

# MARKETS IN MOTION

developments that matter in financial markets

## Impact of Credit Rating on Sovereigns

"The rating system goes hand in hand with the development of large, liquid, deep, international markets. It is a precondition and a tool for ensuring the smooth functioning of these markets."  
**Christian Noyer, Governor, The Bank of France**

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### Credit Rating Agencies

There are three major credit rating agencies (CRAs) operating internationally: Fitch, Standard and Poor's, and Moody's Investor Services. They share the bulk of the \$5 billion rating business globally, relegating other 60-plus local/regional players into just competitive fringes. In India, currently, there are five CRAs registered with SEBI: CRISIL (1988), ICRA (1991), CARE (1993), Fitch India (1996), and Brickworks (2008). However, there are other agencies such as ONICRA, SMERA, etc., which provide rating services mainly in SSI and SME segments, individual credit assessments, etc.

### Call for Reforms

A country's sovereign rating provides a basis for international investors and bondholders to assess the risks of the country's ability to honour its public debt obligations. A credit rating reflects a rating agency's opinion, as of a specific date, of the creditworthiness of a particular country. Sovereign credit ratings act as widely available and internationally comparable indicators of a country's fiscal performance and are important for attracting private capital flows. These ratings influence institutional demand and market liquidity and serve as triggers in investment decisions. Recent downgrades of some of the European sovereigns by credit rating agencies (CRAs) have once again brought them under intense scrutiny amidst criticism that these downgrades trigger uncertainty in the financial markets and, as a consequence, affected the ability of the sovereigns to fund themselves. Ratings represent a rank ordering of credit risk based on default and downgrade risks. This rank ordering takes into account default probabilities, expected losses, and possible rating actions and warnings.

### Observations

According to a recent IMF Working Paper released in January 2012, CRA's opinions have an impact on the cost of funding of sovereign issuers and, consequently, ratings are a concern for financial stability.

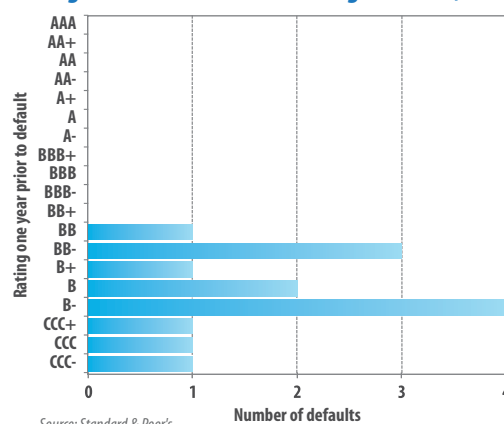
There is a close association between spreads and ratings with lower credit categories being reflected in higher spreads. Negative outlook announcements are followed by statistically significant spread widening. The evidence suggests 100 basis points for advanced economies and 160 basis points for emerging economies.

Crossing the investment-grade classification boundary is associated with a statistically significant widening of CDS (Credit Default Swaps) spreads. Specific downgrades out of the investment grade categories (Baa3 or better) to high yield categories (Ba1 or lower) lead to a statistically significant widening of the CDS spreads of 37 basis points.

### Accuracy of ratings

CRAs are perceived as powerful institutions that can influence issuer survival by affecting their access to funding markets, and their funding costs. At the same time, there have been claims that they just follow the market and react to events rather than anticipate them. As CRAs influence the market, their opinions are important from a financial stability perspective. Taking into account the difficulty in predicting rare events, the following figure shows that all 14 sovereign defaulters involving 12 countries between 1975 and 2009 had S&P ratings of BB- or below, i.e., all were noninvestment grade one year prior to default and none was in the investment-grade category.

### Ratings One Year Prior to Sovereign Default, 1975-2009



Similarly, the recent downgrades of some of the European sovereigns are seen as reaction to events.

Internationally, in view of the inadequacies observed in the functioning of CRAs, particularly in the wake of the sub-prime financial crisis, there is a growing concern among the regulators about the potential gap between expectation and realization between reliance on credit ratings and the reliability of such ratings. The concern emanates from the fact that inaccurate credit ratings could disturb the market allocation incentives, cost structures, and competition. Moreover, recent heavy downgrade activity suggests that ratings should embed the notion that risk is a forward-looking dimension, conditional on the macroeconomic scenario. In this regard, ratings should be better tied to macroeconomic conditions, including the sovereign's resilience to stress scenarios.

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