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Analytical Linkages Between Sovereign And Bank Ratings

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There could be rating implications for many banks in Europe following yesterday's CreditWatch actions on 15 sovereigns in the European Economic and Monetary Union (EMU). This article explains the linkages between sovereign ratings and bank ratings as defined by our rating criteria.

Governments can affect the creditworthiness of banks in multiple ways. Over the last four years--particularly in the U.S. and Europe--we have seen governments support banks with fresh capital, more liquidity, asset insurance, and guarantees. Banks can, in turn, impact a sovereign's credit strength. For some countries, such as Ireland, the consequence of supporting banks has, in our opinion, meant weakening their own creditworthiness. We have also seen several policy initiatives, such as Basel III, aimed at strengthening banks in order to reduce the risk that future government-sponsored bailouts will be required, though we believe it is too early to tell whether these initiatives--some of which are already law--will be effective.

We consider that sovereign risks are also important for assessing bank creditworthiness. Sovereign credit pressures, such as those we have seen in Greece and Italy, have led Standard & Poor's Ratings Services to downgrade banks in those countries.

Our revised bank, Banking Industry and Country Risk Assessments (BICRA), and sovereign rating methodologies, both published this year, provide a comprehensive framework to assess these significant and varied interactions. The framework helps us to measure and comment upon the evolving relationship between banks and governments in a coherent and globally consistent manner. We classify the rating linkages between governments and banks into three broad categories:

- Direct Links: The sovereign rating can have a direct impact on the bank rating.
- Indirect Links: There are common rating factors affecting sovereigns and banks.
- Other Influences: Government factors that are not part of the sovereign rating but do affect banks.

Rating committees assess both the direct and indirect links at the same time. Generally, within a short period following a sovereign rating action, we could take a similar rating action on banks with direct links to the sovereign. However, assessing the impact of a sovereign rating action on banks with indirect links can require more analysis and deliberation.

Direct Links

In our view, direct links exist when (i) a bank's Stand-Alone Credit Profile (SACP), or its Issuer Credit Rating (ICR), are the same or higher than the sovereign foreign currency rating(1); and (ii) when a bank ICR is higher than the SACP based on government support.

- Few banks are rated stronger than the sovereign foreign currency rating because most banks in a country are likely to face many of the same underlying economic risk factors that would lead to a sovereign stress. While not impossible, we believe it is unlikely that a bank could withstand a sovereign stress at a rating level which is higher than the sovereign's own rating. Consequently a negative rating action on a bank is likely to follow a similar rating action on the sovereign. Likewise, a positive sovereign rating action could result in similar action on a bank rating.

• Sovereign support raises bank ratings above SACPs based on the combination of our assessment of the likelihood of support, the bank's SACP, and the sovereign's local currency rating. Consequently a change in a sovereign rating may lead to a change in a bank rating according to the tables in the criteria for Rating Government-related Entities (2,3) (see "Rating Government-Related Entities: Methodology and Assumptions"; hereafter referred to as "GRE criteria"), and in the Support Framework (4,5) (see "Banks: Rating Methodology And Assumptions"; hereafter referred to as "bank criteria").

We assess different degrees of the likelihood of government support for GREs and other banks with systemic importance to a country. There are seven categories for this likelihood:

- "Almost certain'" (GRE criteria, paragraph 31)
- "Extremely high" (GRE criteria, Table 4)
- "Very high" (GRE criteria, Table 5)
- "High" (GRE criteria, Table 6; Bank criteria, Table 21)
- "Moderately high" (GRE criteria, Table 7; Bank criteria, Table 22)
- "Moderate" (GRE criteria, Table 8; Bank criteria, Table 23)
- "Low" (GRE criteria, paragraph 35; Bank criteria, paragraph 194)

Each category applies a different level of support to a bank's SACP. For example, the table below describes the relationship between a bank SACP, a sovereign rating and a "moderately high" likelihood of support. If a bank SACP is 'a-', the government rating is 'AAA' and the likelihood of support is "moderately high", the bank rating is likely to be 'A+'. If the sovereign rating is lowered to 'AA+' and the bank SACP remains the same, we are likely to lower the bank rating to 'A'. Therefore, if a 'AAA' sovereign's outlook changes to Negative, the outlook on a bank in that country with "moderately high" importance would also change to Negative if a lower sovereign rating would result in a lower bank rating.

Moderately High Likelihood Of Extraordinary Government Support

	Government's local currency rating															
SACP	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-
aaa	AAA															
aa+	AA+	AA+														
aa	AA	AA	AA													
aa-	AA	AA-	AA-	AA-												
a+	AA-	AA-	A+	A+	A+											
a	A+	A+	A+	A	A	A										
a-	A+	A	A	A	A-	A-	A-									
bbb+	A	A	A-	A-	A-	BBB+	BBB+	BBB+								
bbb	A-	A-	A-	BBB+	BBB+	BBB+	BBB	BBB	BBB							

Moderately High Likelihood Of Extraordinary Government Support (cont.)

bbb-	BBB+	BBB+	BBB+	BBB+	BBB	BBB	BBB	BBB-	BBB-	BBB-						
bb+	BBB	BBB	BBB	BBB	BBB	BBB-	BBB-	BBB-	BB+	BB+	BB+					
bb	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BB+	BB+	BB+	BB	BB	BB				
bb-	BB+	BB+	BB+	BB+	BB+	BB+	BB+	BB	BB	BB	BB-	BB-	BB-			
b+	BB	BB	BB	BB	BB	BB	BB	BB	BB-	BB-	BB-	B+	B+	B+		
b	BB-	BB-	BB-	BB-	BB-	BB-	BB-	BB-	BB-	B+	B+	B+	B	B	B	
b-	B+	B+	B+	B+	B+	B+	B+	B+	B+	B+	B	B	B	B-	B-	B-
ccc+	B	B	B	B	B	B	B	B	B	B	B-	B-	B-	CCC+	CCC+	CCC+
ccc	B-	B-	B-	B-	B-	B-	B-	B-	B-	B-	CCC+	CCC+	CCC+	CCC	CCC	CCC
ccc-	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC	CCC	CCC	CCC-	CCC-	CCC-
cc	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC-	CCC-	CCC-	CC	CC	CC

SACP--Stand-alone credit profile.

