Rating Developments Review

January 2005 Issue 1

"...agencies exhibit surprisingly strong regional biases."

"...this raises questions about the usefulness of long term issuer ratings."

Our independent rating advisory service facilitates relations with international rating agencies. Based on twenty years of expertise analysing banks in emerging markets and our independence from both rating agencies and investment banks, our advisory service benefits banks seeking first time ratings and those wanting to appeal against existing ratings.

Uncovering Regional Biases

This is the first issue of Rating Developments Review, which will from time to time present original research on credit rating related subjects of concern to banks in emerging markets.


Ramin Habibi

Topics will be based on questions raised over my past twenty years working as an advisor and senior credit rating analyst, covering hundreds of banks in emerging markets. While the in-depth experience comes from dozens of countries in Central & Eastern Europe, Russia and the CIS, Africa, the Middle East and Asia, several common themes of concern to banks emerge. These relate to the rules of thumb used by rating agencies and how banks can best work with them.

The first study—in this Review—is titled "Rating Agencies' Regional Bias with Emerging Market Banks". It compares the ratings of 206 emerging market banks that have ratings from more than one agency. It finds that the agencies exhibit surprisingly strong regional biases:

- Moody's rates low in Latin America and high in Eastern Europe.
- Fitch's ratings are closest to the average.
- Standard & Poor's rates banks low in Eastern Europe, Asia and other emerging European markets.
- S&P is rarely the best choice for obtaining a higher rating, possibly because its methodology is less flexible.
- Sovereign rating differences explain part of the biases; S&P's relatively low ratings may reflect added weight given to adverse operating environments.
- The Basel II process is forcing agencies to reconsider the meaning of default; for banks, whether or not exceptional intervention by monetary authorities constitutes a default of sorts.
- When discussing bank rating comparisons, rating agencies emphasize their specialized bank ratings rather than their long term issuer ratings; this raises questions about the usefulness of long term issuer ratings.

This is an important analysis and it is a surprise that similar comparisons have not been made earlier. The agencies were given time to comment on the study, and I have incorporated their remarks where appropriate.

Please contact me if you have comments about this study or if you wish to know more about our rating advisory services for banks in emerging markets. The next Review's theme is "Subordinated Debt and Rating Agencies".

Yours most sincerely,

Ramin Habibi
Managing Director

Rating Developments Ltd
info@ratingdevelopments.com
Tel: +357.25.335371
Fax: +375.25.736229
PO Box 56951,
3311 Limassol, Cyprus

Rating Agencies' Regional Bias with Emerging Market Banks

There are surprising regional biases in the ratings assigned by major rating agencies to banks in emerging markets, according to a Rating Developments study of banks with ratings from more than one agency. The study compared the public long term foreign currency (LT-FCY) issuer ratings of 206 banks[1] that are rated by at least two of the major international rating agencies. The December 2004 ratings covered banks from 48 emerging market countries[2].

