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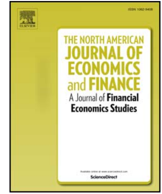

Review

The adjustment of bank ratings in the financial crisis: International evidence

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ABSTRACT

This paper analyses the adjustment of bank ratings which occurred in the United States, some European countries and Japan as a result of the financial crisis. We use a methodology which allows us to decompose the observed change in the rating into an effect associated with the change in agency rating policies (understood in a broad sense) and into another effect associated with the situation of bank assets. The results obtained show that with the crisis there was a generalised fall in the ratings, caused by both a worsening of the bank asset situation and the hardening of rating policies. Specifically, we find that 39.95% and 19.25% of the fall in ratings in the United States and European countries are due to a hardening of rating policies in Fitch and Standard and Poor's, respectively. Although the relevance of the change in the rating policy is lower in Moody's (15.83%), which suggests that has a less procyclical behaviour, this agency adjust their rating to a greater extent (15.94%) than Fitch (8.75%) and Standard and Poor's (8.17%) when the rating action is taken.

1. Introduction

The outbreak of the subprime crisis in 2007 and the subsequent sovereign debt crisis in Europe have increased the doubts regarding the behaviour of the three principal rating agencies (Fitch, Standard and Poor's and Moody's) and the quality of the ratings issued. Specifically, the rating agencies (CRAs) have been accused of relaxing their rating criteria during the period of economic growth up to the outbreak of the subprime crisis (Securities and Exchange Commission, 2008). Agencies have also been criticised because of the conflicts of interest deriving from their business model, lack of transparency and excessive credibility received from investors and regulators (Bank of England, 2011). This is not new, as in the past several episodes have questioned the agencies' operation. First, in the Mexican crisis of 1994–1995 the rating agencies were blamed for reacting to the events that were occurring rather than anticipating them (Reisen & Maltzan, 1999). A similar criticism was made following the Asian crisis of the late 1990s (Ferri, Liu, & Stiglitz, 1999). Later, with the bankruptcies of Enron and Parmalat, the agencies were again in the firing line for having awarded these firms an investment grade rating in the days before their failure (Hill, 2004; Danvers and Billings, 2004).

In response to the criticisms received, the CRAs have defended themselves by arguing that their ratings are drawn up with a medium and long-term perspective (Through-The-Cycle), and consequently ignore the transitory changes occurring in the solvency of the products that they assess, i.e. they do not issue ratings with a "Point-In-Time" perspective. In this context, some previous studies (Altman & Rijken, 2004 and 2006, for example) find evidence in favour of the Through-The-Cycle perspective. Despite defending these arguments, it is true that the ratings have worsened significantly with the financial crisis, suggesting a procyclical behaviour.

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Furthermore, the rating agencies have also hardened their criteria (International Monetary Fund, 2010). These two factors call into question whether the rating agencies actually do follow a Through-The-Cycle strategy.

These criticisms have also been targeted at the regulators, who have been accused of assigning an excessive role to ratings and of performing an ineffective supervision of the rating agencies. In this sense, the International Organization of Securities Commissions (IOSCO) revised its code of conduct with the aim of increasing transparency, independence and competition among rating agencies and of reducing conflicts of interest deriving from their business model. But this has not been the only reform. The European Parliament approved several regulations (EC No. 1060/2009; EC No. 513/2011; 2013/14/EU), establishing a centralised supervision and registration by the European Securities and Markets Authority (ESMA); reducing the over-reliance of investors on external public debt ratings; attempting to mitigate conflicts of interest; and increasing both transparency and competition.

In the United States, a series of reforms were also carried out. The Dodd-Frank Wall Street Reform and the Consumer Protection Act of 2010 imposed restrictions on the agencies to prevent conflicts of interest, and to increase transparency. In Japan, the Financial Instruments and Exchange Act in 2009 was amended in the same line. Lastly, the Basel Committee reviewed the role of ratings in the calculation of regulatory capital requirements (Sundmacher & Ellis, 2011).

While the CRAs adjusted their rating criteria and the regulators carried out different reforms to strengthen their supervision and avoid conflicts of interest, the financial situation of banks worsened significantly to the extent that bank bailouts were necessary (Laeven & Valencia, 2013; BCE, 2008a,2008b). As a consequence, bank ratings suffered a downward adjustment due both to the hardening of rating policies and to the worsening of their asset situation.

