A LOWER BANK RATING?

OWAIN AP GWILYM considers the implications of tighter regulation of credit-ratings agencies for European banks.

FIGURE 1

THE THREE KEY PHASES OF EU CRA REGULATION DEVELOPMENT	
'CRA I' – September 2009	A registration process for CRAs was introduced. A requirement that financial firms only obtain ratings from certified CRAs was instigated. CRAs must now identify and disclose potential conflicts of interest. CRAs must comprehensively disclose rating models, key rating assumptions, historical performance and annual transparency reports.
'CRA II' – July 2011	The European Securities and Markets Authority (ESMA) assumed responsibility for all CRAs' European activities and for enforcing enhanced regulation. ESMA also introduced measures to mitigate the mechanistic market reliance on credit ratings, e.g. to reduce the potential for market overreactions to rating downgrades.
'CRA III' – May 2013	The regulations were strengthened by the introduction of a new civil liability regime and by expansion of the transparency and monitoring requirements. The civil liability regime enables investors and issuers to sue for damages from a CRA if it can be shown that it intentionally, or negligently, rated a firm incorrectly.

Events during the global financial crisis triggered increased attention on the major international credit-rating agencies (CRAs), with numerous criticisms levelled at the influence of the industry's dominant players – Fitch Ratings, Moody's Investors Service and Standard & Poor's (S&P) – in financial markets. This included a perception that serial downgrades of European sovereigns and banks had extended and worsened the eurozone crisis. EU regulatory changes have sought to mitigate the credit-rating industry's perceived lack of transparency, lack of competition and conflicts of interest.

THREE PHASES OF DEVELOPMENT

The regulatory developments occurred in three main phases, as depicted in Figure 1. At the outset of these regulatory changes, the detrimental consequences of excessively high ratings on structured finance instruments were foremost in policymakers' minds. This context also influenced the CRAs in terms of subsequent efforts to rebuild their reputations. However, it is a common error for more casual observers to fail to distinguish between the different issues prevailing across different rating segments, i.e. sovereign, bank, corporate and structured finance ratings. This article specifically focuses on bank credit ratings to consider how tighter regulation of CRAs could have an ongoing impact upon European banks' ratings.

Inevitably, one initially looks to the US for a reference point in pursuing this objective. Evidence from US corporate bond ratings suggests that reputational concerns have a strong influence on CRA rating activity subsequent to the Dodd-Frank Act. There is also evidence that Moody's and S&P reveal greater reputational concerns in industries or markets where Fitch acts as a stronger competitor. The latter bears resonance for European banking, given Fitch's long-standing profile in the financial sector.

REPUTATION VS DISCIPLINE

The quality of credit ratings contributes to the proper function of financial markets, given that ratings are a channel of information transmission. An absence of overly inflated ratings is one important indicator of the quality of ratings. From the academic perspective, researchers have considered whether it is CRAs' reputation building or the force of regulatory discipline that is most important in achieving an environment of reliable and high-quality ratings as the financial sector moves forward from the global financial crisis.

The reputation hypothesis implies that CRAs may respond to reputational shocks and increased scrutiny from both the regulators and a wider set of stakeholders. More specifically, they may seek to reduce the likelihood of criticism arising from a perception of overly generous ratings. This could also result in 'over-shooting', i.e. there is the possibility that ratings reach an equilibrium which is lower than the level warranted by banks' financial characteristics. If this hypothesis is relevant, the observed effects should be stronger in market segments where CRAs care more about their reputation.

The disciplining hypothesis proposes that CRA regulation succeeds in increasing rating quality, on the grounds that increased legal and regulatory demands will motivate CRAs to invest in improvements to their methodologies, due diligence and performance monitoring. The regulation also induces CRAs to disclose conflicts of interests, to strengthen internal control structures and to increase transparency.

Recent research at Bangor Business School has examined whether the EU regulatory reforms of the rating industry in response to the global financial crisis have been successful. The impact of this regulation on rating levels, the incidence of false rating warnings and the responsiveness of stock markets to credit-rating signals have been investigated. Evidence on these issues is based on data for 758 rated European

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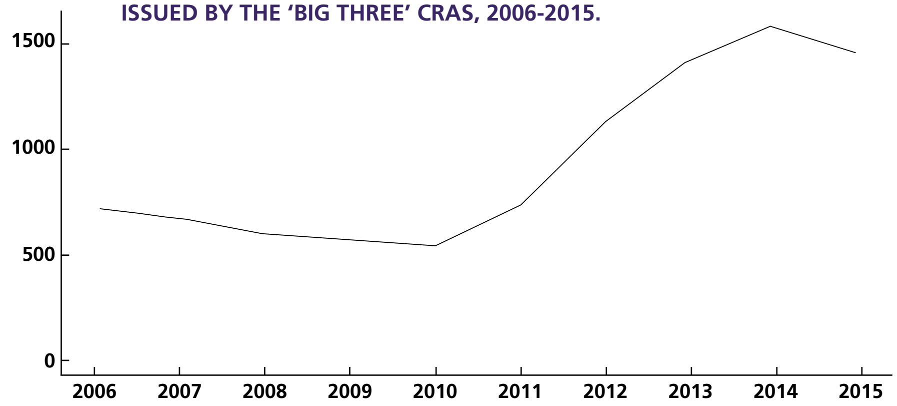
banks for the period from January 2006 to June 2016 across the 28 EU countries.

FALSE WARNINGS

The research finds evidence of CRAs acting on reputational concerns after the sub-prime crisis, but this soon dissipates and is not evident later in the sample period. The overall results reveal that the regulation's disciplining effect on CRAs dominates influences derived from CRAs' own actions in protecting their reputations. There is no meaningful variation in the results across countries with differing levels of competition among the CRAs. The regulation has clearly been successful in reducing the likelihood of overly inflated bank ratings. However, in achieving this, a greater conservative bias in bank ratings has been introduced. This is not necessarily desirable for market participants, let alone for the banks themselves. This bias has led to an increase in the incidence of false rating warnings as illustrated in Figure 2. False warnings are defined as bank rating downgrades within the speculative range that do not correspond with any subsequent financial distress, forced merger or default scenario.

FIGURE 2 FALSE WARNINGS ON A EUROPEAN BANK'S RATING ISSUED BY THE 'BIG THREE' CRAS, 2006-2015.



Associated with this, a decrease in the informational content of (and stock price reactions to) rating downgrades is evident. This could also be driven by a declining reliance on CRAs' opinions by market participants. Mechanistic reactions to rating signals have become less common, thereby meeting one of the European Securities and Markets Authority's key objectives in this context. With regard to bank rating upgrades, there is evidence of some increased stock price sensitivity after July 2011, which is potentially explained by greater market confidence that the upgrades are justified.

To summarise, regulators may have been successful in reducing rating inflation, but there are implications arising from an increased incidence of false rating warnings and an overall loss of information to market participants. These issues are important for banks, which can face economic consequences if their credit ratings are lower than is justified by their financial characteristics. CB

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