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Did Credit Rating Agencies Cause the European Sovereign Debt Crisis?

Rosa M. Abrantes-Metz

Global Economics Group &
New York University's Stern School of Business

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Did Credit Rating Agencies Cause the European Sovereign Debt Crisis?

Rosa M. Abrantes-Metz[1]

I. INTRODUCTION

It must not be easy being a rating agency. Where corporate debt is concerned, the major credit rating agencies ("CRAs") are said to be too slow and lagging the market. When the topic is structured finance, the agencies are said to inflate ratings to attract business.[2] And when the subject is European sovereign debt, those same agencies are said to be suddenly too conservative, issuing aggressive downgrades that destabilize the market and precipitate a crisis which otherwise would not have happened. (If only those CRAs remained slow laggards issuing inflated sovereign ratings, all would be well.)

But, in the sovereign debt case at least, is it instead that CRAs are simply the messenger, telling us what we should have known—that certain sovereign debt service may become unsustainable. Are the CRAs the villains in this story, or are they more like the little boy who announces, "the emperor has no clothes?"

The accusation that CRAs essentially caused the European sovereign debt crisis goes something like this: downgrading a sovereign causes an increase in its cost of funding, which will put further pressure on its balance sheet, which will cause further downgrades, and which, in turn, will increase its funding costs even more, until default becomes inevitable.

Such self-fulfilling arguments are neither novel nor unreasonable. The classic example is a bank run: if people think the bank is unsound, it may well consequently become unsound. Some variant of that argument may apply quite generally: if people think that XYZ Enterprises is insolvent, they will withhold financing so that it may well become insolvent. We can presumably substitute "Greece" for "XYZ Enterprises" and leave the central argument *almost* unchanged. But what really is different when the focus is sovereigns?

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[1] Rosa M. Abrantes-Metz is a Director in the Antitrust, Financial Regulation and Securities Practices at Global Economics Group, and an Adjunct Associate Professor of Economics at New York University's Stern School of Business; RAbrantes-Metz@GlobalEconomicsGroup.com. Disclosure: Abrantes-Metz's husband, Albert D. Metz, is the Managing Director of Credit Policy Research at Moody's Investor Services. The views expressed in this article are my own independent views and may not represent the views of the organizations with which I am affiliated or their clients. They should also not be taken as representative of my husband's views or those of Moody's more generally.

[2] R. Abrantes-Metz, *Is There Misdiagnosis and Mistreatment in the Market for Credit Ratings?*, CPI ANTITRUST CHRON. (Nov. 2013). The article explains why inflation in structured finance ratings is possible given the existent monopsony power coupled with rating shopping, and proposes a specific market reform.

II. HOW SOVEREIGN DEBT RATING IS DIFFERENT FROM CORPORATE AND STRUCTURED RATINGS

Do CRA's really have market-moving influence in the case of sovereign debt? Is it true that a downgrade will cause an increase in sovereign funding costs? After all, the corollary seems to fall apart on its own face: If all the CRA's agreed to rate Greece AAA, does anyone believe that its funding costs would consequently drop to those of the United States?

When rating corporate debt, the major CRAs (S&P, Moody's, and Fitch) often have access to material non-public information, which they are permitted to consider in order to form their credit opinions. If a CRA suddenly, and apparently surprisingly, downgrades a company, it may well be revealing new information to the market. The market may react by discounting the debt of that company, which is the same thing as saying that the company's cost of funding may consequently increase.

This argument would seem to be more reasonable the smaller the company in question is. Large companies such as General Electric or Exxon are under constant scrutiny. Equity analysts follow them closely. They are publicly traded and must satisfy stringent financial disclosure regulations. But smaller companies invite less scrutiny, and any unanticipated rating action might be expected to carry more weight where they are concerned.

Likewise, the argument may be more reasonable where the investor base is less sophisticated. Smaller "mom and pop" investors may put more weight on CRA opinions than do large, sophisticated investment houses and banks which often conduct their own credit analysis. You and I may have no choice but to consider the CRA designation of "junk status" when buying, or not buying, a security. But does Goldman Sachs make its investment decisions based on the opinions of S&P, Moody's, or Fitch?

Sovereign debt is in an altogether different category. First of all, as it is clear in their sovereign rating methodologies, CRAs are privy to no private information.[3] They are the first to admit that their information is limited to what is known by the market. It is also obvious that this should be the case in this particular market. And, as far as "market scrutiny" is concerned, the budgets of the major sovereigns are topics of constant discussion. A day hardly goes by without some commentary on the fiscal health of European sovereigns. Finally, the overwhelming tonnage of sovereign debt is held by banks—not individual, unsophisticated investors. Such investors are, presumably, the least likely to be influenced by an opinion from a CRA.

Against this backdrop, if a CRA were to take an inexplicable, spurious, or "random" rating action on a sovereign, it is not at all clear why the market would—or should—pay any attention to it. Would the funding costs of the United States change if the CRA's rated it BBB instead of AAA? For example, when S&P downgraded U.S. sovereign debt from AAA to AA+ on August 5, 2011, were we aware of subsequent increases in the U.S. cost of funding caused by the downgrade?[4]

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[3] *See* Sovereign Bond Ratings Methodology, Moody's Investors Service, September 12, 2013.

