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INTERNATIONAL

THE AUTHORITY ON CREDIT QUALITY

JULY 4, 1994

A DECADE OF RATINGS IN EUROPE

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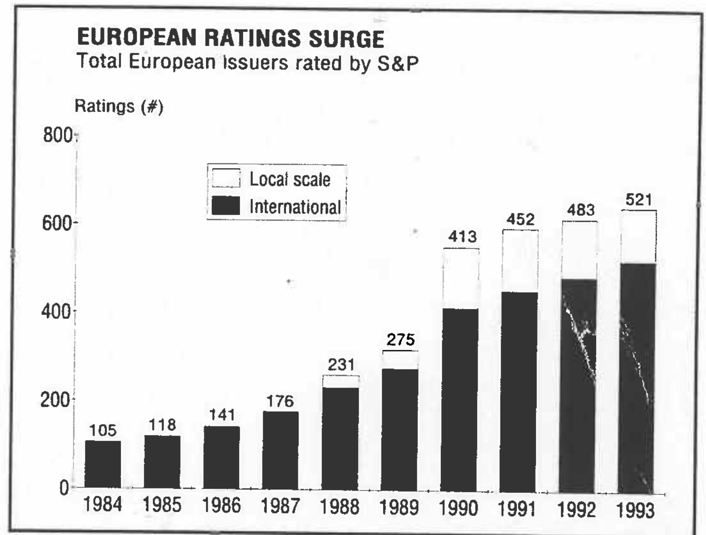
Though ratings have long been a part of the U.S. capital markets, it is only over the last decade that they have begun to take hold in Europe. Since S&P opened its first European office in 1984, the number of rated European issuers has grown fivefold, from less than 100 to approximately 530 today. The growth of the Eurobond market as well as the development of domestic fixed-income markets throughout the continent have been key. Also contributing to this growth have been political and economic changes such as the drive for a unified European market, financial market deregulation, and the trend toward institutional money management.

From $88 billion in 1984, Eurobond issuance quadrupled to $363 billion in 1993, of which S&P rated about 70%; a significant increase from the early to mid-1980s when a relatively small issuer base made the need for a more sophisticated credit evaluation less compelling. However, as the market began to grow in the mid- to late-1980s, the issuer base expanded to include smaller, lesser-known issuers. Consequently, Euromarket investors looked to ratings for guidance in an increasingly complicated universe of debt issues, and, in turn, many issuers sought ratings to distinguish themselves from nonrated, possibly poorer quality, issuers.



A key sector where ratings have played a crucial role is structured finance. The total value of S&P publicly rated European structured finance issues, less than US$1 billion in 1987, grew to approximately US$6 billion in 1993. The expansion of domestic debt markets, particularly the short-term commercial paper markets, has also been substantial, although the growth has slowed in recent years. And finally, while small compared with other markets, Eastern Europe has joined the rating fold. S&P-rated issuers in this region include the Czech Republic, the Slovac Republic,

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A DECADE OF RATINGS IN EUROPE

the city of Prague, and the National Bank of Hungary.

For many years, European companies could issue debt on the strength of their names alone. Investors, primarily retail, would buy their paper convinced that well-known companies do not go broke. Clearly, that has changed. Defaulting issuers, including Olympia & York in Canada, Polly Peck in the U.K., and, more recently, the near failure and subsequent bailout of Metallgesellschaft in Germany, have shown the Euromarkets that credit risk is a real concern.

In addition, many European companies now rely on cross-border financings with investors that do not necessarily know them well. So even sizable, highly regarded companies by and large need ratings, and smaller lesser-known companies most certainly do.

In addition, regulators increasingly rely on ratings to measure and control risks undertaken by the institutions they oversee. In France, ratings growth is attributable partially to financial regulations that mandate ratings in specific cases, such as for commercial paper with maturities in excess of two years and for structured financings.

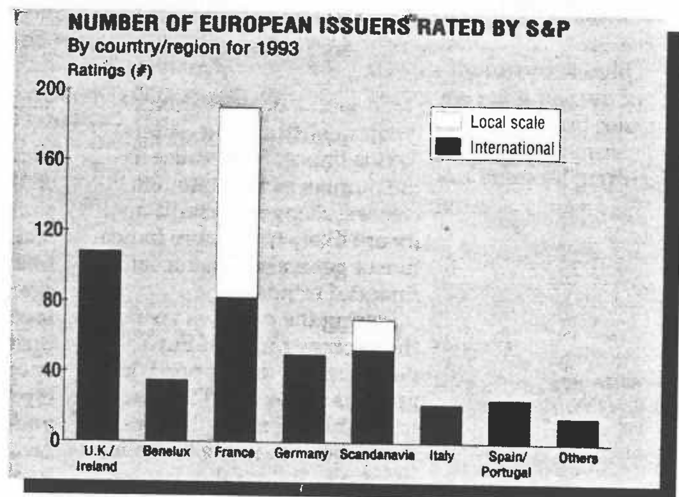
Financial innovations, including asset-backed debt, hybrid securities, and derivatives, have also been critical to ratings growth, particularly over the last few years.