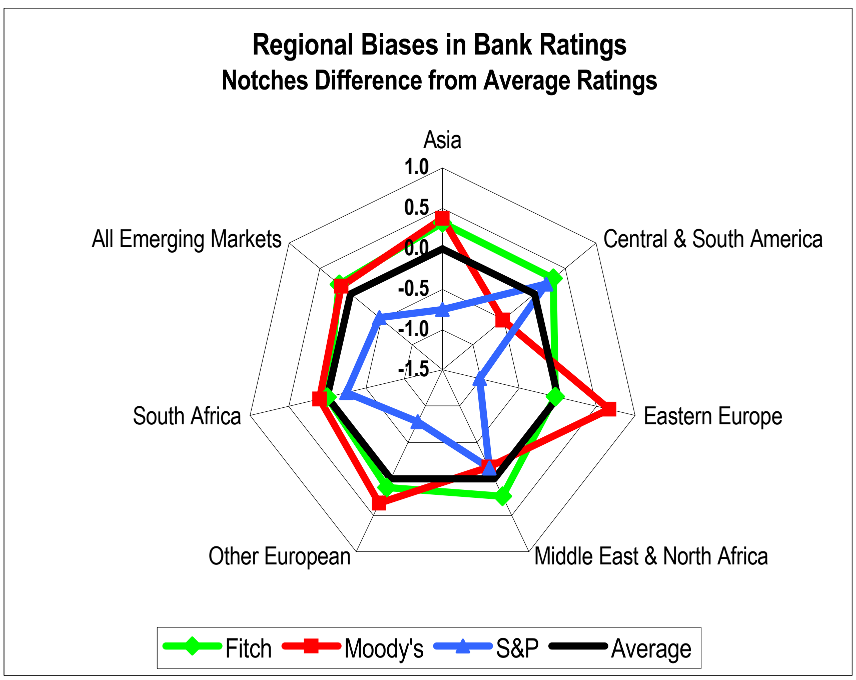
Summary Findings

- Moody's rates low in Latin America and high in Eastern Europe.
- Fitch's ratings are closest to the average.
- Standard & Poor's rates banks low in Eastern Europe, Asia and other emerging European markets.
- S&P is rarely the best choice for obtaining a higher rating, possibly because its methodology is less flexible.
- Sovereign rating differences explain part of the biases; S&P's relatively low ratings may reflect added weight given to adverse operating environments.
- The Basel II process is forcing agencies to reconsider the meaning of default; for banks, whether or not exceptional intervention by monetary authorities constitutes a default of sorts.
- When discussing bank rating comparisons, rating agencies emphasize their specialized bank ratings rather than their long term issuer ratings; this raises questions about the usefulness of long term issuer ratings.

This brief study compares the public ratings of Fitch, Moody's and Standard & Poor's as of December 2004[3] for banks in emerging markets. Ratings assigned to each bank are compared with the average rating for the bank; the results are then consolidated by country and region.

			Average Rating Notches Difference		
Region	Countries	Banks	Fitch	Moody's	S&P
Asia	7	43	0.32	0.38	-0.75
Central & South America	12	44	0.30	-0.52	0.19
Eastern Europe	13	52	-0.04	0.67	-1.02
Middle East & North Africa	11	48	0.24	-0.16	-0.15
"Other European"	4	13	0.12	0.33	-0.79
South Africa	1	6	0.00	0.10	-0.25
All Emerging Markets	**48**	**206**	**0.18**	**0.15**	**-0.47**
		Standard Deviation:	*0.62*	*0.91*	*0.89*

The table on the right (and the chart below) show that both Moody's and S&P show strong biases in certain regions. The table highlights where the average difference between an agency's ratings and the average ratings exceeds half a notch. S&P displays the largest differences—all below the averages—of 1.0 notch in Eastern Europe, and 0.8 notches in Asia and other European emerging markets.



Keep in mind that these are averages, which means that an S&P rating could be two to three notches below the highest other rating assigned to a bank. Moody's rates relatively high in Eastern Europe but below average in Central and South America. Fitch's ratings are consistently closer to the average; although Moody's overall difference is the smallest at 0.15 notches, its biases between regions produce the highest volatility, as shown by the 0.91 notch standard deviation. The radar chart illustrates Fitch's relatively consistent rating pattern, compared to those of S&P and Moody's.

[1] The 206 banks include 77 that have ratings from all three agencies.
[2] The Country Table is at the end of this report.
[3] Sources: Standard & Poor's BankRatings Guide and Moody's Bank Credit Research Monthly Ratings List dated 1st December 2004; Fitch data as of 5th December 2004.

One may conclude that banks would receive higher ratings if they avoided S&P: use Fitch or Moody's in Asia, Fitch in Central & South America and the Middle East & North Africa, and Moody's in Emerging European markets. After all, relatively lower ratings are not necessarily more accurate. Maybe S&P's less flexible rule-bound approach works best with American accounting, regulation and disclosure standards; this would explain why S&P rates banks above the average in most Latin American countries, which most closely follow the U.S. model. Nonetheless—and in defence of S&P—investment banks often recommend S&P ratings because investors may prefer them in some circumstances.

Bank analysts within the rating agencies argue that their LT-FCY issuer ratings incorporate distorting support or currency factors. The agencies produce other, specialized ratings to more closely reflect the stand-alone strength of financial institutions, but their methodologies diverge below the top-level LT-FCY ratings. Fitch analysts refer to their Individual Ratings as the best indicator of a bank's financial health as it excludes external support factors; Moody's analysts recommend their Financial Strength Ratings; S&P's analysts state that a bank's local currency rating is more meaningful in lower-rated countries because it excludes the currency element of risks. While these arguments have merit, investors in emerging markets ultimately have to decide on the basis of the main LT-FCY ratings, which should encapsulate all risk factors. It is for this reason that the study compares the agencies' LT-FCY ratings and their regional biases.

