Box 6
Recent developments in and the outlook for global bank ratings

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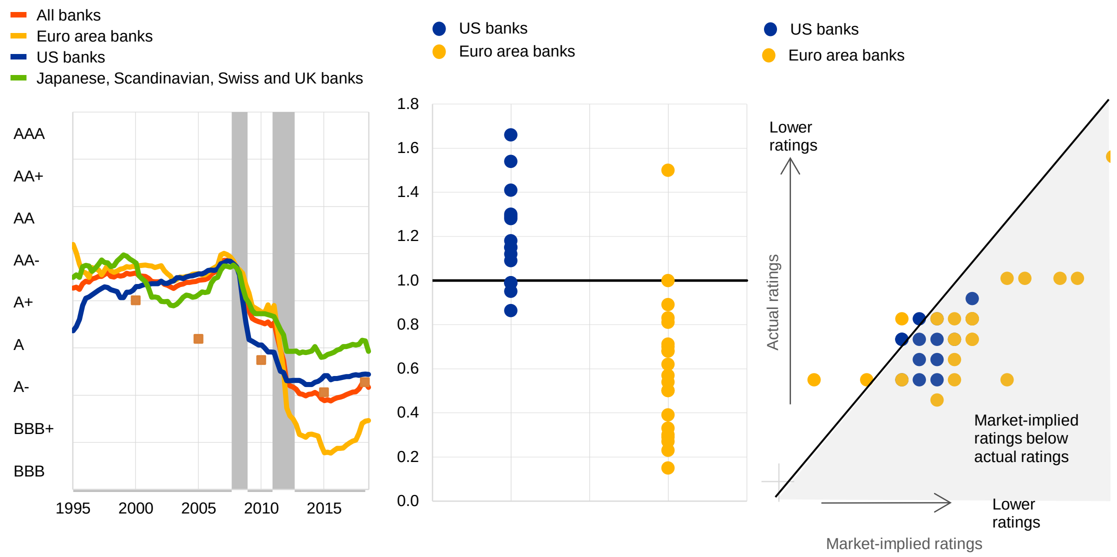
Despite criticism in the aftermath of the global financial crisis, the ratings assigned by the major credit rating agencies continue to play a key role for fixed income investors. Credit ratings can be considered as an overall assessment of the creditworthiness of non-financial and financial corporates. As acquiring information can be costly, they are particularly relevant for the investment decisions of fixed income investors. The classification of issuers and securities into investment grade and high yield strongly affects institutional demand and might amplify the cyclicality of banks' asset prices and funding costs during a downturn. Against this background, this box examines trends in credit ratings of listed banks across major advanced economies with a special focus on the euro area and discusses potential financial stability implications.

Chart A

Ratings of euro area banks have deteriorated relative to those of their international peers

Median ratings for large global listed banks (left panel), price-to-book ratios (middle panel) and market-implied versus actual ratings (right panel)

(left panel: June 1995-Mar. 2019; the grey shaded areas represent the peak-to-trough episodes in the euro area business cycle, as defined by the CEPR; brown squares refer to euro area non-financial corporates; middle panel: price-to-book ratios in Dec. 2018; right panel: actual ratings and market-implied ratings in Dec. 2018)



Sources: Standard & Poor's, Moody's, Fitch Group, Centre for Economic Policy Research (CEPR) and ECB calculations.
Notes: Left panel: the sample consists of 22 euro area banks, 16 US banks and 16 Japanese, Scandinavian, Swiss and UK banks. The sample is slightly reduced in the early part of the time series. The sample of euro area non-financial corporates includes 156 firms. Each agency's individual bank ratings were converted into ordinary scales. Then the quarterly averages (across agencies) for each bank were computed. The aggregated economy-wide ratings were computed as the median across the banks. Right panel: the market-implied ratings are obtained by Moody's with a Merton contingent claims approach, which uses share prices and information on the capital structure of the firms involved. Using the model, it is possible to derive an expected default frequency (EDF) for each firm which is later mapped to Moody's rating scale. More specifically, single-entity EDFs are mapped into implied ratings by calculating median EDF measures per rating category using a "spot median" methodology. The median for a rating category captures the median of the most recent month's EDF values for all the entities that are included in this rating category. The EDF range within a grade is computed from the median EDF of two adjacent rating grades using a geometric mean.

Euro area banks' creditworthiness lags behind that of their main global competitors and euro area non-financial corporates. In order to gauge the secular trends in banks' credit ratings across major advanced economies, a composite indicator was constructed (see **Chart A**, left panel).[36] Four notable features can be inferred from the chart. First, the ratings of global banks remained broadly stable at favourable levels from the mid-1990s until the outbreak of the financial crisis. Second, during the 2007-08 crisis, bank ratings deteriorated and downgrades were particularly pronounced for US banks. Third, a second wave of negative rating events took place at the peak of the euro area sovereign debt crisis in 2011-12. Given the latter's origin and severity, there were larger downgrades of euro area-domiciled banks compared with those banks operating in other advanced economies. The negative ratings gap between euro area and other international banks has remained fairly stable after the sovereign debt crisis. Fourth, while euro area banks had a better rating than their non-financial corporate counterparts until the euro area sovereign debt crisis, the situation reversed afterwards.

