating agencies (CRAs) – a sector dominated by Fitch, Moody's and Standard & Poor's. Numerous criticisms have been leveled at the influence of these CRAs in financial markets, including a perception that downgrades of European sovereign debt worsened the Eurozone crisis. Others argue that CRAs' actions lack timeliness and lag behind other market indicators. EU regulatory changes have sought to address the industry's lack of transparency, lack of competition and conflicts of interest.

CLOSE CONNECTIONS

For banks, sovereign debt ratings are important in several respects. They typically represent a ceiling (or upper bound) for the ratings assigned to financial institutions within that country. Many rating actions on banks are closely attached to the rating actions on the sovereign's debt. 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 have been prominent in the financial crisis period and many policy and regulatory changes have aimed to weaken the links causing sovereign-bank contagion effects. In summary, sovereign ratings are a highly relevant barometer for banks to consider.

It's worth examining the increasing prevalence of differing CRA opinions on sovereign credit risk and how this may affect market reactions and future rating actions. The evidence is drawn from recent research conducted at Bangor Business School. Most sovereign governments are rated by at least two of the major CRAs, and usually by three. Divergence in CRAs' opinions on credit risk is referred to as 'split ratings'.

The Table (below) presents several current examples of split ratings for major economies. This shows there's no systematic direction for the splits – in other words, it's not obvious that any of the three CRAs is consistently assigning higher or lower ratings than the others.

It's important to note that split ratings could be temporary, arising simply from different timings of CRA upgrades or downgrades on the same entity. However, in the recent past, it's evident that split sovereign ratings have become persistent and more 'permanent', including the examples given in the Table. In recent years, split sovereign ratings have reached six rating notches and the question is how these split sovereign ratings arise.

THE POWER OF RATINGS

CRAs base their opinions about sovereign creditworthiness on a combination of qualitative and quantitative considerations, in accordance with proprietary methodologies. The information sets used by different CRAs are similar – all CRAs consider GDP, government finances, political stability and debt structure. But they use different qualitative or quantitative measures and/or attach different weights to these factors. CRAs also have varying experience in different countries, and diverge in the processes they apply for judging creditworthiness.

Do these split ratings matter, and how might they affect markets and institutions? For a start, a split sovereign rating will imply a higher prevalence of split bank ratings in that country, so that a financial institution finds its creditworthiness assessed at a different level by different CRAs. A body of academic research has also investigated what effect such split ratings might have on a bank's (or corporate's) bond yields and funding costs.

More generally, split ratings imply ambiguity about the organisation's creditworthiness and could induce investors to act in ways not solely explained by changes in risk. There's evidence that investors have an aversion to such ambiguity. Consequently, they can interpret good news to be very unreliable while bad news is considered very reliable – thus inducing stronger reactions in asset prices.

In a situation of split ratings, the terms 'superior' and 'inferior' refer to higher and lower ratings, respectively. Positive events on the superior rating set a new rating 'ceiling' (or upper bound); negative events on the inferior rating set a new rating 'floor' (or lower bound). These types of rating action are often interpreted as signals that additional rating events will follow, most likely by other CRAs.

IMPLICATION FOR PLAYERS

The effects of split sovereign ratings have been researched, using data samples for over 100 countries from 2000 to 2014. Evidence is collated on how rating actions for split rated sovereigns affect the reactions of bond and equity markets to the rating events. The effect of superior versus inferior prior ratings is of particular importance. For the bond market, price reactions are far

stronger for negative events on the inferior ratings and for positive events on the superior ratings.

Such evidence is consistent with the notion that market participants display an aversion to the inherent ambiguity of split ratings. Sovereign bond spreads are particularly responsive to negative events announced by S&P (which turns out to be the CRA with a greater propensity to assign the lower ratings). A one-notch downgrade by S&P is associated with a 26 basis points average increase in bond spreads. The immediate spread reactions following negative rating actions are four times larger for inferior than for superior ratings.

Moody's positive events can have a significant bond market impact, but only when Moody's assigns superior pre-event ratings compared to S&P. There is little evidence that split ratings involving Fitch have a significant bond market impact.

Similar results are found for the equity market reactions. Market prices respond to disagreements on sovereign creditworthiness between S&P and Moody's. One-notch downgrades by S&P for a sovereign rated lower by S&P than Moody's have a strong impact (average negative abnormal returns of 1.4%). The recent EU regulatory changes seem to have somewhat dampened the market impact of rating actions, but it is too soon to draw strong conclusions on this.

It's worth asking whether split ratings can be used to infer predictability about future rating actions. The answer is 'yes', particularly for negative rating actions. The presence of a split rating enables a forecast of future rating actions by one or more CRAs, implying some degree of interdependence in their rating decisions.

In summary, split sovereign ratings have become more common, and this generates implications for markets and institutions. New research has shed light on the consequences, and its findings are relevant to many market participants, banks and regulators.

Examples of split sovereign ratings (As at 1 March 2015)

Sovereign	Fitch	Moody's	S&P
Austria	AA+	Aaa	AA+
France	AA	Aa1	AA
Greece	B	Caa1	B-
Italy	BBB+	Baa2	BBB-
Slovenia	BBB+	Baa3	A-
UK	AA+	Aa1	AAA
USA	AAA	Aaa	AA+

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Further details on the contents of this article are available on request to Bangor Business School. The underlying research papers are:

- ***The credit signals that matter most for sovereign bond spreads with split rating***
- ***Differences of opinion in sovereign credit signals during the European crisis***

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