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Evidence and Explanations for a Home Bias in Sovereign Ratings

Andreas Fuchs and Kai Gehring, February 11, 2014

Our study "The Home Bias in Sovereign Ratings" seeks to answer the question of whether the homeland of a rating agency plays a role in the sovereign ratings it assigns. The paper was sharply criticized in a statement by Standard and Poor's (S&P), which has been made public on the FT Alphaville blog on February 4th. Most of the criticisms raised by S&P, however, appear not to be based on a thorough examination of the paper's actual research design and results. In this response, we will thus review the main results of the paper and respond to S&P's criticisms.

Many observers level accusations against ratings agencies. The Russian president, Vladmir Putin, and the German Finance Minister, Wolfgang Schäuble, both speak of ratings agencies' "abuses" and "abusive behaviour." The Turkish Premier Recep Tayyip accuses them of "unfair" decisions and the EU Commission President José Manuel Barosso speaks of a "bias [...] when it comes to the evaluation of the specific situation of Europe." Behind many of these and similar accusations lays the assumption that the home country of an agency affects its ratings. A simple comparison of the sovereign ratings of ratings agencies from various countries reveals clear differences. For example, the Chinese rating agency Dagong rates the BRICS countries, including China, considerably better and the G7 countries, including the United States, worse than S&P (see the table below). This gives weight to the arguments that differences in ratings are not based on objective factors alone.

The aim of our empirical study is, however, to go beyond these simple accusations and to empirically investigate whether sovereign ratings are indeed biased to the benefit of the home country and of countries with close economic, political and cultural ties with it. Moreover, we want to shed light on the factors that can explain such biases. The aim of our paper is not, as S&P

claims, to produce a "better" rating with what they call a "Heidelberg rating mechanism" – we are happy to leave this to the ratings agencies. Our study applies modern panel-econometric methods to explain the rating decisions of agencies and tests whether there are systematic biases. To this end, we evaluated the sovereign ratings provided by nine different ratings agencies from Canada, China, Cyprus, Germany, Japan, and the United States for the 1990-2013 period. The empirical analysis tests whether a rating agency applies the same weighting and assessment to the home country than to all other rated countries' economic and political fundamentals (such as their degree of indebtedness and the quality of their legal system). This study finds that this benchmark is not met: when it comes to their home country, rating agencies on average assign ratings of almost an entire point higher than to other countries with comparable fundamentals.

S&P alleges that we use a supposedly "simplistic" and purely backward-looking model. This shows again a misunderstanding of both the aim and the methodology of our research. In general, as also S&P communicates, a sovereign rating is the "opinion" of an agency on the chance that a country will default on its debts. This opinion is founded on both objective and subjective factors. The data we use for the objective economic and political factors were collected carefully through intensive research of the existing scientific literature and the agencies' official documentation (see the online appendix of our study with all sources). The regressions based on this "backward-looking" indicators explain 86% of the variation in sovereign ratings.

In addition to this objective component of the ratings, which is based on past data, agencies have to assess the future development of the countries and "soft" indicators, such as the belief in a country's willingness to repay its debts. Our study examines whether the subjective part of credit ratings is directly related to the home countries of ratings agencies. Here, our investigation goes far beyond a simple look at whether the home country itself is favored in the rating agencies' decision making. We also test whether there is a significant relationship between sovereign ratings and the geopolitical and economic interests of the home country, as well as the cultural similarity between home and sovereign. Theoretically and according to the official guidelines of the agencies, none of these factors should play a role in determining the chance that a country will default on its debt. Despite this, we find that countries in which the home country's banks hold relatively larger stakes receive better ratings. Further, the subjective part of ratings is influenced by the "cultural distance" between the home country and the sovereign: All else being equal, countries that are more similar in terms of linguistic proximity receive better ratings.

As other studies suggest, cultural distance can distort risk perception. Several studies have shown that risks to the home country lead to more optimistic assessments and that there is a positive relationship between cultural similarity and trust. Given this, such a distortion of risk perception can be largely unintended. In scenarios with incomplete information combined with uncertainty, it is easy to fall back on heuristics to assess risks. Researchers from the University of Stockholm und the Hebrew University of Jerusalem have shown that, in regards to credit terms, international banks demand higher interest rates and more collateral for otherwise identical credits from banks in culturally distant countries. There is also scientific evidence that professional financial investors favor investments in their home country and companies with similar cultural backgrounds. Therefore, it would be rather surprising if analysts and members of the rating committee did not fall prey to this very "human" bias in judgments. This means that the finding of such a bias does not necessarily indicate "bad intentions" of agency staff. We are aware that S&P analysts are "of many different nationalities who live and work all over the world." However, we do not find the effect of cultural distance being mitigated by the existence of an office in the rated country.

