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Rating methodologies for banks[1]

The three major rating agencies are reassessing banks' credit risk in the light of the recent crisis. So far, this has resulted in material downgrades, especially of European and US institutions, and increased agreement about banks' overall level of creditworthiness and their greater dependence on public support than in the past. The agencies are also making efforts to enhance the transparency of bank ratings and the role of official support. Agency assessments of regulatory initiatives may affect policymakers' communication with financial markets.

JEL classification: G21, G24, G28.

In the wake of the global financial crisis, the role of the major credit rating agencies and the ratings they assign to financial institutions have come under increased scrutiny. The crisis highlighted risks that had been underestimated, brought into greater relief the value of government assistance and led public authorities to commit to an overhaul of banks' regulatory and support frameworks. In response, one agency has recently proposed significant changes to its bank rating methodology, seeking public comment. Another has recalibrated the relative importance attached to rating factors.

A close look at data on bank credit ratings and agency publications leads to three key findings. First, all three major rating agencies (Fitch Ratings, Moody's Investors Service and Standard & Poor's) consider the creditworthiness of large European and US banks to have worsened materially since the onset of the crisis. Second, rating agencies are currently in greater agreement about banks' creditworthiness than in mid-2007, reflecting shifts in estimates of government support. Third, ongoing revisions to agencies' methodologies and assessments of the financial landscape seem likely to lead to further downgrades in the banking sector.

Changes to ratings methodologies can be a double-edged sword for prudential authorities. By adopting a system-wide perspective on financial risk and paying closer attention to measures aimed at reducing official support to banks, agencies seem so far to be in sync with recent policy initiatives. But

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policymakers may face credibility issues in future if ratings contradict official statements – eg about the authorities' own assessments of banks' health or the design of bank resolution plans – and markets focus on these ratings.

In the rest of this article, we proceed as follows. In the first section, we discuss in general terms the information that ratings convey about creditworthiness. In the second, we examine the relationship of ratings and other credit risk indicators observed before the recent crisis to banks' performance during the crisis. In the third, we put this relationship in context by discussing reasons why accurate assessments of banks' creditworthiness may be inherently difficult to obtain. After outlining the bank rating methodology of each of the three major agencies in the fourth section, in the fifth we examine how actual bank ratings differ across these agencies and how they have evolved since the beginning of the crisis. We discuss policy implications in the final section, paying particular attention to the agencies' recent drive towards greater transparency.

Credit ratings: general background

Ratings are expert opinions …

Ratings are opinions about the creditworthiness of a rated entity, be it a sovereign, an institution or a financial instrument. They reflect both quantitative assessments of credit risk and the expert judgment of a ratings committee. Thus, no rating can be unequivocally explained by a particular set of data inputs and formal rules.

… reflecting relative creditworthiness

Ratings convey information about the relative and absolute creditworthiness of the rated entities. Agencies often emphasise that a rating reflects the creditworthiness of the rated entity *relative* to that of others. That said, agencies regularly publish studies that convey the historical association of ratings and indicators of *absolute* creditworthiness, such as default rates and the magnitude of losses at default. Moreover, in the case of structured finance products, ratings are explicitly tied to estimates of default probabilities and credit losses.[2]

Ratings and other credit indicators prior to the recent crisis

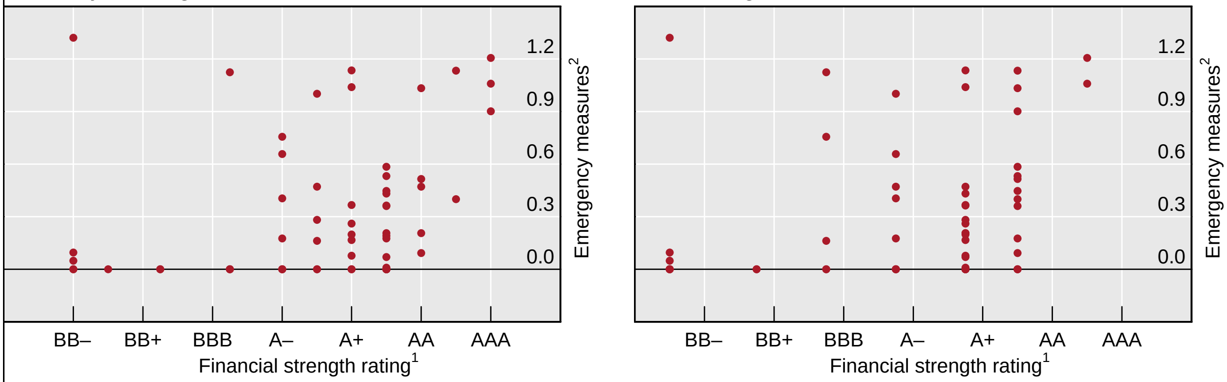
Missed vulnerabilities ahead of the crisis

