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Rating agencies' signals during the European sovereign debt crisis: Market impact and spillovers

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ABSTRACT

The ongoing financial crisis has drawn considerable attention to the role of credit rating agencies in the financial system. We examine how the foreign exchange market reacts to sovereign credit events prior to (2000–2006) and during the crisis (2006–2010). The sample includes a broad set of countries in Europe and Central Asia in order to investigate spillover effects. We find that rating agencies' signals do affect the own-country exchange rate and we identify strong spillover effects to other countries' exchange rates in the region. In both cases, the impact of outlook and watch signals is stronger than the impact of actual rating changes. Market reactions and spillovers are far stronger during the financial crisis period than pre-crisis. Negative news from all three major agencies has an impact, whereas only Moody's positive news produces a reaction. Negative news from Fitch tends to have the strongest effect. The findings are important in enhancing understanding of the role of rating agencies and the market response to their signals.

1. Introduction

The European sovereign debt crisis brought increased attention to the role of credit rating agencies (CRAs) and the interdependence between financial markets during crises. IMF (2010a) stated that sovereign default was the most pressing risk facing the global economy. Many sovereign ratings, particularly for Greece, Ireland, and Portugal, became under persistent downgrade pressure, as a result of increased government deficits and debt levels, and weak economic growth. Sovereign bond and credit default swap spreads widened, and stock markets were deflated, not only in the worst-affected countries, as market concerns spread to other indebted states in the euro-zone and to the USA. The crisis was also accompanied by exchange rate volatility, including the US$ versus the Euro.

CRAs were accused of contributing to the US subprime crisis by being too lax in rating some structured finance products. There is an ongoing debate on revenue versus reputation issues (e.g. Mathis et al., 2009). In contrast, the criticism of CRAs during the European sovereign debt crisis has been more focused on the extent and timing of downgrades. The role of CRAs has expanded significantly during the last 20 years, whereby credit ratings are now heavily hardwired into investment processes, financial contracts and regulatory frameworks. Hence, CRA news releases have potentially systemic consequences (Bank of England, 2011) and recent regulatory changes have sought to reduce this effect.

The uses of ratings imply that CRAs must manage a tension between the stability of their ratings and their short-term 'accuracy' (e.g. Löffler, 2005). To mitigate the stability-accuracy tension, credit outlook and watch are supplemental

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instruments used by CRAs to signal adjustments in their opinion of issuer credit quality.[1] These instruments perform an important economic function (e.g. Boot et al., 2006; Bannier and Hirsch, 2010). Each CRA has a clear reputational goal of providing timely and high quality credit signals to financial markets. Prior studies show that outlook and watch signals are at least as important as rating changes in their market impact (e.g. Kaminsky and Schmukler, 2002; Sy, 2004; Hill and Faff, 2010; Afonso, 2011). The IMF (2010b) stresses that CRAs influence stock and bond prices, not only by revealing new information but also through a 'certification' role, though this is most evident via their use of outlook and watch signals rather than rating changes. Kim and Wu (2011) provide evidence that improvements in sovereign credit quality help to encourage international bank flows from developed to emerging economies, but they point out that outlook and watch events are associated with much stronger economic effects than are rating changes. Such evidence is not surprising given that rating changes are partially anticipated in some cases since market participants are aware of the prior outlook/watch status.

Sovereign ratings represent a ceiling for the ratings assigned to non-sovereign issuers within the country.[2] This was particularly problematic for several Greek, Irish and Portuguese banks, since their ratings were downgraded to speculative status. In addition, sovereign ratings contribute to the smooth and efficient working of the global sovereign debt market (House of Lords, 2011). They also have a direct impact on a sovereign's cost of borrowing, and this is central to the question of whether CRA actions contributed to a worsening of the European sovereign debt crisis.

This paper firstly documents the extent of sovereign rating news from Moody's Investors Service, Standard and Poor's (S&P) and Fitch during the European sovereign debt crisis. The analysis then proceeds to examine how the foreign exchange spot market reacts to sovereign credit events in the Europe and Central Asia (EU–CA) region prior to, and during this crisis. We also investigate spillover effects, i.e. the impact of a given sovereign credit signal on other countries' exchange rates, which is a key contribution of this study. To the best of our knowledge, this paper is the first to provide evidence on how sovereign credit news affected the foreign exchange market during and immediately prior to the current financial crisis (see Section 2).

We aim to identify whether sovereign credit signals released by a particular CRA have a stronger influence on the market during the crisis than the signals of other CRAs. We also add to the literature by analysing whether any influence on the market is related to a specific type of credit signal (positive versus negative events, and actual rating changes versus outlook actions versus watch signals). Prior related research has mainly centred on actual rating changes (see Section 2). We also extend the methodology previously applied in the literature on the information content of credit ratings by employing a logit-type transformation of the numerical-rating scale to account for non-linearity (see Sy, 2004).

The main findings are summarised as follows. The local and spillover effects of sovereign credit news on foreign exchange markets in the 'EU–CA' region are stronger during the crisis period. The effect of negative sovereign credit events are most marked for higher-rated countries during the crisis period, while the impact is most marked for lower-rated countries in the pre-crisis period. During the crisis period, negative news from the three CRAs affects the own-country exchange rates and contributes to contagion. Also, positive news from Moody's affects the home currency and those of other countries. Fitch signals induce the strongest reactions during the crisis period. We also find a unique market reaction to S&P in the case of negative outlook signals during the crisis period. Overall, watch and outlook signals have much more impact than rating changes on the foreign exchange market.

The rest of the paper is organised as follows. Section 2 briefly reviews the literature on the market impact of sovereign ratings. Section 3 discusses the effect of the 2007–2011 financial crisis on European economies and on CRAs. Section 4 describes the data set of sovereign credit events and foreign exchange rates. Section 5 presents the methodology used to examine the effects of sovereign credit news. Section 6 discusses the empirical results, and Section 7 concludes the paper.

2. The market impact of sovereign rating signals

Prior literature demonstrates that sovereign rating news does affect financial markets. Negative rating events impact own-country equity and bond markets and cause significant spillovers to other countries' equity and bond markets, while upgrades have limited or insignificant impact (e.g. Kaminsky and Schmukler, 2002; Brooks et al., 2004; Sy, 2004; Gande and Parsley, 2005; Ferreira and Gama, 2007; Hooper et al., 2008; Hill and Faff, 2010; Afonso, 2011). Negative credit announcements are typically more informative than positive ones, given the stronger negative reputational effects for an agency being tardy in the case of downgrades (Alsakka and ap Gwilym, 2010). Issuers may have no incentive to leak negative news prior to a downgrade, while they do so for positive news prior to an upgrade. Goldstein et al. (2000) and Sy (2004) examine whether sovereign ratings anticipate currency crises, and find that sovereign ratings help predict the probability of distressed debt events, but they fail to predict currency crises. The key line of defence provided by CRAs is that ratings represent an assessment of the likelihood of default, not the likelihood of currency crises.

[1] Outlooks reflect a CRA's medium-term (1–2 years) view on the development of a credit rating, while watchlists are stronger indications focused on a typical ex-ante target horizon of 3 months.

[2] Though the ceiling effect is no longer absolute, as Moody's, S&P and Fitch have recently eliminated their sovereign ceiling rule, there remains a 'sovereign ceiling lite' (Borensztein et al., 2007).