

Sovereign Credit Rating Revolution – Why and how to launch a new rating procedure today

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Summary

Are we really willing to accept the criteria still used for the rating of sovereign debt and company risks after two heavy financial market crashes? While thinking about this question rating agencies continue measuring the ability of countries to generate the figures that are required to meet the rating benchmarks. Is there an alternative? Our rating is based on Index Benchmarks, the GDP-wealth-ratio and Social Capital Assessment. This paradigm change is crucial for rebalancing capital markets and giving countries and companies equal access to capital. Capital should be used where it is needed to achieve progress in society and environment, not only to guarantee an enduring and fixed interest rate for investors or national pension funds.

I. Why time has come for a new rating approach

The following factors shaped our decision to launch a new rating standard:

- The ongoing AAA/AA+ rating of the United States of America by Standard&Poor's, Moody's and Fitch
- The denial of the Sovereign Lending Group of the UNCTAD to consider Social Capital as an indicator
- The denial of the World Economic Forum to consider Social Capital as an indicator
- The denial of the United Nations Development Programme to consider Index Benchmarks and Social Capital as indicators
- The European Commission, the European Parliament and the European Central Bank continue to use the GDP-debt-ratio as a base for financial policy after two crashes
- The Basel III criteria of the Basel Bank of Settlements and the Basel Committee

II. What does the current rating measure?

Sovereign Risk

The current rating of Sovereign Risk covers two major subjects:

1. The ratio and development of government spending and revenue
2. The gross domestic product, its growth and the GDP-debt-ratio

Furthermore, only Developing and Emerging countries have to pay for the rating. None of the 20 countries with AAA ratings is paying for the audit.

Companies

According to the rules provided by the IASB (International Accounting Standards Board), which are used by most international companies to make their balance, four major criteria are relevant:

1. Price-earning ratio
2. Price-to-book ratio
3. Price cash flow ratio
4. Price sales ratio

In addition all stock ratings consider the recommendations (from „sell“ to „strong buy“) from other analysts. The three major rating agencies are making their business by rating stocks, bonds, funds and other related products.

A second class of rating is made by applying sustainability as an additional criterion, which has become widely accepted for capital market products.

III. Why we need a new rating

The current rating mode creates an incentive: a good rating provides positive benchmarks and therefore encourages countries to meet the criteria. However, this invites governments and companies to manipulate their basic figures. Iceland, Ireland, Greece, Spain and Portugal are examples of this widespread practice. Offshore havens on the one side and heavily indebted countries with AAA ratings are sending out a dangerous message: Just fake your figures and you'll get a AAA ranking. Thus the current rating mode only measures the capability and capacity of a country to generate and to communicate the right figures to meet the criteria of the agencies.

This weakens the ability of healthy states to raise capital on the markets at acceptable interest rates. The disequilibrium in international economy can therefore not be reduced, which causes Billions in opportunity costs for financial and development aid.

IV. The new criteria

The fact that current official data on the evaluation on sovereign risk is not reliable due to misleading incentives, puts national statistics into question. The Basel Institute of Commons and Economics therefore weights existing statistics with only 30%. The Index Benchmarks (15%) are based on 8 leading international indices. The GDP-wealth-ratio is a method developed by our institute by using data collected by the World Bank and the Credit Suisse Global Wealth Report.

70% of the information is generated by a Social Capital Assessment of politics, economy and society.

The new rating of sovereign debt

Social Capital Assessment			Index Benchmarks	GDP-wealth-ratio
Government	Economy	Society		
20%	20%	60%		
70%			15%	15%

V. How robust is the new approach?

Social Capital

We define Social Capital as the value of non-monetary relations within a society. Social Capital has a clear impact on sovereign debt. Governments have either to reduce public spending or to increase tax revenues (e.g. through a net assets levy) to pay off their debts. However, both options depend on the will of the population to support governmental actions.

In order to estimate Sovereign Risk, we measure the existing social capital at three levels:

1. Government/Opposition: are they willing to take action?
2. Economy: will economic stakeholders support the action?
3. Society: will the people support the action?

This approach requires a Social Capital Assessment. Part of the assessment is a panel: the Social Capital Monitor, which has been launched in [Germany](#) and [Switzerland](#).

Le code postal de votre lieu de résidence

En nous le donnant, vous nous aidez à calculer l'indice du climat social de votre quartier/commune/ville.

Comment évaluez-vous le climat social de votre lieu de résidence?