In the long run, two other debt markets, if they develop to the extent that seems likely, could have an even more profound impact on the demand for ratings. They are the local government or municipal markets throughout Europe and the emerging markets in Eastern Europe.

Over the last several years, an increasing number of city and regional governments in Europe have been looking to raise funds in the international capital markets. This is due in large part to the budget constraints faced by central governments throughout the continent and the resultant drop in financial support flowing to cities and regions. Another key factor has been the shift toward market economics, which has brought about a wave of privatizations, deregulation, and fiscal conservatism.

Because of its lengthier history, the U.S. municipal market is more established than the incipient one in Europe. However, given current governmental policies and economic trends, the prospects are good that over time a fairly substantial market for European municipal debt will develop. The number of new city and regional government ratings, mostly coming out of Scandinavia, France, Germany, and Spain, have been rising steadily the last several years. A total of 32 have been rated, including governmental entities as diverse as German Länder, French Provinces, Swedish Municipalities, and Spanish Autonomous Communities.

Ratings growth in Eastern Europe depends largely on the success of economic and political reforms taking place throughout the region. Currently bond issuance, and consequently, the use of ratings, are inhibited by the small number of entities that are in a position to borrow internationally. Thus far, S&P has rated Czech and Hungarian entities as they are further along the path to reform than their neighbors. Hungary, for example, has been the Eastern Europe's biggest recipient of foreign investment, over $7 billion since 1987. Poland is the best positioned of the region's other countries to issue debt on the international markets as it has made substantial progress towards establishing a market economy. In fact, its economy grew 4% in 1993—the fastest in the region. Also, Poland's recent debt reduction and rescheduling agreement should make the country more attractive to investors. Looking ahead, as the economies of the region begin to grow and the demand for capital increases, companies as well as governmental entities may turn to the international debt markets to raise funds. Project financings for infrastructure development and asset-backed financings are two vehicles likely to be employed.



CREDIT QUALITY TRENDS

The growth in European fixed-income markets has coin-

S&P IN EUROPE

The growth in demand for ratings has naturally brought about a rapid expansion of S&P's European presence. From the original London office, S&P now has four other European offices: Frankfurt, Madrid, Paris, and Stockholm in the company's worldwide network. S&P has expanded largely through joint ventures and acquisitions. S&P-Nordisk Ratings AB, a wholly owned subsidiary of Standard & Poor's founded in 1988 in conjunction with the Stockholm School of Economics, was the first new endeavor in Europe following the 1984 London office opening. In the early 1990s, S&P set up joint ventures in France and Spain: first in 1990 with Agence de Evaluation Financiere, the leading French debt rating agency; then in 1992 establishing Iberating with five Spanish partners. Later that year, the company rounded out its European network opening an office in Frankfurt. Also, in 1990, S&P purchased London-based Insurance Solvency International, Europe's largest insurance rating service. Thus, from a handful of European based analysts in 1984 to almost 100 today, S&P has become an integral part of Europe's financial markets.

Initially, the bulk of S&P ratings was concentrated in the financial institutions and public sectors. In 1982, for example, S&P rated 20 financial institutions and only seven corporations. By 1987, the number of rated financial institutions increased modestly to 35, while those of corporations shot up to 30. The growth of ratings was even more pronounced over the next five years, with corporate ratings increasing to 100 by 1993, while that of financial institutions grew even more in that time to 164. Public sector ratings, including sovereign and sovereign-supported issuers as well as regional and local governments have grown steadily over the last 10 years and now account for 20% of S&P European ratings, or 112.

Over the next several years ratings growth should continue, albeit at a somewhat slower pace than that which was achieved during the late 1980s and early 1990s. Roughly 90 to 120 new European ratings are likely in the next two to three years, thanks in part to the introduction of new rating products covering among other things money market funds, derivative instruments, and covenants.

cided with a deterioration of credit quality among issuers. This is important because as the number of rated issuers increases, changes in credit quality are likely to be more indicative of general economic and financial trends.

