International Review of Financial Analysis 21 (2012) 45–55

Contents lists available at SciVerse ScienceDirect

International Review of Financial Analysis

Rating agencies' credit signals: An analysis of sovereign watch and outlook

Rasha Alsakka [a,*], Owain ap Gwilym [b]

[a] Bangor Business School, Bangor University, Bangor, LL57 2DG, UK
[b] Bangor Business School, Bangor University, UK

ARTICLE INFO

Article history:
Received 25 June 2010
Received in revised form 13 October 2011
Accepted 30 October 2011
Available online 4 November 2011

JEL classification:
G1
G2

Keywords:
Credit rating agencies
Sovereign outlook
Sovereign watch
Lead–lag relationship
Momentum

ABSTRACT

We analyse sovereign watch and outlook signals from Moody's, S&P and Fitch. Prior literature shows strong market reactions to these signals, which arguably contain more new information than rating changes. We show that the agencies' actions imply different policies: S&P has more emphasis on short-term accuracy, while Moody's actions are consistent with greater stability. We find evidence of momentum in negative (not positive) outlook signals, but no watch momentum. We also examine the lead–lag relationships, finding that S&P (Fitch) demonstrates the least (most) links with other agencies' actions. Moody's tends to be the first mover for positive outlook and watch signals.

1. Introduction

The sub-prime mortgage crisis in the United States placed credit ratings agencies (CRAs) under the spotlight, and brought increased attention to their performance. There is an ongoing debate on issues of revenue versus reputation (e.g. Mathis, McAndrews, & Rochet, 2009). However, the U.S. Securities and Exchange Commission (SEC, 2011) finds 'no material regulatory deficiency' based on its recent examinations of the ten registered Nationally Recognized Statistical Rating Organizations (NRSROs), despite ongoing concerns about whether CRA policies are entirely adequate to avoid conflicts of interest.[1] Meanwhile, criticism of CRAs during the European sovereign debt crisis was more focused on the extent and timing of downgrades.

In response to the perceived role of CRAs in the sub-prime crisis, the International Organization of Securities Commissions (IOSCO) revised the Code of Conduct Fundamentals for CRAs in 2008 to address issues of independence, conflict of interest, transparency and competition. A formal European Union (EU) regulation on CRAs entered into force in December 2009, and CRAs are now subject to legally binding rules based on the IOSCO Code. Within the EU, the responsibility for the registration and regulation of CRAs was handed to the European Securities and Markets Authority (ESMA) in July 2011. Ratings issued outside the EU can be used for regulatory purposes by regulated entities in the EU by means of either endorsement or certification with ESMA. The Basel Committee also reviewed the role of external ratings in its capital adequacy regulations, mainly to incorporate the IOSCO Code in the eligibility criteria.[2]

CRAs aggregate information about the credit quality of borrowers, reducing information asymmetry faced by lenders, and hence allowing borrowers to access financial markets and attract investment funds.[3] Rating changes are the means by which CRAs signal permanent changes in an issuer's credit quality. However, CRAs' rating outlook and watch are supplemental tools to communicate potential changes in credit quality. Outlook and watch signals were developed to provide indicators of the likely direction and timing of future rating changes (Hamilton & Cantor, 2004). A complete CRA credit opinion on an issuer consists of a credit rating and a rating outlook/watch status. One criticism of CRAs is their apparently slow reactions in changing ratings. However, because of CRAs' "through the cycle" methodology and the sound reasons for stability in ratings (Altman & Rijken, 2006; Löffler, 2004, 2005), watch and outlook signals are

* Corresponding author. Tel.: +44 1248 383571.
E-mail addresses: r.alsakka@bangor.ac.uk (R. Alsakka), owain.apgwilym@bangor.ac.uk (O. ap Gwilym).

[1] The ten registered NRSROs are A.M. Best, DBRS, Egan-Jones, Fitch, JCR, Kroll, Moody's, Morningstar, R&I and S&P (at end-2010).

[2] For more details about the Basel II capital framework, see Sundmacher and Ellis (2011), for example. Further, in 2009, the U.S. SEC amended its regulations for CRAs to require enhanced disclosure of performance statistics, rating methodologies and annual reporting, and additional restrictions on activities that could produce conflicts of interest.

[3] Credit ratings are now heavily hardwired into investment processes, financial contracts and regulatory frameworks.

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doi:10.1016/j.irfa.2011.10.002

very likely to be the source where CRAs reveal more private information. Bannier and Hirsch (2010) analyse the economic function of the watchlist, and find that CRAs employ watch signals to improve the delivery of information.

Several prior studies demonstrate that outlook and watch signals have a significant market impact. Hand, Holthausen, and Leftwich (1992) show that watch signals by Moody's and S&P (pooled together) for corporate issuers are associated with stronger abnormal bond and stock returns than are actual rating changes. Hull, Predescu, and White (2004) show that negative watch signals by Moody's contain information for the credit default swap (CDS) market, while rating downgrades do not. The average increase in the CDS spread at the time of a watch event is almost 10 basis points. Norden and Weber (2004) find that negative watch actions by Moody's and S&P for corporate issuers affect stock returns and CDS spreads while rating downgrades by S&P do not. Kaminsky and Schmukler (2002) illustrate that sovereign outlook and watch signals by the larger three CRAs have a stronger impact than rating changes for emerging stock and bond markets. Pukthuanthong-Le, Elayan, and Rose (2007) show that sovereign outlook and watch events by S&P influence bond and equity markets, while the effect of ratings changes is either insignificant or weaker. Hooper, Hume, and Kim (2008) find that the impact of sovereign outlook/watch changes by the larger three CRAs is twice as strong as the impact of rating changes. Sy (2004) finds that S&P and Moody's sovereign credit signals, including negative watch and outlook events, help predict the likelihood of distressed debt events within the next year. Hill and Faff (2010) highlight that sovereign outlook and watch events are more timely and more informative than rating changes.