To balance the potential for sovereign support in bank ratings, we determine what impact this implicit support has on a sovereign's fiscal position. We assess the size of the sovereign's contingent liabilities in the event of a crisis in the financial sector. In summary, a large and risky banking sector can lead to a negative adjustment in our assessment of a sovereign's debt burden. However, when a sovereign is limited in its ability to support banks, we reduce or eliminate the perceived benefit of sovereign support in our bank rating(6).

Indirect Links

We consider there to be indirect links when the sovereign and banks operating in that same country face common underlying credit trends. According to our criteria, we organize these trends into assessments on six rating factors that determine a bank's SACP. The first two, economic and industry risk, build upon our BICRA and combine to set the anchor, or starting point, for the SACP. The anchor is then adjusted up or down on the SACP scale based on the aggregate assessment of the remaining four bank-specific rating factors: business position, capital and earnings, risk position, and funding and liquidity(7).

A change in economic risk can lead to several changes:

• A change in a bank's anchor--the starting point in assigning a credit rating;

• A change in our assessment of capital and earnings--greater economic risk is likely to lead to pressure on earnings and an increase in capital charges in our risk-adjusted capital framework (RACF)(8) for the same exposures, including sovereign and public finance exposures.

• A change in our assessment of risk position. Changes in RACF risk weights could change our view of whether the RAC ratio under- or over-estimates the risks for a particular bank.

Our assessment of economic risk in the BICRA focuses on three main areas: economic resilience, economic imbalances, and credit risk in the economy. We establish the economic risk for each country on a scale of '1' (lowest risk) to '10' (highest risk) and then apply it on a weighted average basis to each bank. We weigh the economic risk for a bank based on its risk exposures by country. Much of the economic risk analysis focuses on very similar underlying factors to those in our sovereign risk analysis. Specifically, the BICRA analysis of economic resilience is closely linked to our conclusions about a country's economic structure and growth prospects, and the country's economic and policy flexibility. Using our sovereign criteria, we assess these factors in the economic, political, monetary, and fiscal scores. Similarly, a country's external position--that is, the country's ability to generate receipts in a foreign currency versus its demands to pay liabilities in that currency--can influence our BICRA assessment of economic imbalances.

There are two further specific areas where a sovereign rating can directly shape our BICRA assessments of economic or industry risk: first, as regards credit risk in the economy; and second, as regards systemwide funding. Both relate to rapidly evolving situations where the sovereign is experiencing a credit stress, which we define as when the sovereign foreign currency rating falls by three notches or more within 12 months.

• Credit risk in the economy is part of our economic risk assessment. Our analysis focuses on the private and corporate sectors and not the public sector, except when the sovereign is experiencing distress and its rating falls below 'BBB-'. The debt burden of public finances in a stable environment is not so critical for banks, in our view; however, deteriorating sovereign creditworthiness is likely to lead to greater debt in the private and corporate sector, and, we believe, leads to higher economic risk for banks.

• Systemwide funding is part of our industry risk assessment. A government and its agents often play an important role in the way banks access funding and liquidity, and we form a view on whether this role is a positive, neutral, or negative factor. In addition, a sovereign in distress can weigh down our assessment of systemwide funding, because we see that a rapid deterioration in sovereign creditworthiness often leads to negative wholesale and interbank funding conditions for banks based in that country.

Generally, these factors don't change quickly, but in fluid macro environments like the present one, the movement can be quick. A change in our industry risk assessment could also lead to a change in the anchor.

Other Government Influences

There are additional government influences on bank ratings that are not directly captured in the sovereign rating and we assess these in the BICRA for each country. In addition to the role of government in our systemwide funding analysis mentioned above, the BICRA also considers the influence of government in our assessments of the institutional framework and competitive dynamics of a banking industry. Governments influence the regulatory and supervisory framework of banks, as well as the standards for transparency and disclosure of banking information. Governments can also influence the way banks compete. For example a government-owned bank may be able to compete with lower margin products because a government may not require the same returns on capital as private investors. Also a government can legislate which can force banks to make changes in their business models.

Related Research And Criteria

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Sovereign Government Rating Methodology and Assumptions, Jun. 30, 2011
- Banking Industry Country Risk Assessment Methodology and Assumptions, Nov. 9, 2011
- Rating Government-Related Entities: Methodology and Assumptions, Dec. 9, 2010
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

Footnotes:

(1) Banks: Rating Methodology and Assumptions, Section C. Rating Above The Sovereign paragraphs 206-212

(2) Rating Government-Related Entities: Methodology and Assumptions.

(3) Tables 1, 4-8, in Rating Government-Related Entities: Methodology and Assumptions.

(4) Banks: Rating Methodology and Assumptions, Section B. Factoring Government Support Into The Indicative ICR, paragraphs 178-205.

(5) Tables 20-23 in Banks: Rating Methodology and Assumptions

(6) Banks: Rating Methodology and Assumptions, paragraphs 204-205

(7) Chart 2, Banks: Rating Methodology and Assumptions.

(8) Bank Capital Methodology And Assumptions