Notch Differences: Bank Ratings adjusted by Sovereigns			
	Fitch	Moody's	S&P
Asia	0.27	0.33	-0.65
Central & South America	0.45	-0.79	0.33
Eastern Europe	-0.01	0.38	-0.76
Middle East & North Africa	0.00	0.23	-0.39
"Other European"	0.03	0.25	-0.62
South Africa	0.00	0.10	-0.25
All Emerging Markets	**0.18**	**0.08**	**-0.39**
Memo: Unadjusted Ratings :	*0.18*	*0.15*	*-0.47*

To exclude the sovereign factor, the table on the right adjusts for the agencies' sovereign biases by deducting regional sovereign bond notch differentials from the bank rating notch differentials to highlight the residual regional biases of the rating agencies. The text box below explains the basis for the sovereign adjustment. The table shows that S&P has substantial regional biases—with low ratings in Asia, Eastern Europe and other European countries—even after making the sovereign adjustment, although Moody's Latin American bias is largest. The most likely explanation for S&P's lower ratings is an extra weight added to difficult operating environments. The adjustment does not have a significant effect on Fitch's overall differential, but the reduced differentials for Moody's and S&P shows that sovereign factors have some impact on their below—and above—average ratings.

The Effect of Sovereign Ceilings on Regional Biases

Sovereign ceilings are a significant factor underlying the differences between rating agencies. The following tables show the average notch differentials by region of the agencies' sovereign LT-FCY bond ratings and LT-FCY bank country—or "deposit"—ceilings, which can be different from the sovereign ratings. These sovereign rating and ceiling differentials are then deducted from the bank rating differentials to check by how much they close the gaps between the agencies' ratings.

Notch Differences	Sovereign LT FCY Bond Ratings			LT FCY Country Ceilings		
	Fitch	Moody's	S&P	Fitch	Moody's	S&P
Asia	0.05	0.05	-0.10	0.43	-0.43	0.00
Central & South America	-0.15	0.28	-0.14	0.91	-0.46	-0.37
Eastern Europe	-0.03	0.28	-0.26	0.82	-0.33	-0.49
Middle East & North Africa	0.24	-0.39	0.24	0.52	-0.67	0.33
"Other European"	0.08	0.08	-0.17	1.42	-0.08	-1.33
South Africa	0.00	0.00	0.00	0.67	-0.33	-0.33
All Emerging Markets	**0.01**	**0.07**	**-0.08**	**0.78**	**-0.43**	**-0.27**

The Sovereign bond ratings are the more accurate adjustment for this exercise as the ratings spread of sovereign bond ratings is much smaller than the differences for sovereign deposit ceilings. Fitch's sovereign ratings are again the closest to the average ratings assigned to each country and region, while Moody's ratings for the Middle East and North Africa are notably below average.

The Basel II process is forcing rating agencies to reconsider what their ratings mean, as studies such as this compare their ratings. Agencies have concentrated on the probability of default, but with banks in particular, this is a difficult definition: are we referring to the event of exceptional intervention by a parent or monetary authority, delays in repayment, or the event of final bank failure? Differences in approach to these questions will be another source of the differentials we find in bank ratings.

Moreover, now that regulators are closely scrutinizing and comparing public credit ratings, rating agencies' are emphasizing their specialized bank ratings rather than their historically prominent LT-FCY Issuer ratings. This inevitably raises questions about the usefulness of LT-FCY Issuer ratings when assessing bank creditworthiness.

