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RATINGS AGENCIES AND SOVEREIGN CREDIT RISK ASSESSMENT

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Highlights

- Credit rating agencies (CRAs) have not consistently met the expectations placed on them by investors and policymakers. It is difficult, however, to improve the quality of ratings through regulatory initiatives. In the short term, changes to the CRAs' regulatory environment, in a context of high market uncertainty, may add to market stress.
- The role of credit ratings in regulation should be reduced but eliminating it entirely would have significant downsides, at least in the short term. The transfer of ratings responsibility to public authorities, including the European Central Bank, is unlikely to be a good alternative because of inherent conflicts of interest. The notion of risk-free sovereign bonds is challenged by the crisis, but the most straightforward way to address this challenge in the euro-area context would be the establishment of a euro-area-wide sovereign bond instrument.

This Policy Contribution was prepared as a briefing paper for the European Parliament's Economic and Monetary Affairs Committee's Monetary Dialogue. The views expressed are the authors'. Copyright remains with the European Parliament at all times. Nicolas Véron (n.veron@bruegel.org) is a Senior Fellow at Bruegel, and a Visiting Fellow at the Peterson Institute for International Economics. Guntram B. Wolff (guntram.wolff@bruegel.org) is Deputy Director of Bruegel. The authors would like to acknowledge research assistance by Chiara Angeloni.

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SOVEREIGN CREDIT RATINGS have been in the spotlight since the start of the European sovereign debt crisis, receiving considerable attention from both the media and the political community. The European Union has been an active legislator on ratings with the adoption of the first (November 2009) and second (May 2011) Regulations on Credit Rating Agencies, and proposals for a third published by the European Commission in November 2011. The European Parliament has been an active participant in this process, including the adoption in March 2011 of a Report on Credit Rating Agencies (2010/2302(INI)) by its Committee on Economic and Monetary Affairs (ECON).

This Policy Contribution attempts to clarify key policy questions related to sovereign credit ratings. It leaves aside broader policy challenges posed by credit rating agencies which are not specifically related to the sovereign credit segment. These have been reviewed in a separate Bruegel Policy Contribution (Véron, 2011).

1 THE IMPACT OF SOVEREIGN CREDIT RATINGS ON THE SOVEREIGN BOND MARKETS

Credit rating agencies have been repeatedly blamed for causing or exacerbating negative market developments in the context of the European sovereign debt crisis[1]. Some recent developments, in particular Standard & Poor's (S&P) erroneous announcement to some of its clients of a downgrade of France, have added to volatility.

However, the question of the extent to which credit ratings exacerbate fluctuations in sovereign credit markets is far from trivial. Consensus on sovereign bond markets often evolves faster than credit ratings, which tend to typically be 'behind the curve'. Negative ratings decisions are often made after the deterioration of market-based credit indicators. This has been a consistent pattern since the start of the financial crisis. In that sense, ratings can be considered a lagging indicator that often show only information that is already known by the market.

When negative ratings decisions are made, they are unsurprisingly generally associated with yield increases (an outlier was the downgrade of the United States by S&P in early August 2011, which was associated with a general increase in risk aversion and lower yields on US bonds because of their safe-haven status). This effect is confirmed by recent studies such as those published by the International Monetary Fund (Arezki, Candelon & Sy, 2011) or the European Central Bank (Afonso, Furceri & Gomes, 2011).

However, the extent of this impact is less clear. In particular, the ECB study notes that negative ratings decisions tend to be preceded by negative market developments, raising questions about the direction of causality. Consistent with previous literature, the ECB paper confirms the existence of a significant reaction, on the part of both sovereign yields and CDS spreads, to rating announcements (this is true in particular for negative events). The analysis goes a step further since it assesses if both sovereign yields and CDS spreads had already absorbed the information contained in changes to ratings before their announcement. As regards the anticipation mechanism, the main result is that the information contained in rating announcements is not anticipated by the credit market while the CDS market seems to anticipate the information contained in ratings downgrades. The ECB study specifically investigated the issue of causality between ratings changes and yields/CDS spread over the short-term and concluded that there is *"two-way causality between sovereign credit ratings and government bond yield spreads"*, namely that *"past values of changes in yield (CDS) spreads are significant determinants of the change in effective rating and vice-versa"* (Afonso, Furceri & Gomes, 2011).

1. See, for example, Nowotny, July 2011: "It is all apparent from public statistics and whether these statistics are accurate or not, the rating agencies... do not give any more intrinsic knowledge, they simply give opinion. And these opinions, they continue to give them in such a way that it worsens the crisis" (available at http://in.reuters.com/article/2011/07/12/ecb-nowotny-idINLDE76B1Q320110712).

