A lead lag analysis of banking sector watchlist, outlook and credit rating announcements between Moody’s and S&P.

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1. Introduction

Credit ratings are used to reduce the information gap between investors and borrowers (Duff and Einig, 2009) and have been a significant area of interest to investors, regulators, and other market participants over the last two decades. Numerous studies have shown that assigned ratings and rating changes have a significant impact on the pricing of risk and the rate of return for fixed income instruments (Livingston *et al*, 2008). There are seven major international credit rating agencies (CRAs) within the industry, the main two accounting for 80% of the market are Moody’s Investors Service, Standard and Poor’s (S&P) and Fitch accounting for around 15% of the market.

Credit ratings assigned to issuers by agencies are frequently used within the pricing of risk and investors such as market analysts and traders rely on credit ratings and ratings changes to price risk properly.

**Investors want ratings to reflect changes in credit quality even if they are going to be reversed within a short period of time (Ellis, 1998). However, investors also want some level of ratings stability in order to keep their portfolio rebalancing as low as possible (Altman and Rijken, 2004).** Cantor and Mann (2007) suggest that if ratings were to adjust frequently such as day to day, asset managers would incur extremely high transaction costs from buying, selling then re-buying the same security.

Standard and Poor’s (2002, cited in Amato and Furfine, 2004) argue that there is no point in raising a firm’s credit rating when they are enjoying a temporary peak, similarly if they are experiencing a period of poor performance, they would not decrease the firm’s rating. The CRA does not know how long it will last and therefore there must be a delay in the change in rating, to enable the ratings to have stability. According to Moody’s, ratings are changed only when the change in the company’s risk profile is expected to be permanent (Altman and Rijken, 2004), a view also supported by Hamilton and Cantor (2004).

Altman and Rijken (2005) state that CRAs apply through-the-cycle methodology whereas, investors have a point-in-time perception of credit worthiness. Watchlist and outlook provide additional information to investors to try and resolve this difference in opinion, regarding an issuer’s credit rating and inform them of the possible future direction of their credit rating. Rating outlooks and watchlist have been introduced to signal an imbalance in an entity’s risk but a rating change is not certain (Alsakka and ap Gwilym, 2012). Once this imbalance is resolved an issuer’s rating is either confirmed or changed (Hamilton and Cantor, 2004).

Due to the difficulties and costs involved for CRAs to change an assigned rating for an issuer, especially in opaque industries such as the banking sector (Morgan, 2002) a lead- lag analysis is necessary to investigate whether any CRA demonstrates a lead or a lag, or one CRA influences another, when conducting credit rating actions.

Alsakka and ap Gwilym (2010) found that the probability of an upgrade (downgrade) by one CRA is much higher for a sovereign issuer that has recently been upgraded by another CRA. They also found that none of the three larger CRAs lead another, although Moody’s does tend to lead upgrade actions amongst the three (Alsakka and ap Gwilym, 2010).

This paper contributes to literature by examining which CRA reacts more quickly when new information arrives which is relevant to a bank’s creditworthiness and do they react by announcing a watchlist, outlook or a rating action. Similarly, does one CRA lead or lag in the area of watchlist, outlook, rating announcement or all three.

1. Methodology

An ordered probit model will be used to examine the data (2007-2022) which covers four economic cycles, including 3 crises, the sub-prime crisis (2007-09), the European crisis (2010-12), a period of stability/expansion (2013-2019) and the covid-19 pandemic (2020-2022).

The data set includes banks from developed countries, including North America (USA and Canada), selected European countries (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, Turkey and UK) and Asia Pacific (Australia and New Zealand).

Developed countries were chosen to try and eliminate issues with the sovereign ceiling, which is when a banks credit rating cannot exceed the countries sovereign debt rating (Kaminsky and Schmukler, 2002). All listed banks from within these countries were included in the dataset.

Similar to Alsakka and ap Gwilym (2012) this paper investigates whether there is a lead lag relationship present between two agencies, Moody’s and S&P, in ratings, outlook and watch actions. If this relationship does exist it would imply that a banking issuer which has recently[[1]](#footnote-1) experienced a ratings change or been placed on positive (negative) outlook/watch is more likely to experience a further ratings change or positive (negative) outlook/watch action within a given time horizon.

The null hypotheses of these tests are:

1. There is no positive or negative lead-lag relationship amongst Moody’s and S&P in ratings changes.
2. There is no positive or negative lead-lag relationship amongst Moody’s and S&P in watch announcements.

1. Findings

The data analysis for this paper is a work in progress but will be done in time for the full paper submission for the conference.

1. Conclusion

Work in progress.

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1. Time windows are 360 days prior to this initial announcement or rating change. [↑](#footnote-ref-1)