



Rating Agencies: Foreseeing the New Forms of Measuring Political and Credit Risks

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Abstract

The security, credibility and growth of a country, corporation or product are many times measured by ratings given for certain entities, for instance, the risk notations periodically published by major rating agencies. As a matter of fact, the investor's guide their investment strategy by such classifications. The present research enable us to develop a careful "free" review of the 2007/2008 financial crisis causes, consequently we can state that their ratings had some correction problems that would be manipulated by "hidden" interests and "actors". It's required to find out new measurement techniques of the corporate and countries investment risk. To develop our research, we chose to analyze the political and credit risk. Considering the extremely volatile political risk, it would occur in an unexpected concern, as well as, would be supported in a revolution or in riots, and, it would be a change through a Government change and/or laws changes implemented.

Keywords: Political Risk, Credit Risk, Credit Default Swap, Risk Measurement

Introduction

The credit ratings reflect the credibility and strength of a corporation, country or product. In this paper, we will try presenting an alternative to credit ratings to measure that credibility and strength, giving investors a new method of risk measurement, which is based on the CDS market trading, and this new credit rating score is independent of rating agencies. So, we'll try to establish a link between the funds flows and spreads of *credit default swaps*, in order to measure the credit market pulse, to demonstrate that *credit default swap spread* can be used as instrument or tool to measure and anticipate a country's political risk or credit risk.

Types of risks: default risk and political or sovereign risk

Credit risk depends on the creditworthiness or liquidity of the obligee and is "the risk of non-fulfillment of the corresponding obligation by the debtor, also said, therefore, the risk of the counterpart."¹ Credit means reputation or trust, hence credit risk is closely linked to the possibility of breach of the debtor's trust or reputation. The risk will be all the greater when as the evolution of the debtor's situation deteriorates, and even if this deterioration does not necessarily lead to default, it is sufficient that this probability is increased so that there is a credit risk. The nature of this risk cannot be confused with the nature of market risk, since market price variations, whether of shares, bonds or commodities, are expected and inherent in the functioning of the market, while credit risk relates more with the situation that a given credit position assumes in the context of the debtor's financial situation of the obligation, which is a slower and more independent development. Counterparty credit risk means the risk of default by a counterparty in a transaction before the final settlement of the respective financial flows. This risk generally encompasses all the relations between two parties. In the event of default in the fulfillment of one of the obligations it legitimates the valuation in respect of all other transactions that the parties retain. That is, the delay in relation to a credit portfolio operation legitimates a correlation with the other obligations belonging to the credit portfolio relative to that debtor, since the counterparty risk is verified and is related to the debtor and not in relation to a specific obligation. With the exponential growth of the credit default swaps market, counterparty risk increased in parallel. Indeed, one of the major concerns was precisely that the largest *dealers of credit default swaps* served as counterparties to others and therefore were interdependent.

So, regarding the credit risk, the hazard is that the debtor may fail to fulfill his payment obligation. There are many variants that may determine the fluctuation of that risk in each moment.



Understanding and anticipating the credit risk of certain entities becomes vital for the pursuit of any good investment policy. In this regard, Noro said “the last two decades have been characterized by several financial disasters; large institutions collapsed proving that an insufficiency of financial risk management can cause huge losses and ripple effects throughout the financial markets. Quantitative approaches to risk management gained popularity and have been widely adopted. Nowadays firms need to understand their ability to face risks and to manage them carefully. Above all, the financial markets turmoil highlighted the importance of counterparty credit risk which is one of the many complex areas of financial risk”¹.

We speak of political risks whenever the ideologies pursued by a country in terms of investment policies are restrictive or prohibitive, making it difficult to invest abroad and the consequent outflow of capital from the country. We will also consider it as a political risk whenever the internal governance stability of a country is at stake, as is the case at the moment with Brazil.