Ahead of the financial crisis, credit ratings were not particularly successful in spotting the build-up of widespread vulnerabilities in the financial system or in identifying which institutions were most exposed to them. In particular, pre-crisis ratings would have contained useful information had they been lower for banks that subsequently resorted to stronger emergency measures, such as capital-raising and asset sales. However, for a sample of 60 large internationally active banks, the financial strength ratings assigned by two of the major agencies in mid-2007 had a weak and *positive* relationship with

[2] Depending on the agency or type of rated entity, some ratings are intended to convey information about default probabilities while others refer to expected credit losses. This alone limits comparisons across sectors and agencies. More generally, Fender et al (2008) argue that ratings comparability is impaired by the fact that a single rating scale cannot rank the rated entities along multiple dimensions of credit risk simultaneously.

Pre-crisis ratings and in-crisis performance of large banks

Moody's ratings and resilience | Fitch ratings and resilience



[1] Referred to as "individual rating" by Fitch and "bank financial strength rating" by Moody's. Translated into a standard scale on the basis of mapping tables in Fitch (2010) and Moody's (2007b). [2] Sum of the values of fixed income, capital and hybrid instruments issued and assets sold from mid-2007 to end-2009, divided by total equity in 2006.

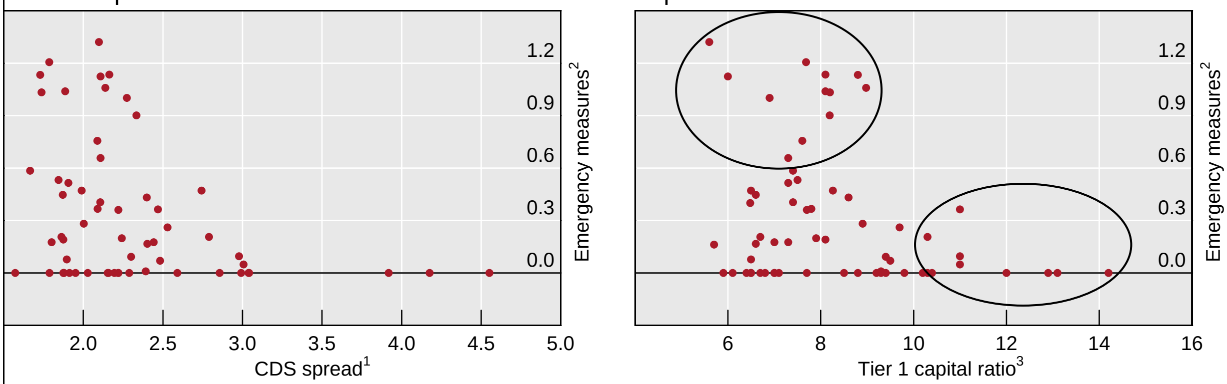
Sources: Bloomberg; Fitch Ratings; Moody's Investors Service. Graph 1

banks' subsequent reliance on emergency measures (Graph 1).[3] To be sure, other credit market indicators faired similarly poorly. For instance, bank CDS spreads prior to the crisis are not informative about banks' performance during the crisis (Graph 2, left-hand panel). Even though these CDS spreads might be expected to relate positively to the extent of banks' subsequent reliance on emergency measures, the empirical relationship is weak and *negative*.

