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Does sovereign creditworthiness affect bank valuations in emerging markets?

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ABSTRACT

We analyse the impact of sovereign rating actions by S&P, Moody's and Fitch on bank valuations in emerging markets. We find strong evidence of a *rating channel* for the transmission of sovereign risk to bank valuations. *Collateral* and *guarantee channels* play modest roles, but are more relevant to countries that experienced positive actions. Positive sovereign actions by S&P have the strongest impact on bank valuations. Both negative and positive new rating information, outlook and watch actions are associated with strong market impact. The findings identify clear evidence of links between emerging market governments' external credit standing and banks' market valuation.

1. Introduction

The impact of sovereign risks on economic and financial performance has recently attracted huge attention given such serious events as the European sovereign debt crisis and the turmoil in the Middle East (e.g. Liu et al., 2013). Credit rating agencies (CRAs) are active in financial markets through disclosing credit information, which reduces information asymmetries and enables borrowers to access capital markets. Sovereign ratings are opinions of the CRAs on the ability and willingness of governments to meet their financial commitments. Sovereign ratings are particularly important in emerging economies because they are generally more risky, and the information flows are of lower quality compared to developed countries. Investors pay close attention to sovereign rating actions when investing capital in emerging countries.

CRAs' activities in emerging markets have expanded rapidly in recent years. For example, S&P's coverage of sovereign ratings increased from seven in 1975 to 129 in December 2014, with the growth coming predominantly from emerging countries seeking access to global financial markets. Many factors motivate governments in emerging countries to seek ratings from CRAs. Sovereign ratings enhance the capability of emerging countries' governments and private sectors to access global capital markets and help to attract foreign direct investment. The net private capital flows to emerging markets reached a record volume of $1231 billion in 2013 (IIF, 2014). Kim and Wu (2008) find that improvements in an emerging market's sovereign rating improve international capital inflows in the form of foreign direct investment, international banking flows

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and portfolio flows. Kim and Wu (2011) highlight that improvements to the sovereign ratings in one region draw G7 bank inflows away from the other emerging market world regions. Using a sample of 19 emerging countries, Christopher et al. (2012) find that sovereign credit signals positively affect regional stock market integration. Rating upgrades provide benefits for surrounding countries in a region, while rating downgrades lead to investors shifting funds from the downgraded country into the surrounding region.

Credit risk changes are more frequent in emerging markets and events can unfold quickly and unpredictably (e.g. Russia in 2014). Thus, the role of CRAs is more challenging, problematic and costly in emerging markets. An understanding of the effects of sovereign ratings in emerging markets has become important given the significant and growing flow of institutional funds into emerging countries due to globalisation and investors' increasing focus on international diversification. Many emerging market governments have issued dollar-denominated sovereign bonds in order to give their private sectors better access to external funds. Duggar et al. (2009) identify that 71% of defaults by rated corporates in emerging markets occur during sovereign crises. They also suggest that sovereign credit risk is a key factor in corporate defaults outside sovereign credit events.

One of the main constraints for emerging market non-sovereign issuers is that their rating rarely surpasses the sovereign rating. Borensztein et al. (2013) refer to this as the sovereign ceiling 'lite', and they find that sovereign ratings can affect the cost of borrowing in the private sector. They also highlight that sovereign defaults can have a serious negative impact on the domestic economy as a whole, or have 'spillover' effects from the sovereign to private debtors. Other impacts include the imposition of direct capital controls or measures that prevent private borrowers from servicing their external obligations when the sovereign reaches a situation near default.

In general, links between sovereigns and the financial sector have become a highly topical issue. Several studies analyse potential links or contagion channels between sovereign credit risk and banks, but primarily for developed countries (see Section 2.2). Because emerging market bank ratings are strongly related to their sovereign ratings (e.g. Williams et al., 2013), actions on the sovereign rating affect banks' cost of capital, their capital requirements, government guarantees and to some extent their profitability from lending/borrowing decisions.

This paper investigates whether changes in sovereign creditworthiness affect the stock market valuations of banks in emerging markets. The analysis extends to consider several channels through which such effects could permeate. Effects based on the rating channel (through the sovereign ceiling), countries' levels of financial freedom, domestic credit levels, collateral and government guarantees are considered.

This paper focuses on the relative influence of actions by S&P, Moody's and Fitch. The sample period is 2001–2011, and the data includes daily time series of sovereign rating changes along with changes to outlook and watch status. While rating changes communicate permanent changes in issuer credit quality, credit outlook and watch are supplemental instruments to signal potential rating adjustments. Prior studies show that outlook and watch actions are at least as important as rating changes in their market impact (e.g. Alsakka and ap Gwilym, 2012; Sy, 2004). We examine how the share prices of 277 banks react to sovereign rating events for 19 emerging market countries. The data allows us to identify which CRAs induce reactions in emerging market bank valuations, and which rating action type (if any) induces the strongest reactions. Prior literature shows that all three CRAs play different, but nevertheless significant roles in the markets (e.g. Afonso et al., 2012; Alsakka and ap Gwilym, 2012; Hill and Faff, 2010), yet many studies examine data from only one CRA (e.g. Caporale et al., 2012; Chen et al., 2013). We also examine the joint impact of the three CRAs by constructing a '*new rating information*' variable, which can potentially demonstrate that market participants make use of the rating information provided by all three CRAs.

The key findings are as follows. There is strong evidence of a *rating channel* for the transmission of sovereign risk to bank valuations, while *collateral* and *guarantee channels* only play modest roles, but are more relevant to countries that experienced positive sovereign rating actions. We highlight unequal responses to the three CRAs' actions, driven by variations in rating policy and rating models across the three largest CRAs. Positive signals by S&P induce the strongest positive bank returns, while negative independent actions by Fitch are the timeliest signals. We find that both positive and negative *new rating information*, outlook and watch actions have a strong impact on bank valuations. We also show a stronger effect of S&P positive (negative) sovereign actions on bank valuations in countries with tighter (less) government controls over their banking systems. Further, Fitch actions have a stronger impact on bank valuations in countries where the financial sectors provide higher levels of domestic credit. Banks in countries with higher sovereign ratings are more affected by Moody's positive sovereign actions. Positive sovereign rating actions have a stronger (weaker) impact on bank valuations in countries running relatively lower (higher) levels of government debt. In contrast to other evidence for developed countries, we find that larger banks in emerging countries are neither perceived as being safer nor more vulnerable in times of sovereign distress.

The remainder of the paper is organised as follows. Section 2 discusses the previous literature, while Section 3 provides a framework for the empirical design. Section 4 explains the data sample and presents the methodology. Section 5 discusses the empirical results, and Section 6 concludes the paper.

2. Literature review

2.1. Market impact of sovereign rating actions

Prior literature demonstrates that sovereign rating news affects financial markets. Negative credit signals impact own-country equity and bond markets and cause significant spillovers to other countries' equity and bond markets, while upgrades