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An Introduction

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Financial Crises, Credit Ratings, and Bank Failures

An Introduction

Carmen M. Reinhart

Financial crises of every variety rocked emerging markets in the second half of the 1990s. Nearly every region experienced currency crashes, banking crises were both numerous and severe, and a few countries, facing extreme duress, defaulted on their sovereign debt. Not surprisingly, then, there is considerable interest in policy and academic circles and within the investment community in gaining a better understanding of financial and economic distress.

An aspect that has received particular attention in the growing empirical literature on financial crises is crisis prediction or, more broadly, assessment of imminent downside risks—for banks, currency, or sovereign debt. Much of this literature focuses on selecting the “right” set of economic and occasionally political fundamentals. Rating agencies, responsible for monitoring credit risks, came under considerable scrutiny following their lackluster performance in anticipating the Mexican peso crisis (which nearly resulted in default) and the Asian crises of 1997–98.

The impact of changes in sovereign credit ratings on financial markets also became a matter for 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 multilateral lending institutions in particular became painfully aware of the pressing need to develop and implement more robust ways of “stress testing” financial systems, to ensure adequate capital requirements and provisioning and limit the risk of bank failure.

Three articles in this issue address various aspects of these topics—in particular, the behavior and impact of sovereign credit ratings and the development of a portfolio model for testing the vulnerability of banks. Two of the articles address the usefulness and impact of sovereign credit ratings. Reinhart evaluates the performance of credit ratings in anticipating currency crises and defaults, finding that ratings systematically fail to anticipate currency crises but do somewhat better in anticipating defaults. However, downgrades in credit ratings usually follow currency crises, suggesting both that currency instability increases the risk of default and that credit ratings tend to be procyclical. Using a very

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different sample, data frequency, and analytical approach from Reinhart, Kaminsky, and Schmukler also find evidence of procyclicality in sovereign credit ratings. They show that credit upgrades usually take place during market rallies and downgrades during bond and equity market slumps.

In the third article, Balzarotti, Falkenheim, and Powell focus on bank defaults rather than sovereign defaults, exploring how capital and provisioning measures can limit bank failures. Their approach stresses a portfolio-based model for estimating the 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 used to develop better measures of banks' credit risks.