Hindsight points to indicators that could have improved the accuracy of pre-crisis ratings. On a system level, there is a general agreement that features of the regulatory environment and financial culture in banks' home and host

Pre-crisis characteristics and in-crisis performance of large banks

Credit spreads and resilience | Capital and resilience



[1] On log scale. [2] Sum of the values of fixed income, capital and hybrid instruments issued and assets sold from mid-2007 to end-2009, divided by total equity in 2006. [3] In per cent.

Sources: Bankscope; Bloomberg; Markit. Graph 2

[3] Likewise, mid-2007 financial strength ratings exhibit no relation to banks' profitability in 2008 and 2009, scaled by banks' equity in 2007. These results pertain only to the ratings of Moody's and Fitch. Standard & Poor's had published financial strength ratings only for banks in the Asia-Pacific region, whereas our sample is composed mostly of US and European banks.

countries – such as the degree to which exposure to complex financial products was encouraged or tolerated – would have provided useful information. Macroprudential indicators, based on above-trend credit growth and asset price increases, may also have been effective in pointing to a build-up of vulnerabilities.[4] And in terms of bank-level characteristics, both rating agencies and markets could have paid closer attention to the level of high-quality capital. Banks with high Tier 1 capital ratios in 2006 had little or no need for emergency measures during the crisis, while the largest emergency measures were taken by banks with low ratios (Graph 2, right-hand panel). It is thus not surprising that rating agencies are reviewing their assessments of banks' risk in the light of the crisis.

Why assessing banks' creditworthiness is difficult

Bank ratings need to account for ...

The difficulties rating agencies, credit markets and many financial analysts had in forecasting banks' performance during the recent crisis are rooted in unique features of the banking industry.[5] Banks' role as financial intermediaries and their importance for financial stability determine the degree of external assistance they receive and shape the risk factors to which they are exposed. Assessments of bank creditworthiness thus need to account for the degree of external support, gauge the degree of systemic risk and address the inherent volatility of banks' performance.

Accounting for external support: stand-alone versus all-in ratings

Since banks play a key role as financial intermediaries, they often benefit not just from the support of the parent institution – as any other firm would – but also from that of public authorities. The recent crisis illustrated that support can come in different forms: as capital injections, asset purchases or liquidity provisions. When there is a commitment to support the creditworthiness of a bank, be it explicit or implicit, the rating agency has to evaluate not only the *ability* of the parent or sovereign to honour this commitment but also their *willingness* to do so. And even if support can be expected to be strong most of the time, what matters is its availability when the bank needs it. This suggests that the *correlation* between distress of the bank and its underlying source of support should also be examined.

... external support to banks ...

Given the importance of external support, rating agencies generally assign at least two different ratings to banks, which in the remainder of this feature we refer to as "stand-alone" and "all-in" ratings. A stand-alone rating reflects the intrinsic financial strength of the institution and, thus, its likelihood of default, assuming that no external support is forthcoming. In addition to accounting for stand-alone financial strength, an all-in rating factors in the likelihood and

[4] See, for example, Borio and Drehmann (2009).

[5] For evidence that uncertainties about banks' creditworthiness lead agencies to disagree more about bank ratings than about the ratings of firms in other industries, see Cantor and Packer (1994) and Morgan (2002).

magnitude of extraordinary external support that the bank may receive if and when it is in distress. While all-in ratings matter to banks' creditors and trading counterparties, stand-alone ratings provide useful information to a prudential authority interested in the underlying strength of institutions.[6] In addition, by comparing the stand-alone rating of a bank with its all-in rating, investors can infer the agency's assessment of external support and, possibly, make adjustments to this assessment for their own use.

Accounting for systemic risk

The recent crisis has underscored the need for a holistic approach to assessing bank risk. In particular, it has become clear that the creditworthiness of a bank depends on vulnerabilities that may build up in different parts of the financial system, as well as on interlinkages in this system. Thus, a bank's rating should not be derived in isolation but should reflect the industrial, financial and economic context of the bank's business.

... banks' financial and regulatory environment ...

Adopting a system-wide perspective is not straightforward. First, there has to be an operational definition of the relevant system, which gives rise to a tension between the desire to be comprehensive and the need to be practical. Should the system comprise only banks or also other financial institutions to which the bank is linked, or should it be expanded even further? And should it be limited geographically to the home country or cover all the countries in which a given bank operates? What is the right approach to analysing internationally active banks that fund themselves in one part of the world while the liquidity of their investments depends on financial conditions in another?

