Financial crises, credit ratings, and bank failures: An introduction

Reinhart, Carmen

University of Maryland, College Park, Department of Economics

2002

Financial Crises, Credit Ratings, and Bank Failures: An Introduction

World Bank Economic Review, Vol. 16 No. 2, 2002, 149-151.
Carmen M. Reinhart
University of Maryland NBER and *CEPR*

Financial crises of every variety rocked emerging markets during the second half of the 1990s. Currency crashes hit nearly every region, banking crises were both numerous and severe, and a few countries facing extreme duress defaulted on their sovereign debts. Not surprisingly, there is considerable interest in policy and academic circles as well as in the investment community in gaining a better understanding of the various aspects of financial and economic distress. Perhaps, one of the aspects that received the most attention in the growing recent empirical literature on crises has to do with the issue of "crisis prediction" or, more broadly, the assessment of imminent downside risks—be it for the banks, the currency, or the sovereign debt.

Much of the literature on crisis prediction, focused on selecting the "right" set of economic and, occasionally, political fundamentals. In this regard, rating agencies, responsible for monitoring credit risks, came under considerable scrutiny owing to their lackluster performance in anticipating the Mexican peso crisis, which barely avoided default, and the Asian crisis of 1997-1998. The impacts of changes in sovereign credit ratings on financial markets also became a matter of some debate, with some evidence that credit rating agencies could be fueling a boom-bust cycle in international capital markets. Central banks across the globe and the multilateral institutions, in particular, became painfully aware that there was a pressing need to develop and implement more robust ways of “stress testing” financial systems, so as to ensure adequate capital requirements and provisioning and limit the risk of bank failure.

Three of the papers in this volume address various aspects of these issues—in particular as regards the behavior and impact of sovereign credit ratings and the development of a portfolio model that lends itself to testing the vulnerability of banks. Two of the papers address issues related to the usefulness and impacts of sovereign credit ratings. Reinhart evaluates the performance of credit ratings in anticipating currency crises and defaults. The main finding is that ratings systematically fail to anticipate currency crises but do somewhat better in anticipating defaults. However, downgrades in credit ratings usually follow the currency crises, possibly suggesting both that currency instability increases the risk of default and that credit ratings tend to be procyclical. Using a very different sample, data frequency, and analytical approach from Reinhart, the Kaminsky and Schmukler paper also finds evidence of procyclicality in sovereign credit ratings. Namely, they show that upgrades usually take place during market rallies, while downgrades occur when bond and equity markets are experiencing a downturn.

Unlike the other two papers, Balzarotti, Falkenheim, and Powell do not focus on sovereign default—their concern is with the default of banks. Or more precisely, how to limit bank failures through capital and provisioning measures. Their approach stresses a portfolio-based model to estimate potential losses of banks under a variety of adverse but plausible scenarios. An important implication of their study is that for the many emerging markets that have developed public credit registries, the information collected by these agencies can be gainfully used to develop better measures of bank's credit risks.

References

Balzarotti, Veronica, Michael Falkenheim, and Andrew Powell "On the Use of Portfolio Risk Models and Capital Requirements in Emerging Markets: The Case of Argentina," *World Bank Economic Review* Vol. 16 , No. 2 , 2002, 197-212

Kaminsky, Graciela, Richard Lyons and Sergio Schmukler "Mutual Fund Investment in Emerging Markets: An Overview," *World Bank Economic Review*, Vol. 16 Issue 2, May 2001, 315-340.

Reinhart, Carmen M., "Default, Currency Crises, and Sovereign Credit Ratings" *World Bank Economic Review*, Vol. 16 No. 2, 2002, 151-170