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Does the disclosure of unsolicited sovereign rating status affect bank ratings?

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This paper integrates three themes on regulation, unsolicited credit ratings, and the sovereign-bank rating ceiling. We reveal an unintended consequence of the EU rating agency disclosure rules upon rating changes, using data for S&P-rated banks in 42 countries between 2006 and 2013. The disclosure of sovereign rating solicitation status for 13 countries in February 2011 has an adverse effect on the ratings of intermediaries operating in these countries. Conversion to unsolicited sovereign rating status transmits risk to banks via the rating channel. The results suggest that banks bear a penalty if their host sovereign does not solicit its ratings.

1. Introduction

Credit Rating Agencies (CRAs) play a prominent role in modern financial markets. Globalization and the increasing complexity of investment products have triggered a growing demand for widely recognised risk assessment. Sovereign ratings serve as a basis for evaluating the creditworthiness of a country, and thereby influence long-term investment and lending decisions across borders. Rating downgrades have major implications for financial markets and institutions, including rising costs of credit and hindered market access (e.g. BIS, 2011; Alsakka, ap Gwilym, & Vu, 2014; Correa, Lee, Sapriza, & Suarez, 2014).

The global financial crisis brought CRAs renewed publicity and ongoing scrutiny by regulators. CRAs were blamed for worsening economic conditions by downgrading some sovereigns too quickly and too severely. The overreliance on ratings by market participants led to cliff effects whereby downgrades had a disproportionate effect. The situation in Europe has further emphasised the hazardous effects of negative spillovers while highlighting interconnectedness between international financial institutions (e.g. Arezki, Candelon, & Sy, 2011). The influence of ratings on global financial stability has become a

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major concern. In 2009, the European Commission (EC) implemented a new set of regulations aimed at CRAs including registration procedures, governance requirements, internal controls, disclosure rules and improvements in rating methodologies (CRA I Regulation).[1] This regulation was amended in May 2011 (CRA II Regulation) and in November 2011 (CRA III Regulation). The responsibility for supervising and certifying CRAs was handed to the European Securities and Markets Authority (ESMA) in July 2011. This paper draws attention to the disclosure rules with particular focus on Article 10 (5) of the EU Regulation 1060/2009, which requires that when a CRA issues an unsolicited rating, it needs to be identified as such.[2] As a result of implementing the Article in February 2011, S&P disclosed the conversion to unsolicited status of 14 rated sovereign governments (S&P, 2011a, 2011b, 2011c). Unsolicited ratings are one of the most controversial features of the CRA business. Prior literature (e.g. Poon, Lee, & Gup, 2009; Bannier, Behr, & Gűttler, 2010; Van Roy, 2013) finds that banks and corporations rated on an unsolicited basis have significantly lower ratings. Concerns exist that unsolicited ratings are biased downward because CRAs are not compensated for their service. Additionally, policymakers have focused on this feature, because both solicited and unsolicited ratings are permitted for some regulatory uses. The broad aim of this paper is to examine whether the disclosure rule on solicitation status achieves its objective of more credible rating services or has unintended consequences. Specifically, we investigate whether conversion to sovereign unsolicited rating status (induced by disclosure rules) results in lower bank ratings (in the re-designated unsolicited sovereign states). Previous literature on the controversies related to unsolicited (non-sovereign) ratings provides a theoretical framework (see Section 2.3). Additionally, it is well known that sovereign risk spills over to financial institutions through many channels (BIS, 2011; De Bruyckere, Gerhardt, Schepens, & Vennet, 2013; Alsakka et al., 2014). Studying whether the mandatory disclosed unsolicited status of sovereign ratings transmits risk to banks is a key motivation for this research.

The novelty of this study derives from building on three streams of research, which meaningfully overlap and result in a synergy which has not been previously explored. The first theme relates to the unique opportunity to investigate the dynamics of rating solicitation for sovereigns. To the best of our knowledge, no prior study has investigated the rationale and impact of rating solicitation status for sovereigns. The existing literature concentrates on the solicitation of corporate and bank ratings (Bannier et al., 2010; Poon, 2003; Poon et al., 2009; Van Roy, 2013) yet it does not include any study of solicitation conversions. The second theme relates to the impact of sovereign ratings on bank ratings through the rating channel. This aspect of the paper builds on recent work (Alsakka et al., 2014; Huang & Shen, 2015) while adding a new dimension to the type of constraints imposed by sovereigns on banks via rating ceilings.

Thirdly, this paper considers the influence of the recent EU CRA regulation. To the best of our knowledge, there is no published empirical work on the effects of enhanced disclosure by CRAs introduced since 2009. Jorion, Liu, and Shi (2005) study the effect of U.S. Regulation Fair Disclosure (Reg FD), introduced in 2000, and find that both positive and negative rating changes have a stronger informational effect on stock prices after the Reg FD took effect. Poon and Evans (2013) find that the impact of rating downgrades on bond yield premia (after Reg FD) depends on the size of the firm. Studies on other forms of rating-related regulation focus on periods prior to the EU CRA regulation (e.g. Becker and Milbourn (2011) utilize a U.S. sample from 1995 to 2006).

The paper uses a large sample of 147 banks rated by S&P incorporated in 42 countries in Europe, Asia–Pacific and Latin America for the period between 2006 and 2013. We apply an ordered probit model estimation, along with many robustness checks including placebo tests and matching exercises. We strongly endeavour to rule out the possibility of sample selection bias or that the observed phenomenon arises from events other than the adoption of EU disclosure rules for CRAs.

The results strongly suggest that disclosure of unsolicited sovereign status adversely influences bank ratings through the rating channel. Banks in countries converted to unsolicited status are more likely to be downgraded and less likely to be upgraded compared with banks in sovereigns which retained solicited ratings at all times. The marginal effects (MEs) analysis suggests that the former banks are 1.73%, 0.74% and 0.47% more likely to be downgraded by 1, 2 and $\geq$ 3 Comprehensive Credit Rating (CCR) points respectively.[3] The significance of the MEs should be considered in relation to the total number of bank (sovereign) rating downgrades which represent 3.28% (2.73%) of all observations. Additionally, the analysis confirms a strong ceiling effect between sovereigns and banks. These findings have clear policy implications for regulators and banks, since there are potential costs to the institutions and the wider economies through this rating ceiling effect. The phenomenon represents an unintended consequence of regulation, and suggests a need for greater awareness of CRA rating policies in designing future regulation. Policymakers should take a closer look at unsolicited sovereign ratings and their implications. The findings of this study reveal an undesirable impact of recent regulatory developments on the European economy and will be informative in shaping future proposals. The paper is structured as follows. Section 2 draws from prior theoretical and empirical literature to frame the research questions and the testable hypothesis. The data and descriptive statistics are discussed in Section 3. Section 4 discusses research methodologies, Sections 5 and 6 present the empirical results and Section 7 concludes the study.

[1] Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies.

[2] A solicited rating is a rating requested by the issuer who incurs the cost of the appraisal. An unanticipated (by the issuer) assessment by the CRA using public information about the issuer is known as an unsolicited rating.

[3] These figures relate to outlook action, watch event, and downgrade by one notch or more.

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