During the past five years, the average rating of European issuers has dropped, just as it has in the U.S. This is attributable in part to the dramatic increase in the number of ratings and weaker issuers acquiring ratings as investors begin to accept, albeit tentatively, lower-rated debt. Still, it is clear that credit quality has deteriorated. European corporates had an average rating of 'AA' in 1987, today the average is 'A+'. The bank rating average has gone from 'AA' to 'A' during the same time. In addition, there have been several sovereign downgrades including Italy, Finland, Sweden, and Turkey.

BANK DOWNGRADES

More than any sector, banks have fallen the furthest. In 1993 alone, 23 out of 46 bank ratings were lowered, accounting for the bulk of European downgrades that year. Taken in conjunction with the 34 downgrades of European financial institutions the previous year, this represents a significant deterioration in credit quality. No doubt slumping economies and slack real estate markets played a role. Longer-term trends, however, that are not necessarily favorable to the banking industry seem to be more responsible for the drop in credit quality. Deregulation and internationalization are increasing competition among banks, while disintermediation has brought competition from other types of financial service providers. Italy and France are privatizing state-owned banks, putting additional pressure on ratings. Thus, it appears that the decline in credit quality, while likely to moderate, may be a long-term problem for European banks.

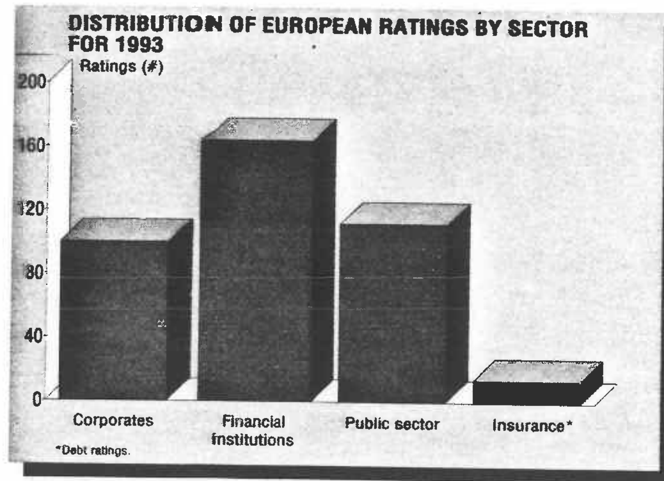
Corporate issuers have also struggled over the last several years, although the decline in credit quality has been less pronounced. In 1992, 17 European corporate ratings were lowered, and none were raised. In 1993, there were eight downgrades and three upgrades. The ongoing Europe-wide recession took its toll, as did the falling real estate market, which hit construction and property companies particularly hard. Car companies, among the first and most prominent rated European issuers, continued to suffer from weak demand and industry overcapacity—a situation that is likely to persist in the short term. Oil and gas companies could also see a deterioration in credit quality due to low oil prices and over supply. In addition, a number of state-owned corporates may see their ratings fall due to privatization. Overall, the near-term outlook for European corporates is negative to stable.

GROWTH TO CONTINUE

The growing acceptance of the need for ratings, the increasing size and complexity of European fixed-income markets, and investor concern over credit quality suggest that ratings will continue to become more important in Europe. Thus, the growth in ratings, while not likely to be as spectacular as that experienced in the 1980s, should continue.

Several ongoing financial market and economic trends point in that direction, too.

Of the 584 Eurobond issues that went to market in the first



quarter of 1994, 337 were rated by S&P, or a 58% market penetration. While the percentage goes up when measured in terms of the volume of debt (70%), it is clear that there is room for growth, particularly when compared with the near 100% market penetration S&P has achieved in the U.S. Ratings are even less prevalent in Europe's domestic capital markets, although their use varies substantially from market to market.

Bank disintermediation, the maturation of domestic capital markets, the privatization of state-owned enterprises, Eastern Europe's drive to establish market economies, and the development of new rating products should push those percentages up over time. So, too, should managements' more positive attitude toward public debt issuance as well as the institutionalization of the investor base with its greater emphasis on credit fundamentals.

The number of rating agencies throughout the world, including Europe, has grown markedly over the last several years. The trends referred to above along with the globalization of financial markets are undoubtedly responsible. So too are investors, who in making investment decisions are relying less on the "brand name" of issuers and more on the objective opinions of rating agencies. S&P's second decade in Europe should, therefore, see it play an increasingly important role in the overall development of European financial markets.