BRIEFING

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Credit Rating for Euro Area Member States and European supranational institutions

This document presents the latest credit ratings issued by the three major Credit Rating Agencies for the Euro Area Member States and three European institutions that issue "EU bonds": the EU Commission, the European Investment Bank and the European Stabilisation Mechanism. It provides an overview of the framework of sovereign credit ratings and shows their relationship with the financing costs of Euro Area Member States.

Credit Ratings are independent assessments of the **creditworthiness** associated to a financial entity (e.g. a company, a public institutions or a government an individual, a firm or a government) or to a financial instrument and are issued by private **Credit Rating Agencies (CRAs).** The assessment carried out by the CRAs is based on public and non-public information and considers both quantitative and qualitative indicators. Credit ratings indicate the ability to pay back the debt (both the existing and prospective one) and its probability of defaulting in the future. Therefore, this evaluation represents an important signal for investors and lenders, and borrowing costs are related to the credit ratings. The three major international CRAs are Standard&Poor's (S&P), Moody's and Fitch.

Sovereign credit rating is associated to a State and its general government debt. The credit risk associated with a sovereign authority represents the likelihood that a government might be unable to meet its debt obligations in the future. Hence, **better credit ratings usually correspond to lower financing costs for the country issuing sovereign bonds**. When setting the rating, the CRA considers both the macroeconomic and political situation of the country, as well as other relevant factors.

The sovereign credit rating has a strong effect on the **rating of domestic companies**, determining *de facto* the ability of the whole economy to issue bonds and to attract foreign direct investments. This effect is driven by the CRAs' practice to apply a cap on the corporate ratings ("sovereign ceiling rule"), which results in a compression of ratings in countries with low sovereign ratings (only lately CRAs have started to deviate from that practice, here a recent paper on that). In the banking sector, given that the governments tend to be explicitly or implicitly the lender of last resort, the relevance of the sovereign is particularly visible. Furthermore, the ratings of financial instruments determine their suitability for investments (or the amount of such instrument that can be held) by sensitive sectors, e.g. pension funds.

CRAs also issue sovereign credit ratings for **international or local/regional institutions. In the EU such ratings are issued for bonds issued by the** European Commission, the European Investment Bank and the European Stabilisation Mechanism.

EU Regulation No 1060/2009 (amended several times over years, the latest one in 2017) sets the **EU provisions on the CRAs** and their activities, including the use of ratings for regulatory purposes. In the EU, the European Securities and Markets Authority (ESMA) is the CRAs' supervisor.

ECONOMIC GOVERNANCE SUPPORT UNIT (EGOV)
Authors: A. Zoppè, S. Lenzi
Directorate-General for Internal Policies
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Rating systems by the CRAs, outlooks and comparisons

Each CRA has its own ranking system: the ranking is a combination of uppercase and lowercase letters, with additional either plus or minus signs or numbers. Table 1 presents the different scale systems adopted by the three major agencies. Entities classified as "Prime" are the most reliable and sound, while the "Highly Speculative" ones present the highest risk of default.

Table 1 presents also the **"Credit Quality Steps" (CQSs)**, as set in the relevant EU Regulation[1]: CQS facilitate the comparison of the credit rankings. In this framework, the CQS "1" indicates the highest grade, which identifies entities with strong capacity to meet their financial commitments.

In addition to the ratings, all CRAs also provide an **"outlook"** of the current situation. The outlook may be positive, negative or stable and signals the expected future developments in the corresponding rating grade. In this respect, a rating outlook assesses the opinion regarding the likely direction of a credit rating over the short term, the medium term or both, taking into consideration changes in the economic and/or political condition of an entity. Nevertheless, an outlook is not necessarily a precursor of a rating change[2].

In accordance with EU legislation,"*A credit rating agency shall disclose to the public the methodologies, models and key rating assumptions it uses in its credit rating activities*". Box 1 presents some information on the methodology used by S&P to assess the sovereign ratings, as an example.

ESMA maintains a database on ratings that has been set up following an amendment to the EU Regulation on CRAs.