S&P also asserts that we apply a "one-size-fits-all-agencies" algorithm and do not differentiate between agencies. This is simply untrue. As can be seen from Table 5 of our study, we analyze each agency separately. By doing so, we allow for a flexible weighting and assessment of the political and economic fundamentals by each agency. For example, China's "AAA" rating from Dagong can be entirely explained by how the Chinese agency weights and assesses economic and political fundamentals of other countries. However, Dagong appears to systematically assign better ratings to countries geopolitically aligned with China. Furthermore, six of the nine agencies studied, including S&P, are shown to give higher ratings to countries with the same or similar languages.

We are amazed that S&P calls the idea that home countries can put pressure on ratings agencies an "imaginative claim". On September 3rd, 2013, S&P itself called a lawsuit from the US government "a retaliation for defendants' exercise of their free speech rights with respect to the creditworthiness of the United States of America." The smaller US-based rating agency Egan-Jones was stripped of their recognition by the SEC for one year, a decision which was seen as an intimidation related to the agency's previous repeated downgrades of US government debt. Throughout the study, we did not "make up" any of the claims, but simply put existing arguments to an empirical test. For example, the suspicion that there might be potential conflicts of interest with regard to cross-shareholdings and voting rights in the rating industry stems from an official document of the European Commission in which it proposes new rules and limits (European

Commission - MEMO/13/13). Doubts about the role of the committee could easily be resolved with greater transparency: as there is nothing to hide, the easiest trust-building measure would be to make the voting results accessible to the public.

We are by no means opponents of rating agencies. As we write in the conclusions, our "results should not be taken as evidence that rating agencies do not fulfil an economically relevant and potentially efficiency enhancing role." Moreover, we do not necessarily blame existing biases on "bad intentions." The study concludes that "our finding of a "cultural home bias" does not necessarily reflect 'irrational' behavior on behalf of the agencies. Their judgments are based on imperfect information provided by the rated countries as well as third parties. It can be rational to rely on heuristics such as bilateral trust to evaluate this information, which can lead to a lower perceived likelihood that a more familiar state defaults on its debt."

Like all financial market participants and investors, we have a great interest in reliable ratings. External ratings are meant to fulfill a vital economic function, which cannot be entirely provided by an internal valuation. First, individual investors do not necessarily have at their disposal the resources and skills required to make credit rating assessments. Second, if banks were to evaluate their risks from government bonds on their own, there would be an obvious conflict of interest. As a complete abandonment of external ratings is neither economically efficient nor incentive compatible, the aim should be to improve the existing methodologies and procedures. The newly founded agency ARC Ratings, which is a merger of five ratings agencies from Portugal, India, Brazil, Malaysia and South Africa, appears to have recognized this potential problem. Every rating decision must be agreed upon by three experts from three different regions in order to ensure their objectivity. Such an approach, combined with publishing the rating committee's voting outcomes, can both increase transparency and reduce the influence of the home country in the rating process.

What can be achieved through regulation? Approaches that limit the publication of ratings or slow the rating process through unnecessary bureaucracy can be counter-productive. The focus should shift instead to strengthening competition. If the use of external ratings is economically desirable, then it should be mandatory to use ratings from several agencies from several countries with different cultural backgrounds instead of a single rating. If these measures were taken, a more diverse set of opinions would be gained, distortions would be minimized, and competition would be intensified.

Table: Foreign-currency ratings of selected sovereigns
(as of February 10, 2014)

	Dagong	**S&P**
BRICS		
Brasilien	**A-**	BBB
China	**AAA**	AA-
Indien	**BBB**	BBB-
Russland	**A**	BBB
Südafrika	**A-**	BBB
G7		
Deutschland	AA+	**AAA**
Frankreich	A+	**AA**
Großbritannien	A+	**AAA**
Italien	BBB	**BBB-**
Japan	A+	**AA-**
Kanada	AA+	**AAA**
USA	A-	**AA+**

Source: Dagong, S&P