Second, even when the relevant system is defined, there is no agreed formal metric for assessing systemic risk. The literature has proposed a number of model-based measures that are either overly stylised or quite data-intensive and difficult to communicate to the general public. As an alternative to model-based measures, rating agencies often rely on leading indicators based on empirical regularities that signal the build-up of vulnerabilities in the system, such as high credit growth and asset price increases.[7]

Accounting for earnings volatility

... and large uncertainties about banks' performance

Another reason banks' creditworthiness is especially hard to assess is that their earnings performance is highly volatile, not least because of structurally high leverage. For instance, on the back of leverage roughly five times that of firms in other sectors, the volatility of returns on banks' stocks over the past several decades has been consistently higher than that of non-financial stocks (BIS (2010), Chapter VI). Evaluating the outlook for banks' earnings – the key source of loss-absorbing capital – is a critical component of bank credit analysis. It is important to evaluate not only the extent to which a bank's

[6] That said, when one bank has a credit exposure to another bank, it is common practice to use the all-in rating of the second in assessing the risk-weighted assets of the first for regulatory requirements.

[7] See Drehmann and Tarashev (2011) and Borio and Drehmann (2009).

earnings can absorb adverse shocks, but also how far investors would allow the bank to retain more earnings through reduced dividend payouts when raising fresh capital is difficult. Banks that wait too long to increase earnings retention may be particularly unstable, as the speed at which distress unfolds can overwhelm banks' concurrent earnings capacity. Agencies use this argument to explain why they consider banks that consistently retain a greater share of their earnings during tranquil times as more creditworthy.

Agency methodologies

This section discusses sequentially the rating methodologies of the three major rating agencies. The discussion is condensed in Table 1.

Fitch Ratings[8]

Fitch's assessment of external support ...

The Fitch methodology provides stand-alone ratings (which the agency calls "individual ratings") and, for ease of comparison, a mapping table for translating them into the scale of the more granular all-in ratings ("issuer default ratings"). To enhance the transparency of all-in ratings, Fitch also publishes separate ratings on a five-point scale designed to capture the likelihood and magnitude of external support either from the state or from an institutional owner ("support ratings"). In cases where these support ratings reflect potential assistance from the state, Fitch announces a support rating floor utilising the same scale as the all-in ratings scale. The all-in rating is then the higher of the stand-alone rating and the support rating floor.

... will become more transparent

Fitch intends to make the link between its stand-alone and all-in bank ratings more transparent than in the past. In mid-2011, it will convert its nine-point stand-alone ratings scale into a 19-point scale that corresponds exactly to that of all-in ratings. The new stand-alone scale will provide both more granularity on Fitch's financial strength assessments and clarity on the specific benefits of support.

Even though Fitch was the first major rating agency to engage in explicit assessments of systemic risk and to provide ratings for national banking systems, these assessments are used as input to its sovereign ratings rather than directly in the calibration of individual bank ratings. In 2005, Fitch introduced two systemic risk measures, each of which characterises the economic and financial stability of a country. The first incorporates a bottom-up approach, as it equals the system-wide average of individual banks' stand-alone ratings. The second is based on macroprudential indicators designed to capture abnormal growth of bank credit to the private sector and unusually strong asset price increases, drawing explicitly on Borio and Lowe (2002). A combination of weak scores on both measures is viewed as most worrisome.

8 This subsection draws on Fitch Ratings (2005, 2010, 2011).

Rating methodologies for banks			
	Fitch	Moody's	Standard & Poor's[1]
Stand-alone assessments (intrinsic financial strength)	Focus on off-balance sheet commitments, funding and liquidity risk	Emphasis on forward-looking assessments of capital ratios, based on embedded expected losses	Focus on risk-adjusted performance and ability to grow capital from profits
All-in ratings (with external support)	Distinct ratings of sovereign support provide a floor	Based on a joint default analysis of banks and providers of support	Anticipated support increases with the bank's systemic importance
System-wide assessment			
Country rating	Based on: - macro indicators - average bank rating	None	Based on: - macro indicators - industry and regulatory environment
Does systemic risk affect banks' ratings?	Not explicitly; anticipated support increases with the bank's systemic importance but falls in times of generalised distress	Not explicitly; anticipated support increases with the bank's systemic importance	Yes, through: - macro indicators for countries where the bank operates - assessments of the industry and regulatory environment in the home country
Last major changes	2005: systemic risk analysis	2007: joint default analysis in support assessment	2011: overhaul of the rating methodology. Greater emphasis on: - system-wide risks - link from earnings to capital