Furthermore, this is not a static picture as investors' behaviour changes over time. Anecdotal evidence suggests a gradually reduced dependence on credit ratings since the start of the euro-area crisis. For example, some large investors appear to have moved away from reliance on ratings-based sovereign-bond benchmarks indices to form their own benchmarks. Strikingly, some negative ratings decisions during the past 18 months have had negligible market impact, suggesting that many commentators' emphasis on 'mechanical effects' does not capture the complexity of linkages. It should be noted, in particular, that the above-mentioned IMF and ECB analyses are based on data series stopping in May and October 2010 respectively, and therefore do not include observations of the latest 12 months of the crisis. This is significant as, especially after the G20 Deauville declaration of 18 October 2010, market developments appeared to be driven more by political pronouncements and less by ratings decisions. The Bank for International Settlements has concluded that the Deauville declaration had significant market impact (BIS, 2010).

2 REDUCING OVER-RELIANCE ON CREDIT RATINGS

Credit rating agencies derive some of their importance from the fact that the regulatory system relies on their assessments. This reliance is observed in bank regulation, which in some circumstances sets banks's capital requirements in relation to asset risks as assessed by CRAs. Similar regulations exist for insurance and other financial market participants. Following the failures of ratings in the US sub-prime mortgage-based securities market, significant work has been undertaken by regulators and supervisors, at the global level and on both sides of the Atlantic, to reduce regulatory reliance on credit ratings. The most radical initiative so far has been the decision by the US Congress to ask federal supervisors to eliminate all references to credit ratings in their rules (Section 939A of the US Dodd-Frank Act of July 2010). However, implementing this decision is proving difficult, not least because it impedes the adoption by the US of global supervisory standards ('Basel 2.5' and Basel III), which do refer to credit ratings (Westlake, 2011). At the global level, a review of this issue by the Financial Stability Board has concluded that *"in certain cases, it may take a number of years for market participants to develop enhanced risk management capability so as to enable reduced reliance on credit rating agencies"* (FSB, 2010).

One problem is that, while references to risk ratings in regulations are undesirable, the alternatives might be even worse. In particular, banks' own models of risk assessment have been proven by the crisis to be even less reliable than credit ratings, including in the largest banks where risk management was widely believed to be most advanced (see for example UBS, 2008). Replacing references to ratings with references to market-based risk indicators may sharply increase pro-cyclicality, as such indicators are typically much more volatile than credit ratings[2].

As a consequence, it is to be expected that ratings will be complemented with other measures of risk, but that a complete elimination of references to credit ratings from the European financial rulebook would appear both impractical and undesirable given the lack of proper alternatives in many cases. Moreover, contemplating such steps in the current period of market stress may contribute to short-term volatility.

In particular, the EU and its member states should proceed with full implementation of the 'Basel 2.5' and Basel III accords, including the extent to which these still refer to the use of credit ratings in spite of the Basel Committee's efforts to reduce reliance. These efforts by the Basel Committee and other international financial standards-setters are expected to continue and to bring about gradual improvements in the years to come. Opting for a complete elimination of any regulatory reference to credit ratings in the short term would have significant downsides.

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2. See for example Moody's (2009) in the case of corporate ratings.

3 A EUROPEAN RATINGS FOUNDATION

In a June 2011 resolution, the European Parliament asked the European Commission to study the creation of a new fully-independent European Credit Ratings Foundation (European Parliament, 2011). The resolution does not include an explicit deadline for this. The Commission's proposal for a third EU Regulation on CRAs (CRA 3) does not retain the option of EU-level public sponsorship of a new CRA:

> *"This proposal is not aimed at setting up a European credit rating agency. As requested by the European Parliament in its report on credit rating agencies of 8 June 2011, this option was assessed in detail in the impact assessment accompanying this proposal. The impact assessment found that even if a publicly funded CRA may have some benefits it terms of increasing the diversity of opinions in the rating market and providing an alternative to the issuer pays model, it would be difficult to address concerns relating to conflicts of interest and its credibility, especially if such CRA would rate sovereign debt. However, these findings should by no means discourage other actors from setting up new credit rating agencies. The Commission will monitor to what extent new private entrants in the credit rating market will provide for more diversity"* (European Commission, 2011).

In June, the Parliament also proposed to establish a European ratings index (EURIX), incorporating all ratings of registered CRAs that are available on the market (European Parliament, 2011).

