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"Emerging Countries Sovereign Rating Adjustment using Market Information: Impact on Financial Institutions Investment Decisions"

(with Dominique Guegan and Bertrand Hassani)

Abstract:

Assets, debts and other financial products issued by emerging countries are usually considered more speculative than those issued by developed economies. Therefore, relying on traditional rating agencies to invest in these countries is problematic as the information used to assess the economic and market condition in these economies is quickly outdated. Consequently, both the investment opportunities and the necessity to clear particular positions may be missed, respectively resulting in potential significant costs of opportunity or losses. Therefore, an approach taking into account the latest information displayed by financial markets may enable us bypassing the traditional limits. As a result, this chapter proposes a creditworthiness evaluation methodology based on adjusting ratings obtained from macroeconomic fundamentals (GDP growth rate, inflation, external debts, etc.) and financial market movements (bonds, equity volume, volatility, etc.). In the first step, a general panel model is applied on country-specific information to generate fundamental ratings. In the second step, applying a multi-factor model to market indicators and breaking down long-term sovereign bond yields into different risk premia, market implied ratings are obtained. Finally, the final rating to be considered (denoted Delta-Rating) for investment purposes is a combination of fundamental ratings and market implied ratings carrying out an adapted Buhlmann-Straub method (Credibility Theory). Then, emerging countries Delta-Rating will be compared to those obtained from developed countries and discussed against financial institutions risk appetite.