[1] Refers to the agency's proposed methodology for bank ratings, as outlined in Standard & Poor's (2011). Table 1

Moody's Investors Service[9]

Moody's ratings for banks have reflected ...

In 2007, ahead of the financial crisis, Moody's introduced a new bank rating methodology, called joint default analysis (JDA). Motivated by studies showing that the default frequency of banks was consistently lower than that of non-bank corporates with similar ratings, JDA analysed more systematically the external support available to banks. The methodology takes stand-alone ratings (called "bank financial strength ratings") as its starting point. Then, in order to arrive at all-in ratings ("issuer ratings"), it sequentially assesses four types of support – operating parent, cooperative group, regional government and national government – and adjusts the stand-alone rating accordingly. For each type of support, the all-in rating reflects the guarantor's capacity to provide support (as captured, for example, by its rating), its willingness to

[9] This subsection draws on Moody's Investors Service (2007a, 2007b, 2009).

provide support and the probability that it is in default when the bank needs support (or the joint default probability).

In contrast to the other two agencies discussed here, Moody's does not publish a specific summary measure of banking system risk. That said, publications of the rating agency implicitly acknowledge that background assessments of a bank's role in, and exposure to, systemic risk are natural inputs when estimating the extent of support from national authorities. On the one hand, given the fiscal costs involved, the agency expects national authorities to be *less able* to provide support to a bank that shares common exposures with the rest of the system and thus is more likely to need support at a time of general distress. On the other hand, it expects them to be *more willing* to provide support when the institution is more systemically important, since its failure could have stronger adverse knock-on effects on other banks.

... changing perceptions of government support

Moody's reaction to the global financial crisis has been to recalibrate the relative importance attached to certain rating factors. A notable example is the weight on support from national authorities, which changed as the crisis evolved. During most of the crisis, the willingness of national authorities to provide all-encompassing support turned out to be stronger than Moody's had originally expected. This translated into a wider gap between all-in and stand-alone ratings.

At the same time, the depth of the crisis has raised questions about the ability of some sovereigns to provide support and has prompted the international policy community to express clearly the intent to wean banks off extraordinary support. Thus, in recent publications, Moody's has forecast a decline in the weight it will assign to government support in the future. In particular, in reviewing the level of systemic support available for banks in non-AAA sovereigns, it has described in detail the parameters that affect its assessment of governments' ability to provide support. In many cases, the revisions are likely to worsen all-in ratings.

Lessons from the crisis have also led Moody's to revise its assessment of stand-alone strength. The agency has indicated its intention to put a greater emphasis on forward-looking assessments of bank capital ratios, based on analyses of expected losses for risk assets in stress scenarios.

Standard & Poor's[10]

Standard & Poor's is the agency that has proposed the most significant revisions to its methodology since the financial crisis, though they are not yet final. In addition, it plans to enhance the transparency of its bank ratings, broadening the set of banks for which it publishes stand-alone credit risk assessments (called "stand-alone credit profiles"). This will allow investors to gauge the role of support in determining Standard & Poor's all-in ratings ("issuer ratings").

S&P intends to overhaul its bank ratings methodology

The stand-alone risk profiles that Standard & Poor's intends to assign to banks will be based on so-called anchor profiles, which themselves draw on

[10] This subsection draws on Standard & Poor's (2010, 2011). The latter publication contains criteria proposals that are still being reviewed and are likely to be finalised in late 2011.