This political risk is always exacerbated in electoral periods, given that there is always a certain amount of uncertainty that is not compatible with investment purposes. However, even after the election period, the political risk can be maintained, especially when a change of ideology or political party occurs. In these cases, in the initial moments and after the takeover of a government, there is still a considerable degree of uncertainty that increases the political risks, since the elected government does not always recognize and accept the obligations assumed by the previous government.

Political risks still exist in so-called nationalization processes because they are generally burdensome for a country's financial structure.

This risk no longer has its origin in the financial situation of the counterparty, but rather in the location where the counterparty is located, that is, the political risk is affected by reference to the location of the counterpart in the economic area.

Rating Agencies

The rating assigned by the rating agencies presents itself almost as an absolute truth, never questionable, while *gatekeepers* of the financial markets. However, in this particular case, the rating agencies only assume the actual situation of an entity when there is a default situation.

Browning said that “the credit rating agencies play a vital role in the financing of firms in our economy. The difference of a single rating category can often mean a 100 basis point differential. Thus, even the smallest drop in rating category could cost firms very significant amounts in financing”².

In fact, because of the wrong ratings assigned by the rating agencies to certain financial products marketed that were the basis of the systemic risk spread of the negative effects of the financial crisis in 2007/2008 in the United States of America, we believe that this behaviour should be subject to scrutiny by the courts, that is, the responsibilities of the managers of these companies should be ascertained. It is almost practically impossible to continue to have a complacent attitude in relations to the mistakes of the rating agencies, which seem gross in the face of the data that those entities could and should have in order to formulate their ratings. In other words, the

¹ Vide Noro, E. (2017). Models and Methods for Counterparty Credit Risk Measurement, Università Ca' Foscari Venezia, <http://hdl.handle.net/10579/9964>

² Vide Browning, L. (2017). *An Examination of the Association of Firm Credit Ratings with Real Activities Manipulation, Audit Quality, Corporate Governance, and Credit Default Swaps*. (Electronic Thesis or Dissertation). Retrieved from <https://etd.ohiolink.edu/>.



rating given by rating agencies can no longer be overvalued. This raises the need to find new ways of measuring the credit and political risk of certain entities in order to guide investors.

New forms of measuring political and credit risks: *credit default swap*

The *credit default swap*, created by Blythe Sally Jess Masters of JPMorgan Chase & Co. in 1994, translates into a financial instrument used to speculate or *hedge* against the risk of default by a reference entity, which may be a company or a country, allowing the swap of the credit risk of a fixed income product between the parties, where the risk of bankruptcy of the reference entity is transferred from the buyer of the product to the seller of the *swap*³. The reference entity is not a part to the contract. In simpler terms, the *credit default swap* is used to prevent your buyer from the risk of defaulting on an asset by your debtor. It is essentially designed to avoid credit risk.

The *credit default swap* is a bilateral agreement as it gives rise to obligations for both parties, and the buyer's obligation (*protection buyer*) translates into the obligation to pay a certain amount at certain predetermined periods of time to the seller (*protection seller*).

We can thus define the *credit default swap* as a "*credit derivative contract in which one of the parties - protection buyer - transfers the credit risk associated with an underlying asset - which it may not own - to another party - protection seller - by means of the payment of a premium - a single premium, at the head or staged, which assumes the risk of default on the underlying asset credit.*"⁴.

Credit derivatives make it possible to separate the credit risk from other risks and their value depends on the creditworthiness of a given entity and, in these particular credit derivatives, the underlying asset will be a reference credit and for which the creditor intends transfer to another party the risk of non-performance by the debtor in that legal credit relationship.

Thus, the greater the risk of default by the reference entity or the greater the likelihood of insolvency of that entity, the higher the *credit default swaps* price for that entity. The underlying principle is the same as for example in life insurance, where the higher the age of the insured, the more expensive the insurance premium becomes, which is calculated on the basis of the level of risk.

We ask, do the protection sales people in the CDS have an interest in disclosing "news" that places the reference entity in a critical situation, regardless of whether this corresponds to reality? This situation is made possible by the predetermined information and commissioned by the agents whom it takes advantage of, and the unclear connections of these to certain *rating* agencies were unraveled after the financial crisis of 2007.