Table 1: Rating systems and comparisons

Grade	S&P	Moody's	Fitch	Rank	Credit Quality Steps
Prime	AAA	Aaa	AAA	1	1
High grade	AA+	Aa1	AA+	2	
	AA	Aa2	AA	3	
	AA-	Aa3	AA-	4	
Upper medium grade	A+	A1	A+	5	2
	A	A2	A	6	
	A-	A3	A-	7	
Lower medium grade	BBB+	Baa1	BBB+	8	3
	BBB	Baa2	BBB	9	
	BBB-	Baa3	BBB-	10	
Non-investment grade speculative	BB+	Ba1	BB+	11	4
	BB	Ba2	BB	12	
	BB-	Ba3	BB-	13	
Highly speculative	B+	B1	B+	14	5
	B	B2	B	15	
	B-	B3	B-	16	

Note: The table reports only a part of the ratings' scales.
The selected range includes the ratings investigated in this note.
Source: Country Economy, based on CQSs.

[1] Commission implementing regulation 2016/1801. The regulation is set for External Credit Assessment Institutions (ECAI), which are CRAs recognized in the European Union for the purposes of Article 113(1) of the Capital Requirements Directive (CRR).

[2] In Regulation No 1060/2009 section D/2/f is specified that: "in the case of a rating outlook, the time horizon is provided during which a change in the credit rating is expected.".

BOX 1: Methodology adopted by S&P to assess the sovereign credit rating

In 2017, S&P published a document with a detailed explanation of the criteria taken into consideration when assessing the sovereign credit rating of a country. The foundation of their sovereign credit analysis rests on five pillars: Institutional assessment, Economic assessment, External assessment, Fiscal assessment and Monetary assessment. The first two pillars give indications on the institutional and economic profile of the country, which reflects their view on the resilience of a country's economy, the strength and stability of its civil institutions, and the effectiveness of policymaking. The remaining three pillars account for the flexibility and performance profile, which reflects their view of the sustainability of a government's fiscal balance and debt burden.

More specifically;

- The institutional assessment reflects their view of how national institutions and policymakers affect a sovereign's credit fundamentals, by delivering sustainable public finances, promoting balanced economic growth, and responding to economic or political shocks.
- The economic assessment incorporates the country income level (measured in GDP per capita), growth prospects and economic volatility.
- The external assessment is an indication of the economy's ability to generate the foreign exchange necessary to meet its public- and private-sector obligations to non-residents.
- The fiscal assessment analyses the debt sustainability of a country's deficit and its debt burden.
- Finally, the monetary assessment considers the ability of the monetary authority to fulfil its mandate, and for the Euro Area it refers to the ECB.

Furthermore, each of the above-mentioned five pillars is assessed on a six-point numerical scale from '1' (strongest) to '6' (weakest). Both quantitative factors and qualitative considerations are applied in this estimation exercise and the averages determine an "indicative rating level", which, in absence of additional adjustment factors, determines the overall final sovereign credit rating.

Credit ranking for Euro Area Member States and relationship with 10-years bonds yields

Table 2 presents the credit ratings of Euro Area Member States (updated to their last changes or the latest publication) and the respective yields on sovereign bonds (10 years, secondary market, as defined by the ECB). The latter is the financing costs borne by the countries and varies widely among Member States; an EGOV note on Public finances in EAMSs: selected indicators provides figures and information on other relevant indicators related to public debts and debt sustainability.

The table shows, *inter alia*, that:

- Germany, the Netherlands and Luxemburg have the highest ratings by all the three CRAs (AAA/Aaa/AAA), and they lie within the **"Prime"** grade;
- All euro area Member States are considered **"investment grade"** by the three CRAs, except Greece, which is considered "speculative", and Cyprus, which is considered "speculative" only by Moody's;
- Moody's has only positive or stable **outlooks** for euro area Member States, while S&P gives a negative outlook for Italy and Fitch gives a negative outlook for Latvia, Belgium and France;
- In April 2020, Cyprus had the highest **yield on sovereign bond** (1.87 %), while Germany the lowest (-0.45 %).