Banking Industry Country Risk Assessments (BICRA). First, the agency will assess the industry and economic/financial risks in a given country and combine them to form the BICRA. Then, focusing on a particular bank, it will obtain: (i) the industry risk component of the BICRA score of the bank's home country; and (ii) a weighted average of the economic/financial risk components of the BICRA scores of all the countries in which the bank operates. Combining the two will lead to the bank's anchor profile. Finally, bank-specific strengths and weaknesses will guide the mapping of the anchor profile into the bank's own stand-alone risk profile.

Standard & Poor's has also signalled changes to its bank-specific analysis. Among other things, it intends to align stand-alone risk profiles better than in the past with the degree of uncertainty surrounding banks' performance. The agency plans to accomplish this by placing less emphasis on diversification benefits and more on the risks related to off-balance sheet derivatives and structured finance instruments. Earnings analysis will focus on risk-adjusted performance and ability to use retained profits to increase the bank's level of capital. In addition, in determining the role of extraordinary external support in all-in ratings (including both government and group support), Standard & Poor's will pay particular attention to banks' systemic importance and governments' tendency to support banks. All else equal, greater systemic importance would lead to a better all-in rating.

The proposed revisions to Standard & Poor's methodology are likely to change its bank ratings significantly. In a preliminary analysis of a sample of 138 banks, the agency found that 42% experienced no rating change, around 33% were downgraded by one notch or more, and 22% were upgraded by one notch or more. According to Standard & Poor's, the greater emphasis on system-wide risk factors would affect the geographical distribution of potential rating actions. In particular, Asian (excluding Australian and New Zealand) banks would tend to be upgraded, while European banks would tend to be downgraded.

Ratings differences

Disagreements among rating agencies ...

We collected data on ratings that Moody's, Standard & Poor's and Fitch assigned to 70 large banks before the recent financial crisis (mid-2007) and after it (April 2011), and examine these ratings from two perspectives. First, we look for indications that methodological differences across the rating agencies have resulted in different ratings of the same banks. (Given the two points in time we consider, we can only identify differences among the agencies that have manifested themselves *after* the most recent change in Moody's methodology and *before* Standard & Poor's implementation of its recent proposal.) Second, we investigate how bank ratings have evolved since the crisis began. We pay special attention to differences across geographical regions and countries and to agencies' assessments of external support.

Differences among rating agencies

Ratings differences across agencies are rather pronounced in our sample. In fact, cases where all three agencies assign the same all-in rating comprise only

8% of the banks jointly rated by the agencies. At the same time, a full 33% of these banks have ratings that span a gap of two notches or more.[11]

... have diminished since the crisis

Rating agencies have disagreed not only at the level of individual banks but also in systematic ways across banks. At least at the two points in time we consider, Moody's has consistently assigned higher all-in and stand-alone ratings than the other two major agencies (Table 2). The all-in ratings assigned by Moody's in mid-2007 were roughly 1.5 notches higher on average than those assigned by Standard & Poor's and Fitch. This difference has recently declined, and stood at around one notch in April 2011. By contrast, the wedge between the stand-alone ratings assigned by Moody's and Fitch (the other agency publishing similar ratings) has remained quite stable since 2007, ranging between 1.3 and 1.4 notches. Taken together, these findings suggest that the convergence in all-in ratings is due to evolving views of external support, as opposed to banks' inherent financial strength.[12]

Comparing pre- and post-crisis ratings

Downgrading of banks ...

The financial crisis has resulted in significant downgrades of many large banks by all major agencies, which is hardly a surprise. Over the last four years, the all-in ratings assigned by Standard & Poor's to 62 banks in our sample have declined on average by six tenths of a notch, from an average rating of A+ to an average rating between A and A+ (Table 3). The declines have been similar on average in the case of Fitch. Moody's has moved even more sharply since the crisis began, lowering bank all-in ratings by twice as much as the other two agencies.

Differences across rating agencies[1]

Averages of notch differences

	All-in ratings		Stand-alone ratings	
	Mid-2007	April 2011	Mid-2007	April 2011
Moody's vs Fitch	1.59	0.82	1.26	1.44
	(54)	(56)	(64)	(62)
Moody's vs S&P[2]	1.63	1.04	–	–
	(57)	(57)	–	–
Fitch vs S&P[2]	0.12	0.28	–	–
	(60)	(60)	–	–

A stand-alone (or financial strength) rating is referred to as an "individual rating" by Fitch and as a "bank financial strength rating" by Moody's. An all-in rating, which accounts for financial strength and external support, is referred to as a "long term issuer default rating" by Fitch and an "issuer rating" by Moody's and Standard & Poor's. Stand-alone ratings are translated into the all-in ratings' (standard) scale on the basis of mapping tables in Fitch (2010) and Moody's (2007). Then ratings are translated into numbers as follows: AAA = 20, AA+ = 19, AA = 18, …, C = 0. A notch is the difference between two consecutive ratings.