The International Monetary Fund (2010a) emphasises that CRAs affect stock and bond markets by revealing new information and a 'certification' role, though this is most evident in their use of outlook and watch signals rather than actual rating changes. Kim and Wu (2011) provide evidence that improvements in sovereign credit quality encourage international bank flows from developed to emerging economies, but note that outlook and watch events are associated with much stronger economic effects than are rating changes. Gande and Parsley (2005), Ferreira and Gama (2007) and Ismailescu and Kazemi (2010) find that the impact of sovereign outlook and watch signals is also transmitted to stock, bond and CDS markets in other countries.[4]

Given the economic importance of outlook and watch signals, we investigate the behaviour of sovereign outlook and watch status assigned by Moody's, S&P and Fitch. Specifically, we aim to answer four main questions: (i) Do previous sovereign outlook/watch events carry any predictive power for the direction of future sovereign outlook/watch changes?; (ii) Do the CRAs' polices differ in relation to outlook/watch?; (iii) Do sovereign outlook/watch changes by one CRA appear to be affected by prior actions by another CRA?; (iv) Does any one CRA demonstrate a lead in providing signals to the market through outlook/watch actions for sovereigns?

Prior actual rating changes are demonstrated to carry predictive power for the direction of future rating migrations by the same CRA (rating momentum). Downgrade (but not upgrade) momentum in corporate ratings is supported by Bangia, Diebold, and Schuermann (2002) and Lando and Skødeberg (2002). Fuertes and Kalotychou (2007) and Alsakka and ap Gwilym (2009) provide evidence of downgrade momentum in sovereign ratings. However, the literature is silent on the existence of momentum in outlook and watch signals. Therefore, we examine whether outlook or watch status is affected by previous outlook or watch actions by the same CRA. We find evidence of momentum in negative (not positive) outlook actions, while watch signals do not carry predictive power for the direction of future watch changes.

Within the literature on the market impact of rating signals, there is evidence of unequal reactions to different CRAs' actions. Cantor and Packer (1996) find that Moody's sovereign rating changes have a greater effect on bond spreads than do S&P actions. Brooks, Faff, Hillier, and Hillier (2004) provide evidence that Moody's sovereign upgrades are associated with positive abnormal returns, but S&P and Fitch upgrades are not. Norden and Weber (2004) show that downgrades by Moody's only significantly impact CDS spreads, and negative watch actions by Moody's and S&P are associated with significant negative abnormal stock returns, while no abnormal performance is associated with Fitch actions. Hill and Faff (2010) highlight that S&P is more active and provides more new information than Moody's and Fitch during crisis periods. Outside crisis periods, Moody's tends to lead for ratings of advanced economies, and S&P leads for ratings of non-advanced economies. Each CRA has a clear interest in maintaining a strong reputation in financial markets by providing high quality credit signals (Güttler & Wahrenburg, 2007). Our lead–lag analysis aims to identify whether any given CRA demonstrates a lead in supplying credit signals to the market.

Our evidence shows that different policies are applied across CRAs, whereby Moody's has more emphasis on stability, while S&P puts more weight on short-term accuracy. Our findings on lead–lag analysis are summarized as follows. S&P is the most independent CRA, while Fitch is the most dependent. Fitch watch and outlook actions have an insignificant impact on future outlook/watch adjustments by Moody's, but not vice versa. Moody's and Fitch tend to follow S&P negative outlook/watch actions to a greater extent than S&P follows the others. Moody's tends to be the first mover in positive outlook and positive watch signals.

The remainder of the paper is organized as follows. Section 2 discusses key themes associated with the empirical analysis. Section 3 describes the data, while Section 4 presents the ordered probit models. Section 5 analyses the empirical results and Section 6 concludes the paper.

2. Key themes associated with the empirical analysis

2.1. The importance of outlook and watch signals

A rating *outlook* is an opinion regarding the likely direction that a credit rating may take over the next one- to two-year period. The rating outlook categories are: positive, stable, negative and developing. Credit watch status is a much stronger statement about the future direction of a credit rating within a relatively short horizon (ex-ante target of 3 months). The watch categories are: watch for upgrade, watch for downgrade, and watch with direction uncertain. Watch assignments are formal rating reviews that are likely to result in some rating action (including confirmation of the existing rating). The CRAs' perspective is that an issuer which is on watch has a higher probability of experiencing a rating change than one with a rating outlook assigned. Rating outlooks and watch are designed to signal when risks are imbalanced but a rating change is not certain. Many rating changes are preceded by a non-stable outlook or a credit watch placement, but a positive or negative rating outlook/watch does not imply that a rating change is inevitable. Additionally, ratings with stable outlooks or which are not on watch are frequently changed before the outlook/watch status is revised (see Hamilton & Cantor, 2004; Klaar & Riley, 2005; Vazza, Leung, Alsati, & Katz, 2005).[5]

Previous studies emphasise the economic importance of outlook and watch signals, since these signals offer important information

[4] See Section 2.1 for further details about the importance of outlook and watch signals.

[5] Outlook developing and watch with direction uncertain are a very small minority of the cases of outlook/watch status. As they do not signal a future rating direction, we exclude these cases in the empirical analysis.