[4] *See* S&P's Rating Announcement *available at* http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245316529563.

While I confess to being skeptical that a CRA would have the means to provoke a market reaction on sovereign debt, I am even more skeptical that it would have a reason to do so. Much has been made of the "conflict of interest" inherent in the issuer-pays model of the major CRAs. Put simply, when the issuers of the debt pay for the rating, there may be pressure for the rating agency to assign an upwardly biased rating. The CRA's are not paid for their sovereign ratings, so in the first instance there is no such conflict of interest. The Greek government does not pay for its rating, and hence cannot exert any direct financial pressure for a higher-than-otherwise rating.

But this does mean that the CRAs are under no pressure where their sovereign ratings are concerned. And it certainly does not mean that the CRAs have any incentive to assign low sovereign ratings. The fact is that the sovereign ratings are sometimes inputs into other ratings. In the case of Moody's, for example, they employ an explicit "sovereign ceiling," representing the highest possible rating which can be achieved by domestic issuers under that sovereign. For example, if the sovereign ceiling is A3, then no domestically based credit (including structured credits) can be rated higher than A3; further, no level of credit enhancement could achieve a rating above A3. While that ceiling is often several rating categories ("notches" in the parlance of rating agencies) above the sovereign rating itself, as a practical matter very few corporate issuers are rated above their sovereign.

Therefore, when the CRA downgrades a sovereign, that puts some downward pressure (which may or may not be binding) on all the ratings—corporate, sub-sovereign, government related, and structured—subject to that sovereign jurisdiction. If the CRAs are conflicted by the issuer-pays model to always assign the highest possible ratings they can, then the last thing they would want to do would be to downgrade a sovereign. Further, downgrading a sovereign can prompt substantial—and expensive—analysis to determine any and all impacted credits; credits which may then require downgrades themselves.

So not only do the CRAs have no incentive to lower sovereign ratings, they have every incentive—other than reputational—to leave them alone or raise them. Rating every government "AAA" would certainly be the path of least resistance for a CRA. It just wouldn't be credible.

Following this line of reasoning, the narrative that CRAs would spuriously downgrade European sovereigns, and that the market would consequently discount the sovereign debt, seems dubious on both points. The CRAs have only a long-term reputational incentive to downgrade sovereign debt. And this incentive would have to be measured against short-term pecuniary incentives not to—which suggests it is unlikely a CRA would aggressively downgrade any sovereign ahead of (let alone contrary to) prevailing market sentiment. And since the CRA would not claim any private information, it seems unlikely that the sophisticated investors who overwhelmingly hold the sovereign paper would necessarily change their pricing of this debt as a result.

Fortunately this question can be addressed, if perhaps not ultimately answered, through a fairly standard empirical analysis known as an "event study." Market prices— bond yields or Credit Default Swaps ("CDS") spreads—can be evaluated in a window of time surrounding a rating action to see if there is a statistically robust response pattern. If CDS spreads, which measure the price of insurance against default by an underlying issuer, routinely increase

following a downgrade of the issuer's rating, then such evidence would appear consistent with the argument that the CRAs at least *could* precipitate a sovereign crisis. On the other hand, if there is no relationship between rating actions and spread changes, that could be taken as supporting evidence against the argument.

Economists at Moody's recently conducted an event study of exactly this type, in the context of the CDS market, exploring the empirical impact of credit rating actions on sovereign markets.[5] A rating action includes not only upgrades and downgrades, but also outlook and watchlist assignments that may anticipate rating changes. The paper studies a data set from 2005 through early 2012, and examines the response of the CDS market to sovereign credit announcements of the three major rating agencies—Moody's, S&P, and Fitch. CDS spreads represent the direct prices of credit risk and, therefore, if a rating action *causes* changes in the market perception of credit risk, we would expect to see direct evidence in the CDS market.

Using a standard event study methodology, the study finds that for EA-12 countries[6] there is a small portion - 5 percent - of negative credit events statistically significantly associated with CDS excess returns, consistent with the hypothesis of little or no impact of negative sovereign rating actions. Similar results are found when sovereign rating actions are positive.

The study also finds that sovereign rating actions only have a statistically significant effect on returns of smaller or lesser developed countries, and only if the rating action is credit negative. These results provide supporting empirical evidence that, especially for the core European sovereigns, ratings do not seem to impact market credit perceptions beyond what would be randomly expected.

III. CONCLUDING REMARKS

Blaming the rating agencies for the difficulties of Greece, Italy, Spain, and Portugal truly seems like a case of blaming the messenger. High debt-to-GDP ratios, large and rapidly growing pension and healthcare expenditures, and slow economic growth and consequent tax revenue are facts, not opinions. Investors would discount the debt of these countries no matter what the CRAs said, or even if the CRAs said nothing at all.

Credit rating agencies are not perfect. They may even be in need of significant reform. But, in this case, it seems more likely than not that they are convenient scapegoats, and not villains.

[5] *The Price Impact of Sovereign Rating Announcements*, a Moody's Special Comment, was published in October of 2012.

[6] The group of EA-12 countries is composed of Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain and Greece.