[1] The number of banks, for which a particular average is calculated, is reported in parentheses. [2] S&P stand-alone ratings not available.

Sources: Fitch Ratings; Moody's Investors Service; Standard & Poor's. Table 2

[11] For the numerical examples, we convert ratings into numbers as follows: AAA = 20, AA+ = 19, AA = 18, …, C = 0. A notch is the difference between two adjacent ratings.

[12] In the case of covered bonds, ratings differences in 2007 arose primarily from differences of opinion concerning the protection offered by the cover and its structure rather than from different assessments of bank default risk. See Packer et al (2007).

Bank ratings before the crisis and now[1]

Averages across banks

	Mid-2007			April 2011			Change (number of notches)		
	S&P[2]	Moody's	Fitch	S&P[2]	Moody's	Fitch	S&P[2]	Moody's	Fitch
All-in ratings	A+ (65)	AA (58)	A+/AA– (62)	A/A+ (65)	A+/AA– (61)	A+ (63)	–0.6 (62)	–1.28 (58)	–0.54 (61)
Stand-alone ratings	– –	A (70)	A– (64)	– –	BBB+/A– (70)	BBB (62)	– –	–1.54 (69)	–1.75 (62)

[1] See Table 2 for a definition of stand-alone and all-in ratings and an explanation of how they are mapped into numbers. The number of banks for which a particular average is calculated is reported in parentheses. [2] S&P stand-alone ratings not available.

Sources: Fitch Ratings; Moody's Investors Service; Standard & Poor's. Table 3

… notably in Europe and the US

The downgrading of the global financial system masks some striking differences across geographical regions. All three major agencies have substantially lowered the ratings of US and European banks, reflecting these institutions' position at the epicentre of the global financial crisis (Table 4). By contrast, the rating agencies lowered their assessments of the creditworthiness and financial strength of Asia-Pacific banks very little, if at all.

Increased value of official support

The recent crisis also prompted the three agencies to reassess the external support available to banks. As the crisis unfolded, all-in ratings fell by less on average than stand-alone ratings. Thus, despite questions concerning the willingness and capacity of sovereigns to provide support to banks going forward, they currently contribute to a greater gap between stand-alone and all-in ratings than in mid-2007. Again, this is a phenomenon driven principally by banks in Europe and the United States, where external support has improved ratings by three notches on average most recently, from about two in 2007. At the country level, the percentage change in the ratings improvement due to external support has been largest for US and UK banks (Graph 3).

Rating changes, by region[1]