Table 2: Country Credit Rating by each CRA and yields on 10-years bonds

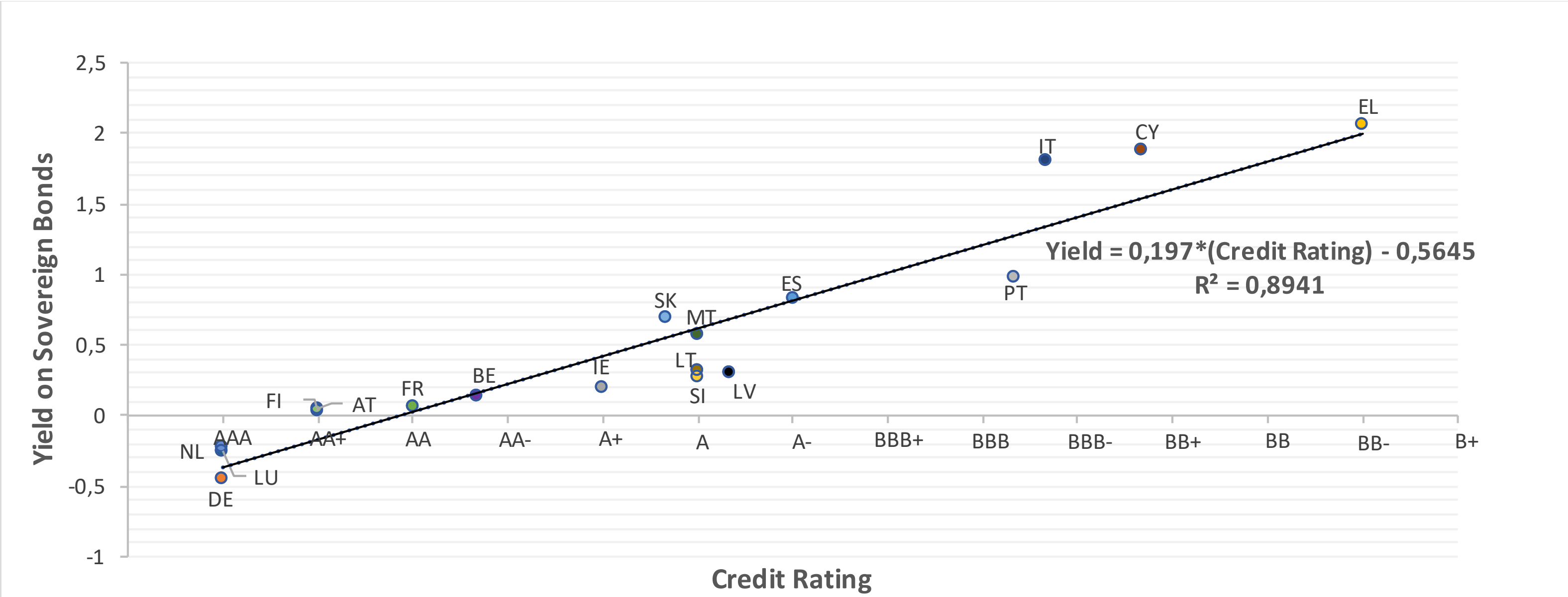
Member State	Credit Rating									Yield on sovereign bonds (10 years)
	S&P			Moody's			Fitch			
	Rating	Outlook	Date[1]	Rating	Outlook	Date[2]	Rating	Outlook	Date[2]	apr-20
Belgium	AA	Stable	28/02/2014	Aa3	Stable	11/10/2019	AA-	Negative	03/04/2020	0.14
Germany	AAA	Stable	13/01/2012	Aaa	Stable	25/01/2019	AAA	Stable	17/01/2020	-0.45
Estonia	AA-	Positive	28/02/2020	A1	Stable	10/05/2019	AA-	Stable	27/03/2020	-[3]
Ireland	AA-	Stable	29/11/2019	A2	Stable	14/02/2020	A+	Stable	28/02/2020	0.20
Greece	BB-	Stable	24/04/2020	B1	Stable	01/03/2019	BB	Stable	23/04/2020	2.05
Spain	A	Stable	20/09/2019	Baa1	Stable	13/04/2018	A-	Stable	13/12/2019	0.82
France	AA	Stable	21/10/2016	Aa2	Stable	21/02/2020	AA	Negative	15/05/2020	0.06
Italy	BBB	Negative	26/10/2018	Baa3	Stable	19/10/2018	BBB-	Stable	28/04/2020	1.80
Cyprus	BBB-	Stable	14/09/2018	Ba2	Positive	20/09/2019	BBB-	Stable	03/04/2020	1.87
Latvia	A+	Stable	21/02/2020	A3	Stable	31/05/2019	A-	Negative	10/04/2020	0.30
Lithuania	A+	Stable	21/02/2020	A3	Positive	23/08/2019	A	Stable	31/01/2020	0.31
Luxembourg	AAA	Stable	14/01/2013	Aaa	Stable	30/08/2019	AAA	Stable	06/03/2020	-0.25
Malta	A-	Stable	13/03/2020	A2	Stable	19/07/2019	A+	Stable	17/04/2020	0.57
Netherlands	AAA	Stable	20/11/2015	Aaa	Stable	22/02/2019	AAA	Stable	24/04/2020	-0.22
Austria	AA+	Stable	29/01/2013	Aa1	Stable	25/05/2018	AA+	Stable	15/05/2020	0.05
Portugal	BBB	Stable	24/04/2020	Baa3	Positive	09/08/2019	BBB	Stable	17/04/2020	0.97
Slovenia	AA-	Stable	14/06/2019	Baa1	Positive	26/04/2019	A	Stable	17/01/2020	0.27
Slovakia	A+	Stable	31/07/2015	A2	Stable	27/09/2019	A	Stable	08/05/2020	0.69
Finland	AA+	Stable	16/09/2016	Aa1	Stable	27/04/2018	AA+	Stable	24/01/2020	0.03