	Rating Notches Differences per Country			
Region/Country	**Banks**	**Fitch**	**Moody's**	**S&P**
ASIA	**43**	**0.32**	**0.38**	**-0.75**
China	5	0.17	1.77	-1.83
India	4	1.00	-1.00	0.00
Indonesia	4	0.56	-0.28	-0.28
Korea, South	11	0.42	-0.03	-0.38
Malaysia	8	0.10	0.10	-0.22
Philippines	4	1.00	0.38	-1.13
Thailand	7	-0.33	1.38	-1.22
EASTERN EUROPE	**52**	**-0.04**	**0.67**	**-1.02**
Bulgaria	2	0.50	0.50	-0.50
Croatia	3	0.67	1.00	-1.67
Czech Rep.	1	-0.50	0.50	
Estonia	1	0.33	-0.67	0.33
Hungary	2	0.00	0.00	
Kazakhstan	8	-0.64	1.33	-1.37
Latvia	1	0.00	0.00	
Poland	6	0.00	0.33	-2.00
Romania	1	1.33	-0.67	-0.67
Russia	21	-0.17	0.72	-0.81
Slovakia	2	1.00	0.50	-3.00
Slovenia	2	-0.25	0.75	-1.00
Ukraine	2	-0.25	0.50	0.00
CENTRAL & SOUTH AMERICA	**44**	**0.30**	**-0.52**	**0.19**
Argentina	1		-0.50	0.50
Bolivia	1		-0.50	0.50
Brazil	13	0.63	-1.15	0.63
Chile	5	-0.06	-0.22	0.17
Colombia	2	0.50	-0.50	
El Salvador	8	-0.28	0.62	-0.33
Mexico	4	0.13	0.00	-0.17
Panama	1		-0.50	0.50
Peru	3	0.00		0.00
Trinidad & Tob.	2	0.00	-1.00	0.50
Uruguay	1	1.00	-1.00	
Venezuela	3	1.00	-1.00	
MIDDLE EAST & N. AFRICA	**48**	**0.24**	**-0.16**	**-0.15**
Bahrain	3	0.00	0.00	
Egypt	4	0.29	-0.21	-0.17
Jordan	2	0.33	-0.67	0.33
Kuwait	1	2.50	-2.50	
Lebanon	8	-0.29	0.75	-0.67
Oman	3	-0.42	0.56	-0.42
Qatar	3	0.00	0.00	0.00
Saudi Arabia	2	-0.25	0.25	
Tunisia	9	0.52	-0.59	0.67
Turkey	1	0.67	1.67	-2.33
U.A.E.	12	0.36	-0.64	0.83
OTHER EUROPEAN	**13**	**0.12**	**0.33**	**-0.79**
Cyprus	3	0.83	-0.83	
Greece	6	0.31	0.47	-0.83
Israel	3	-0.94	1.39	-0.67
Malta	1	0.00	0.00	
South Africa	**6**	**0.00**	**0.10**	**-0.25**
All Emerging Markets	**206**	**0.18**	**0.15**	**-0.47**

Methodology

- The public long term ratings of the three ratings agencies were assigned numerical scores as follows:

Ratings Equivalents and their Scores			
Moody's Long Term Bank Deposits	Fitch Long Term	S&P's Long Term Counterparty	Score
Aaa	AAA	AAA	25
Aa1	AA+	AA+	24
Aa2	AA	AA	23
Aa3	AA-	AA-	22
A1	A+	A+	21
A2	A	A	20
A3	A-	A-	19
Baa1	BBB+	BBB+	18
Baa2	BBB	BBB	17
Baa3	BBB-	BBB-	16
Ba1	BB+	BB+	15
Ba2	BB	BB	14
Ba3	BB-	BB-	13
B2	B	B	11
B3	B-	B-	10
Caa1	CCC+	CCC+	9
Caa2	CCC	CCC	8
Caa3	CCC-	CCC-	7
Ca1	CC+	CC+	6
Ca2	CC	CC	5
Ca3	CC-	CC-	4
C1	C+	C+	3
C2	C	C	2
C3	C-	C-	1

- Banks from emerging markets with long term public ratings from two or all three of the rating agencies were selected.
- S&P's many "pi" public information ratings were excluded because they are not only unsolicited but also only local currency. Moody's unsolicited ratings for ten Saudi banks are included. The study's results would change only marginally if the Moody's ratings were excluded and there would be no impact on the study's conclusions.

Without Moody's Unsolicited Saudi Ratings	Rating Differences in Emerging Markets (bps)		
Average of	Fitch	Moody's	S&P
Middle East & North Africa	*-8*	*+10*	*+3*
All Emerging Markets	*-2*	*+4*	*-*

- Regions were set up according to the geographic organizations of the rating agencies to capture differences between regional teams within agencies.
- The data includes 206 banks that had public ratings from two or three of the major agencies. They included 77 banks with triple ratings.