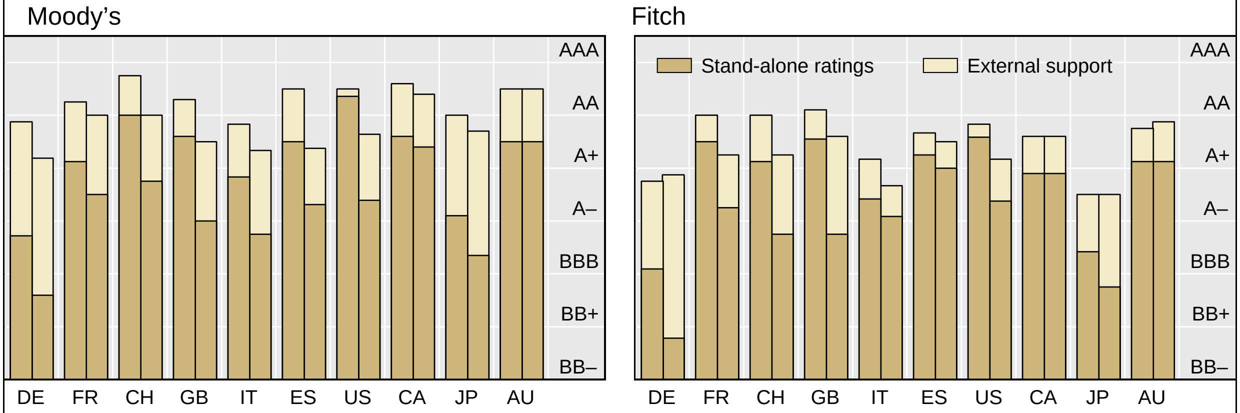
Averages across banks

	Europe[2]			United States			Asia-Pacific[3]		
	S&P[4]	Moody's	Fitch	S&P[4]	Moody's	Fitch	S&P[4]	Moody's	Fitch
All-in ratings	–1.06 (33)	–1.69 (35)	–0.83 (36)	–1.83 (6)	–1.71 (7)	–1.33 (6)	0.40 (15)	–0.33 (9)	0.36 (11)
Stand-alone ratings	– –	–2.39 (36)	–2.80 (32)	– –	–3.93 (7)	–2.42 (6)	– –	0.44 (18)	–0.25 (16)

[1] Between mid-2007 and April 2011. See Table 2 for a definition of stand-alone and all-in ratings and an explanation of how they are mapped into numbers. The number of banks for which a particular average is calculated is reported in parentheses. [2] Refers to banks headquartered in 13 European countries. [3] Refers to banks headquartered in Australia, China, India and Japan. [4] S&P stand-alone ratings not available.

Sources: Fitch Ratings; Moody's Investors Service; Standard & Poor's. Table 4

Stand-alone ratings and the importance of external support[1]



DE = German banks (8; 8); FR = French banks (4; 2); CH = Swiss banks (2; 2); GB = UK banks (5; 5); IT = Italian banks (3; 3); ES = Spanish banks (4; 3); US = US banks (7; 6); CA = Canadian banks (5; 5); JP = Japanese banks (5; 3); AU = Australian banks (4; 4). The first figure in parentheses refers to the number of banks rated by Moody's, and the second to the number rated by Fitch.

[1] For each country, the first bar plots average ratings in mid-2007, and the second those in April 2011. The stand-alone rating plus the rise due to external support equals the all-in rating. See Table 2 for a definition of stand-alone and all-in ratings and an explanation of how they are mapped into numbers for the calculation of averages.

Sources: Fitch Ratings; Moody's Investors Service. Graph 3

The future of bank ratings

The downgrading of the banking sector, which started during the course of the recent financial crisis, is likely to continue. The key reasons for this are lessons learned from the recent crisis about systemic risk and the volatility of banks' performance, weakened finances of some sovereign providers of support, and policy initiatives to wean banks off official support.

Downgrading banks for such reasons could put strain on the sector in the short term, but would also place it on a long-term path towards a sustainable risk profile. In the short term, downgrades can reduce banks' capital-raising capacity, just as they emerge from the crisis with weakened balance sheets and the need to meet stricter regulatory requirements. That said, ratings that reflect changes to regulatory and support frameworks and accurately capture banks' vulnerabilities would help strengthen market discipline and align risk with funding costs. This would lead to a healthier banking sector in the long term.

Of course, changes to bank ratings – be they driven by a methodological overhaul or a simple recalibration of the ratings model – will be consequential only to the extent to which they affect financial decisions. The financial crisis has given rise to policy initiatives that aim to weaken the reliance of regulators and investors on rating agencies.[13] That said, it is not obvious that market players, especially those facing expertise constraints, will find viable alternatives to ratings provided by the major agencies.

[13] See, for example, Dodd-Frank Act (2010) and Financial Stability Board (2010).

To the extent that rating agencies maintain their pre-crisis role in the financial landscape, they will influence the effectiveness of prudential authorities' communication with financial markets. More transparent ratings will convey more explicit assessments of the external support available to banks. Any doubts expressed about policy initiatives to restrict external support and to put in place effective resolution schemes could undermine official statements to the contrary. Conversely, convincing agencies of the irreversibility of these policy initiatives could contribute to a smooth transition to new regulatory and support frameworks for banks.

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