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The sovereign-bank rating channel and rating agencies' downgrades during the European debt crisis

Rasha Alsakka*, Owain ap Gwilym, Tuyet Nhung Vu

Bangor Business School, Bangor University, Bangor LL57 2DG, UK

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A B S T R A C T

We investigate the rating channel for the transmission of changes in sovereign risk to the banking sector, analysing data from Moody's, S&P and Fitch before and during the European debt crisis. Sovereign rating downgrades and negative watch signals have strong effects on bank rating downgrades in the crisis period. The impact is stronger for multiple-notch sovereign rating downgrades, and more pronounced in PIIGS countries. Secondly, we investigate rating agencies' competition in the banking sector during the same periods, finding significant differences in rating policies across the agencies. S&P credit actions tend to be the more independent ones, while Moody's appears to be more cautious, although it is by far the most likely to assign multiple-notch downgrades. In the pre-crisis period, we find no evidence that bank rating actions are linked to sovereign rating signals (nor vice versa) nor to prior bank rating changes by a competing agency.

1. Introduction

Credit ratings are heavily used in financial markets and regulation, and the recent European debt crisis triggered increased scrutiny of the relative performance of credit rating agencies (CRAs). Developed countries have long been accustomed with stable and high investment grade ratings. The fact that this debt crisis originated in European countries seriously challenges the previously common

* Corresponding author. Tel.: +44 (0) 1248 383571.
E-mail addresses: r.alsakka@bangor.ac.uk (R. Alsakka), owain.apgwilym@bangor.ac.uk (O. ap Gwilym).

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belief that their sovereign debts were relatively safe investments, with indebted countries, including Portugal, Italy, Ireland, Greece and Spain (PIIGS), causing widespread concerns in the global economy.

The European debt crisis presented CRAs with a uniquely challenging period. In the context that credit ratings are inherently stable (see Löffler, 2004; Cantor and Mann, 2007), CRAs faced pressures from various directions on the timing and severity of downgrade actions. Acting too slowly would diminish their credibility, given the contemporaneous views of market participants as reflected in the changes in bond yields and CDS prices. However, acting promptly drew the anger of politicians and other commentators since sovereign rating downgrades are somehow more publicly visible than credit market valuations, and therefore made the CRAs potentially vulnerable as scapegoats for deepening the crisis.

A primary focus in this paper rests upon comparing the actions of different CRAs in response to the European crisis period. Two main research questions are addressed. Firstly, we provide detailed evidence on a rating channel through which sovereign risk was transmitted to the banking sector. We investigate the strength of links between sovereign and bank rating actions and ask whether these links differ across CRAs and/or across countries. Secondly, we focus on the banking sector and ask whether different CRAs applied systematically different rating policies in downgrading European banks during the crisis period. This aspect links to the question of whether the credibility of a CRA is enhanced in the eyes of market participants by prompt actions (or leadership) following any change in an issuer's creditworthiness. The positioning of the paper is firmly in the credit ratings literature and we explain the paper's niche relative to other themes in Section 2.

In relation to our first research question, BIS (2011) provides a clear motivation by specifying four different channels through which changes in sovereign creditworthiness can affect bank funding costs and access: (i) banks' holdings of domestic and foreign sovereign debt; (ii) the use of sovereign securities as collateral to secure funding from central bank and market sources; (iii) explicit and implicit government guarantees; (iv) linkages between sovereign and bank ratings. BIS (2011) only offers brief and descriptive evidence on the fourth channel. Similarly, much of the recent literature (see Section 2) has paid attention to the first three channels but neglected this fourth channel. This paper therefore addresses a void in the literature by presenting a comprehensive analysis of the linkages between European sovereign and bank ratings before and during the debt crisis.[1]

In relation to the second research question, we motivate the analysis from a burgeoning recent literature on issues of industrial structure and competition in the rating industry (see Section 2). Because much of this literature is driven by the US sub-prime crisis, there are two dominant themes of ratings inflation and competition among CRAs. The problem of ratings inflation is commonly set in the context of structured finance products prior to the sub-prime crisis. In contrast, the context of the sovereign debt crisis may make this issue less relevant because policy concerns arose about the reverse situation i.e. rapid downgrades of sovereign and bank ratings. However, a view might be taken that some European sovereign and bank ratings were inflated prior to 2010, which then exacerbated the rate of downgrades once the crisis took hold, e.g. Bar-Isaac and Shapiro (2013) argue that ratings quality is counter-cyclical. Although these authors focus on initial ratings, one can infer from their model that CRAs could be relatively relaxed about high ratings in the 'boom' years, yet may place more effort towards rating accuracy in the face of a rapid economic downturn. With regard to the empirical implications of their model, more frequent rating actions could indicate that a CRA is more attentive to ratings accuracy or quality (see Section 2 for further discussion). Our second research question addresses the possibility that each CRA adjusts its policy differently in the face of rapidly changing economic circumstances, and this is empirically investigated using CRAs' bank rating actions in Europe during 2008–2013 compared with the earlier years.

As this is the first paper to address the above research questions, it fills a clear void in the literature on the behaviour of sovereign and bank ratings prior to and during the European sovereign debt crisis. For the first research question, we report that sovereign rating downgrades and negative watch signals significantly impact bank rating downgrades during the crisis period but the implementation of a

[1] Issues surrounding the reverse direction of causality are also addressed in Section 2.1.

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