In this context, the objective of our paper is twofold. Firstly, we analyse the adjustment which occurred in an international sample of bank ratings, quantifying the contributions of the change in policy rating, as well as the worsening of the asset situation. To this end, we follow the methodology proposed by Salvador, Pastor, and Fernández de Guevara (2014) for the particular case of the Spanish Banking System (SBS). We first calculate the probability of a bank obtaining a certain rating as a function of the factors posited by both the methodological reports of rating agencies (Fitch, 2009; 2011; Moody's, 2007a, 2007b; Standard and Poor's, 2011a, 2011b) and the previous literature (Morgan, 2002; Poon, Firth, & Fung, 1999; Tabakis & Vinci, 2002; Iannotta, 2006; Iannotta, Nocera, & Sironi, 2008; Bellotti, Matousek, & Stewart, 2011; Caporale, Matousek, & Stewart, 2011; D'Apice, Ferri, & Lacitignola, 2014; Shen, Huang, & Hasan, 2012; Öğüt, Doğanay, Ceylan, & Aktaş, 2012; among others). Additionally, we test whether a structural change in the behaviour of the rating agencies with the onset of the financial crisis. Secondly, after modelling the bank ratings and empirically testing for the existence of a change in the behaviour of the rating agencies a prediction exercise is performed, allowing the change in the ratings to be disaggregated into two multiplicative factors: one due to changes in the banks' asset situation and the other to the change of the rating policies. Finally, we determine whether the adjustment in the ratings has occurred with the same intensity in all banking systems or whether there are differences between banks in the United States (US), European countries and Japan. Therefore, the main contribution of the paper is the use of an international sample that allows us to consider additional factors in the explanation of bank's ratings. For example, we include indicators associated with the economic environment and the cycle of the country in which the bank mainly operates (sovereign credit ratings, government support or GDP growth rates, for example). Furthermore, the use of an international sample allows determining whether the rating agencies have reacted differently to the financial crisis depending on the country or the geographical area. The paper focuses on the issuer ratings of a significant sample of banks in the United States, Europe and Japan, between 2004 and 2013.

The results obtained show that with the financial crisis in 2008, there is a generalised fall in bank ratings, the intensity of which depends on the CRA considered. On average, a fall in ratings is estimated in Fitch, Standard and Poor's and Moody's of 8.75%, 8.17% and 15.94%, respectively. If the particularity of the Japanese case documented below is not taken into consideration, this fall in Fitch, Standard and Poor's and Moody's is due both to the worsening of the asset situation and to the hardening of rating policies. Specifically, in the case of Fitch, 39.95% of the fall is due to the hardening of the rating policy and 60.05% to the worsening asset situation in the United States and in Europe. In Standard and Poor's, 19.21% is caused by the hardening of the rating policy and 80.79% by the worsening of the solvency level. Consequently, the fall in ratings and the hardening of rating criteria suggest that Fitch and Standard and Poor's did not strictly follow a Through-The-Cycle strategy. In Moody's, the adjustment derived from the change in the policy is less relevant (15.83%). This result suggests that the behaviour of Moody's is more is less procyclical than the other agencies and therefore this agency tried to put more emphasis on rating stability. Despite its less procyclical behaviour, Moody's adjust their rating more (15.94%) than Fitch (8.75%) and Standard and Poor's (8.17%) when the rating action is taken. We also find that, on average, ratings have worsened with greater intensity in the US and the peripheral European countries (also known as GIPSI)[1] due to the deterioration of the bank asset situation with the onset of the financial crisis. Consequently, these results suggest that although the financial crisis has led to a general hardening of rating policy, its relative importance in the downward adjustment of ratings varies depending on the group of countries and rating agency analysed. This result is robust to different specifications, such as the use of different indicators of bank capital, considering subsamples of listed and non-listed banks or the possible government support banks may eventually receive.

After this introduction, the structure of the paper is as follows. The second section briefly reviews the literature on modelling of bank ratings. The third section specifies the sample used and performs a descriptive analysis of the behaviour of ratings during the period analysed. The fourth section defines the methodology and the variables used on modelling bank ratings. The fifth section presents the empirical results, and finally, the last section presents the conclusions.

[1] GIPSI European countries are those most affected by the recent sovereign debt crisis in Europe: Greece, Italy, Portugal, Spain and Ireland.

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