While more competition in the credit ratings market is desirable, it is not clear that this can be achieved through a public initiative. A publicly-sponsored ratings agency would be assumed by market participants to be politically constrained in its credit assessments and would therefore struggle to make a difference in terms of market perceptions – especially in a context in which there is a widespread perception that EU authorities are tempted to increase political leverage over ratings decisions generally, as illustrated by the debate on the preparation of the CRA 3 Regulation before the publication of the European Commission's proposal in mid-November 2011.

Incidentally, it is not clear that a specialisation in sovereign ratings could represent a sustainable business model for a financially independent ratings agency. Sovereign ratings by the three most established CRAs do not generate significant revenue[3]. CRAs rate the largest sovereigns not as a direct revenue generator, but because it is a necessary building block for other, more lucrative ratings segments such as those of corporate issuers. Indeed, many sovereign ratings are unsolicited, especially for the largest sovereign issuers, and as a consequence they are a pure cost centre for the CRAs. The low financial dependence on sovereign ratings also results in less obvious conflicts of interest in rating sovereigns than in other segments of CRA activity.

4 ASSUMPTION OF AN EXPLICIT RATING ROLE BY PUBLIC AUTHORITIES

If a public authority such as the ECB or the IMF were to publish sovereign credit ratings, it is likely that they would be considered by market investors very differently from those assigned by private-sector CRAs, if only because both institutions are at least potentially able to directly impact sovereign creditworthiness with their own policy decisions, and because sovereigns participate in the governance of both institutions. According to a report by the British House of Lords, the IMF (or OECD) cannot avoid conflicts of interests by acting as a ratings agency because it is involved in providing money to the EU and because its constituencies and effective owners are the governments themselves (House of Lords, 2011). In addition, the IMF's or ECB's credibility would suffer if their ratings were perceived as inadequate in the light of developments occuring after their publication.

One specific issue that has been in the spotlight in recent months is the ECB's collateral policy, which has required successive revisions as the sovereign ratings of euro-area countries, in particular Greece, have been downgraded. The consequence has been that the ECB's criteria for the acceptance of collateral have been much less reliant on credit ratings in practice than they had appeared to be in principle. An influential paper by

3. No figures are publicly available but anecdotal evidence suggests that revenue generated by sovereign ratings as a share of the total revenue of the leading ratings agencies is no more than a few percent at most.

'Credit rating agencies have not consistently met the expectations placed on them by investors and policymakers. Reducing the reliance in the regulatory system on ratings in the long term is desirable. However, robust alternative assessments of risk will need to be developed.'

Buiter and Sibert (2005) has even gone as far as to argue that the ECB's own collateral policy for its repo operations has contributed to some of the fiscal indiscipline observed before the crisis because it insufficiently discriminates between euro-area sovereign bonds.

A related issue is the risk-weighting of euro-area sovereign debt in banks' capital calculations, for which the current zero risk-weighting under the applicable Capital Requirements Directives appears increasingly at odds with financial reality. The Deputy Director-General of the Bank for International Settlements, the Chairman of the European Banking Authority, and the Chair of the European Parliament's ECON Committee have all been reported as advocating a reexamination of the zero risk-weighting policy (Hickley, 2011; York, 2011). However, this specifically applies to the euro area as a unique currency union of large developed economies. The fundamental question is not so much the distortions induced by the zero risk-weighting, but the absence of an effective risk-free asset in the euro-area financial construct, which one might relate to the broader current debate on the design flaws of the euro-area fiscal framework. Particularly given current market instability it may therefore be too early to envisage a root-and-branch reform of the principles that underpin sovereign credit risk-weighting in capital regulation, at least as long as the outline of the euro area's future fiscal policy framework remains undetermined (see Tett, 2011, for a broader exposition of this argument).

5 CONCLUSIONS

Credit rating agencies (CRAs) have not consistently met the expectations placed on them by investors and policymakers. It is difficult, however, to improve the quality of ratings through regulatory initiatives. In the sovereign bond market, CRAs often follow a general deterioration in market sentiment. At the same time, major announcements have added to market pressure so that a two-way causality has been established. Ratings decisions on sovereigns have a market impact because the financial system partly relies on ratings for risk assessment and balance sheet composition. However, reducing the regulatory reliance on ratings is not an easy task. The more fundamental questions that the euro area needs to answer are what a safe euro-area-wide reference asset would look like, given that national sovereign bonds are ever less able to play this role, and how it could be constructed.

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