Notes: [1]Date of last change; [2]Date of latest publication; [3]There are no Estonian sovereign debt securities that comply with the definition of long-term interest rates for convergence purposes. See also Public finances in EAMSs: selected indicators. Source: Country Economy and ECB.

The higher the credit rating of a country, the higher the (perceived) creditworthiness of the government; conversely, the lower the rank of the credit rating associated with a country, the higher the likelihood that the government will not be able to meet its financial commitments. The risk associated to financial instruments is reflected by its price and its yield (they move in opposite directions: high price correspond to low yields and vice versa). In this respect, the more reliable is the financial situation of an entity (as signalled by its credit rating), the lower its financing costs are expected to be (as signalled by the yields on its bonds).

Graph 1 presents the relationship between the Credit Rating of euro area Member States and the yield on their sovereign bonds. For each country, the credit rating variable employed in the graph is obtained by averaging the ratings received by the three CRAs (with the values in the fifth column of Table 1). In the x-axis, the rating scale displayed is the one adopted by S&P and Fitch.

Graph 1: Credit Rating and Yield on Sovereign Bonds



Note: There are no Estonian sovereign debt securities that comply with the definition of long-term interest rates for convergence purposes.

Source: Country Economy and own calculations. Yields: ECB - April 2020

The graph shows the high correlation between the financing costs, namely the yield on 10-years sovereign bonds, and the creditworthiness of the country, measured by its credit rating. In particular, it is possible to observe that countries with the highest ratings by the CRAs - such as Germany, the Netherlands, Luxembourg or Finland - are also the countries with the lowest yields; while Greece, which is the only country considered as "speculative" by the CRAs, is also the country with the highest yield on sovereign bonds.

The graph shows that the relationship is clearly linear, as the majority of the countries lie very close to the linear regression line. There are few exceptions, namely Italy, Cyprus, Portugal and Latvia.

Credit ratings for the EU, the ESM and the EIB

Table 3 presents in tabular format some facts and financial information of the three institutions that issue bonds at EU level: the European Commission (EU), the European Stability Mechanism (ESM) and the European Investment Bank (EIB). The following EGOV documents provide details and comparisons: EFSM, ESM, and Comparison ESM/EIB. The ESM and the EIB are both funded with capital provided by Member States. The capital acts as guarantee for borrowing money on the capital markets, and the Member States' capital contribution is proportional to voting rights in the relevant decision-making bodies. The EU has a limited capacity to borrow money.