In fact, Kiesel and Spohnholtz said that "*the empirical analysis shows that logarithmized CDS spreads and issuer credit ratings by agencies have a linear relationship. The new CRS provides market participants with an alternative risk assessment, which is solely based on market factors, and does not rely on credit rating analysts. The results indicate that our CRS is able to anticipate agency ratings in advance. Moreover, the analysis shows that the trading volume has only a limited influence in the anticipation of rating changes*"⁵.

³ Vide BOLTON, Patrick e OEHMKE, Martin, «Credit Default Swaps and The Empty Creditor Problem», *Review of Financial Studies*, Fevereiro 2011, pp. 2617-2655, available at: <https://www0.gsb.columbia.edu/faculty/moehmke/papers/EmptyCreditors.pdf>, (acedido em 05 de fevereiro de 2015 refer that "In a CDS, the protection seller agrees to make a payment to the protection buyer in a credit (default) event on a prespecified reference asset. In exchange for this promised payment, the protection seller receives a periodic premium payment from the buyer".

⁴ Vide ALMEIDA, António Pereira, *Valores Mobiliários, instrumentos financeiros e mercados*, vol. II, 7^a edição reformulada e atualizada, Coimbra, Coimbra Editora, 2013, p. 88. ISBN 9678-972-32-2191-6.

⁵ Vide Florian Kiesel, Jonathan Spohnholtz, (2017) "CDS spreads as an independent measure of credit risk", *The Journal of Risk Finance*, Vol. 18 Issue: 2, pp.122-144, <https://doi.org/10.1108/JRF-09-2016-0119>



But how then can the *credit default swap* serve to assess whether there is too much risk in investing or not in a particular entity or country? We verified above that this agreement serves to cover a credit risk, that is, that the investor is aware of the risk that his investment does not offer him any return or gain, due for example to the insolvency of the debtor of that return. Thus, the greater the probability that the debtor is unable to meet its obligation and thus realize the investor's gain expectations, the more expensive the credit default swap premium will be on that investing entity. The same reasoning we can carry for life insurance. The higher the age of the most expensive insurer is the life insurance premium, because the risk of death, being uncertain its date, is closer and real, according to the rules of experience and probabilities, that is, it represents a risk premium, so the insurance premium for the protection of this risk is also more expensive⁶.

With this parallelism, we can measure the risk of investing in certain entities, since the more expensive the credit default swap is, the more patent the credit risk is on that reference entity in which it is intended to invest. This reasoning must be considered by investors since the protection seller, when determining the premium payable for the protection they grant through the conclusion of credit defaults, has already determined and analyzed the economic and financial reality in which the referral entity is dipped .

Conclusions

So, after our research, we can formulate some conclusions. One of them is that if the investors don't find or use others methods to measure de credit risk or political risk of a country, corporation or product to select their investments, they are hostage to ratings dictated by rating agencies, which are not always correct as we have seen. Besides, that ratings affect some States investment values.

Thus, it is clear from the foregoing that it is essential to consider new ways of measuring investment risks. For us, credit risk and political risk can be perfectly measured by credit default swaps trade and their respective spreads. The difference between this risk measurement (credit default swap and their spreads, and the ratings assigned by the rating agencies is that this one needs analysts while the first, as the most important, is the market factors, and these elements are independent of those analyst's intervention, moreover, in this new method, the risk fluctuation may be known before the risk notation given by the rating agencies.

We are conscious that this method isn't free of fails, especially if this credit derivative negotiation is abusive; as it would be observed in the US financial crisis in 2007/2008 happened. However, having another risk measurement method is helpful for investors to gauge the timeframe of their investments based on it.

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⁶ Sobre a tese de que o credit default swap se traduz num verdadeiro seguro de crédito, veja-se Teixeira, M. E., (2017) O contrato de swap: o credit default swap e o seguro de crédito., Almedina, <http://hdl.handle.net/11328/1490>



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