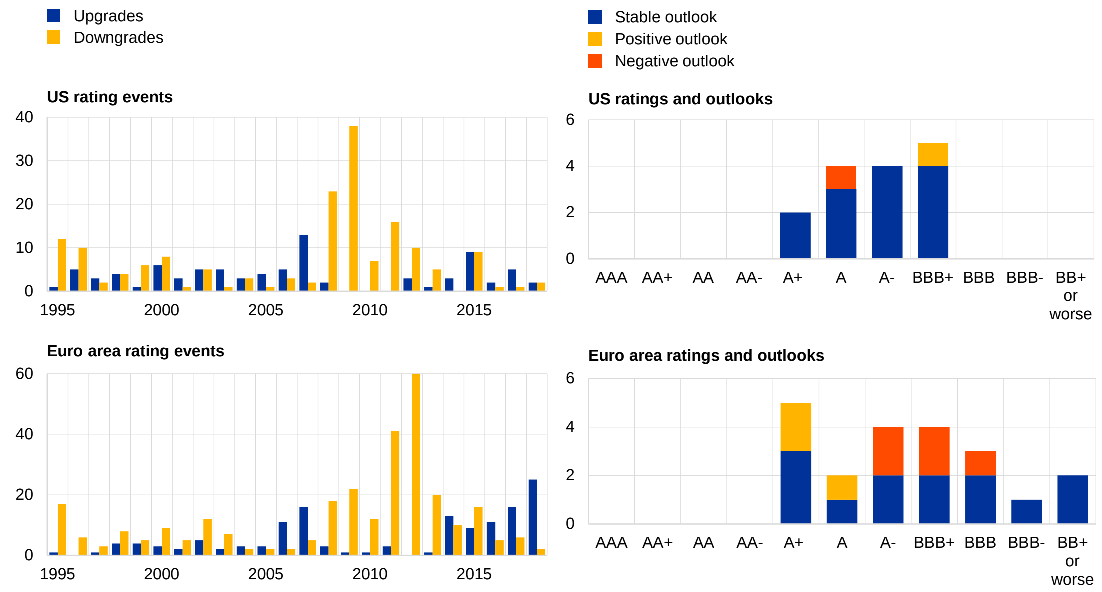
[36] Rating agencies aim to form an opinion about each issuer's credit risk which entails an assessment of the ability to meet its financial obligations in full and on time. Each rating agency uses its own methodology. For financial institutions, the agencies form their rating opinions based on an assessment of the issuer's solvency, profitability and liquidity outlooks.

Chart B

While the number of downgrades of euro area banks is currently small compared with 2011-12, the outlook highlights the potential for downgrades going forward

Number of upgrades/downgrades for large US and euro area banks (left panel) and recent distributions of ratings and outlooks for euro area and US banks (right panel)

(left panel: 1995-2018, number of upgrades/downgrades; right panel: March 2019)



Sources: Standard & Poor's, Moody's, Fitch Group and ECB calculations.
Note: The sample consists of 22 euro area banks and 16 US banks.

Consistent with the rating assessment, most euro area banks are trading at price-to-book (P/B) ratios below those of their international peers. Over the past few years the bulk of euro area banks have traded at P/B ratios below one (see **Chart A**, middle panel). This contrasts with the valuations of banks in other countries, such as the United States (see also **Box 4**). P/B ratios below one would indicate that those banks are not earning their corresponding cost of equity. Under certain assumptions, it is possible to derive an implied level of ratings based on market pricing (see **Chart A**, right panel). Applied to US and euro area banks, such an exercise reveals that, for most banks, the ratings inferred from market pricing are below actual ratings. This feature is particularly pronounced for euro area banks. Thus, markets seem to be somewhat more concerned about bank fundamentals compared with the views expressed by rating agencies.

A larger than expected economic downturn could spark further downgrades of banks' ratings. Previous recession periods have triggered sharp increases in bank rating downgrades (see **Chart B**, left panel). A closer inspection of the current situation shows that the distribution of euro area bank ratings is wider than for US banks and, in addition, a large number of euro area banks are rated below A (see **Chart B**, right panel). Furthermore, rating agencies have assigned a negative outlook to several euro area banks which might push them into the non-investment-grade space, with potential consequences for their funding costs. A negative outlook is not necessarily a precursor of a change in ratings, but still indicates the direction in which a rating is likely to move over a one-to-two-year period.

To conclude, the sensitivity of euro area banks to external ratings points to risks and vulnerabilities for the euro area banking system. This box has highlighted that the creditworthiness of euro area banks lags behind that of their main global competitors. In addition, rating agencies have assigned a negative outlook to several lower-rated investment-grade euro area banks. A worsening of the economic outlook could spark a string of downgrades to the non-investment-grade space which could lead to higher funding costs and lower profitability. To safeguard themselves against potential downgrades, euro area banks need to tackle a number of structural challenges that impede their ability to generate capital organically.