All these institutions receive very high credit ratings from the CRAs. In particular, the EIB presents the highest ranked ratings (AAA/Aaa/AAA), while the EU is rated AA by S&P and the ESM is rated AA by S&P and Aa1 by Moody's. Furthermore, all the three institutions have the status of "preferred creditor" (secondary to the IMF only): a preferred creditor has the first claim to any funds that are available from the debtor, in case the latter does not have enough financial resources to fulfil all its obligations and declares bankruptcy.

When a CRA assesses the rating of supranational organisations, it also considers the creditworthiness of their shareholders. In this respect, on 30 April 2020 Fitch updated its criteria for rating supranational entities: its report describes the criteria adopted for assigning new ratings and monitoring existing ratings. The first step is to determine the organisations' stand-alone credit quality, which Fitch refers to as its "intrinsic rating" (IR); then it assesses the likelihood of it receiving extraordinary financial support from shareholders, considering both the capacity and the propensity to support. The Issuer Default Rating (IDR) is then based on the "intrinsic rating" plus a credit uplift, reflecting extraordinary support from shareholders.

Therefore, the creditworthiness of the shareholders/members, which in the EIB, EU and ESM are the Member States, influences both the initial assessment of the IR, as the countries where the supranational institutions operate represent a key aspect determining this initial assessment, and the second part of the evaluation, being the Member States the entities accounted to receive financial support.

Table 3: Supranational Organisation Characteristics and Credit Rating

	European Union (EU)			ESM			EIB		
Legal form and founding act	Supranational institution established under EU Treaty (TFEU)			International financial institution, established in 2012 under public international law based on an intergovernmental treaty: Treaty establishing the European Stability Mechanism (TESM)			International financial institution, established in 1958 with the Treaty of Rome. Articles 308 and 309 of TFEU **focus on the EIB and its tasks**; Protocol 5 TFEU is on the Statute of the EIB		
Lending capacity	EFSM: €60 bn, utilised €46.8bn, outstanding: €46.8 bn BoP: €50 bn, utilised: €13.4 bn, outstanding: €0.2 bn MFA: no predefined ceiling, €4.72 bn outstanding			The maximum lending volume of the ESM is set at EUR 500 billion, including the outstanding EFSF stability support: €500 bn -Utilised: €89.9 bn, -Outstanding: €89.9 bn -Available capacity: €410.1 bn			250% of subscribed capital, reserves, non-allocated provisions and profit and loss account surplus, less equity participations (excluding loan substitutes): -Subscribed capital of €248.8 bn -Loans disbursed: €449 bn		
Issuing mandate	Provide financial assistance to countries in financial and economic difficulty in order to promote economic and social integration of the member states			Provide financial assistance to euro area member states in difficulties in order to safeguard financial stability in Europe			EU's long-term lending institution: finances sustainable investment projects that contribute to EU policy objectives. More than 90% of activity in EU.		
Shareholders/ Founding Members	27 EU Member States			19 Euro Area Member States			27 EU member states		
Support to Bondholders	EU budget and Member States' obligation to provide the funds necessary to meet the EU's legal obligations. EU Budget 2020: €153.6 bn in payments (€168.7 bn in commitments).			Share capital comprising paid in capital and callable capital. Explicit, irrevocable and unconditional obligation to pay the share of callable capital on demand; 'several' liability -Subscribed capital of €704.8 bn -Callable capital: €624.25 bn -Paid-in capital: €80.5 bn			Explicit obligation on EIB's shareholders to pay their own share of the callable capital, on demand from the Board of Directors; 'several' liability. -Subscribed capital: €248.8bn -Callable capital: €221.6bn -Paid-in capital reserves and surplus: €72.6bn		
Credit Ranking	De facto Preferred Creditor Status			Preferred Creditor Status (after IMF)			Preferred Creditor Status		
Ratings[1]	S&P	Moody's	Fitch	S&P	Moody's	Fitch	S&P	Moody's	Fitch
	AA (stable)	Aaa (stable)	AAA (stable)	AA[1] (stable)	Aa1 (stable)	AAA (stable)	AAA (stable)	Aaa (stable)	AAA (stable)

Source: EU Investor Presentation - April 2020; ESM Investor Presentation - May 2020; EIB Investor Presentation - February 2020. Note 1: rating of the EFSF.