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How credit ratings affect sovereign credit risk: Cross-border evidence in Latin American emerging markets☆



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ABSTRACT

This article builds upon previous literature by providing a better understanding of how contagion changes in bordering sovereign CDS emerging markets resulting from credit rating events. To that end, we follow the novel GVAR methodology using data from six Latin American emerging countries during an extensive sample period from 2004 to 2014. Our findings show evidence for the existence of significant and asymmetric cross-border effects. In particular, a competition effect is observed before the event occurs, indicating that non-event countries suffer (benefit) from upgrades (downgrades) in Brazil, Mexico and Chile (in Argentina and Brazil). In contrast, an imitation effect is observed after rating upgrades in Chile, to the benefit of bordering non-event countries.

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1. Introduction

One of the most significant financial events of the past decade has been the rapid growth experienced by the OTC credit derivatives market. Since 2008, credit default swaps (hereafter, CDSs)¹ are the most widely traded credit derivative instrument used to efficiently transfer credit risk, offering opportunities for business diversification and the effective hedging of counterparty risk. According to the International Swaps and Derivatives Association (ISDA), the notional outstanding value of the CDS market increased from \$8.4 trillion at the end of 2004 to \$21 trillion at the end of 2013, marking a peak of \$58 trillion at the end of 2007. Nowadays, CDSs are considered a good proxy for credit risk, where the probability of default of the reference entity (and therefore the level of risk) is assumed by the counterparty.² Furthermore, CDSs are the most liquid credit derivative product and account for about half the amount of credit derivatives traded on the derivatives market.

Due to its recognised hedging qualities, the expansion of emerging debt markets might have led to the recent increase in the fraction of the CDS contracts written on high-yield debt obligations. Emerging nations are amongst the largest high-yield borrowers in the world; however, when facing financial distress, countries generally do not enter traditional bankruptcy proceedings (hence don't liquidate their assets), so the nature of default risk is somewhat different from that of a traditional debtor. In practice, countries go through debt restructuring mechanisms in which defaulted bonds are exchanged for new longer maturity and lower yield debt instruments.

Furthermore, recent literature has focused on the impact of sovereign credit ratings on sovereign debt, especially for emerging economies. Christopher et al. (2012) assert that sovereign ratings enhance the transparency of an emerging country's credit risk profile, whereas Kim and Wu (2008) argue that rating changes within emerging economies have determinant information about the governments' capacity to deal with both their financial obligations as well as their refinancing conditions, as rating changes provide information about the institutional quality for financial and economic development.

Theoretically, both sovereign credit risk levels measured by CDS spreads and announcements of a credit rating changes should reflect the same information content, given that both are based on publicly available information.³ If this were to be true, we would not expect CDS spreads to react to a rating announcement. However, several recent papers (Finnerty et al., 2013, amongst others) find that the CDS market anticipates credit rating news. This literature has focused on analysing endogenic effects within a country or a firm, and hence little attention has been paid to cross-border effects. Following Wengner et al. (2015), we argue that the study of the response in the country that the rating event occurs is incomplete because it does not reveal how much of the event's information is country-specific and how much is market-wide. In fact, literature has demonstrated that a significant part of sovereign CDS spreads is explained by common factors such as investors' risk appetite and global economic fundamentals (Remolona et al., 2008; Longstaff et al., 2011; Eichengreen et al., 2012), so any credit rating announcement containing new information should have spillover effects on the CDS spreads of other sovereigns. Cross-border analyses allow us to investigate if non-event countries (seen as competitors) benefit or not from the rating event in a given country. In this paper, we shall address this issue.

We use the information contained in CDS contracts of Latin American emerging economies from 2004 to 2014 to investigate the cross-border spillover effects of the credit rating events. In particular, we test whether or not the contagion effect amongst sovereign CDSs has changed depending on rating announcements. The contagion is measured in terms of return spillovers following a generalised VAR (GVAR) approach (Diebold and Yilmaz, 2012). More specifically, we calculate the change in the pairwise contagion before and after the credit rating event. Finally, we contrast whether they are statistically significant on average. We distinguish between positive and negative events, which enables us to analyse whether sovereign CDSs of non-event countries respond symmetrically to rating upgrades and downgrades in a given country.

To sum up, we seek to address the following questions: Is there a significant change in the spillover effect on CDS spreads of non-event sovereign entities due to credit rating announcements of a given country? Is

¹ A CDS is essentially an insurance contract that provides protection against the risk of default by a specific reference entity. The CDS spread is the periodic rate that a protection buyer pays on the notional amount to the protection seller for transferring the risk of a credit event for some period.

² There are several advantages of using CDS spreads instead of bond spreads. See for instance, Blanco et al. (2005), Norden and Weber (2009) and Jorion and Zhang (2009), amongst others.

³ Intuitively, one should expect a negative relationship between them, since the higher the CDS spread, the lower the credit rating.

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