Si vous avez plusieurs lieux de résidence - par exemple la ville en semaine, la campagne en fin de semaine - vous pouvez donner une évaluation pour tous vos lieux de résidence.

1 excellent

2

3

4

5

6

7

8

9

10 insatisfaisant

[Online Social Capital Assessment](#) (French version)

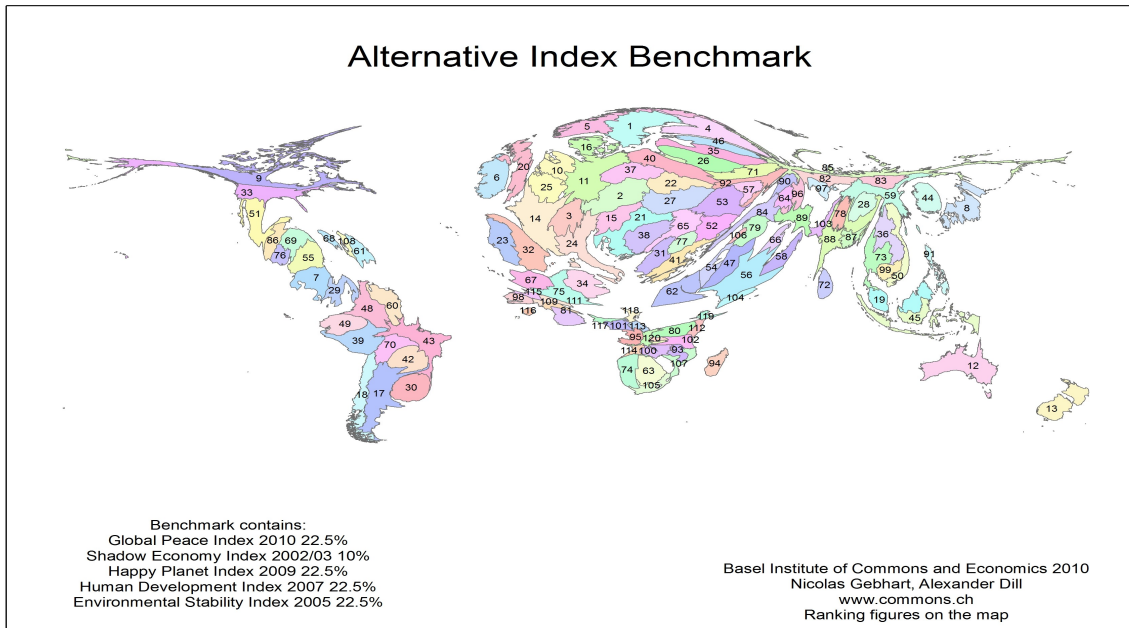
Index Benchmark

The Basel Institute of Commons and Economics is the first to conduct a Global Index benchmark considering the following international Indices:

- GPI: Global Peace Index
- HPI: Happy Planet Index
- HDI: Human Development Index
- ESI: Environmental Sustainability Index
- WGI: World Giving Index
- CS GWD: Credit Suisse Global Wealth Databook
- GCI: WEF Global Competitiveness Index
- CPI: Transparency International Corruption Perceptions Index 2010

The „Your better Life Index“ of the OECD is not considered because it covers the 34 OECD countries only.

The Index Benchmark is averaging these indices and will take new indices into consideration, whenever established.



Wealth-GDP-ratio

In addition the Basel Institute of Commons and Economics compares the share of a country in world GDP with its share in world wealth. The higher the difference is, the higher the risk of a country is, being affected by internal regime change or by international changes in trade regulations and taxation. In 2010 the following countries had the best balance of trade and wealth:

Score	Name	share world gdp	ratio GDP/wealth	share wealth
1	China	8,50	-0,35	8,47
2	Portugal	0,36	5,56	0,38
3	Germany	5,33	6,19	5,66
4	Hong Kong	0,35	8,57	0,38
5	Norway	0,69	-11,59	0,61
6	Indonesia	1,06	-12,26	0,93
7	South Korea	1,57	-14,01	1,35
8	Spain	2,24	-15,18	1,90
9	USA	24,20	15,95	28,06
10	Lebanon	0,06	-16,67	0,05

VI. What we are not assessing

Birth rate and immigration

At a global level neither the birth rate nor the streams of immigrants cause a clear positive effect on sovereign risk. Germany tripled its debt after the reunification, many emerging and developing countries suffer of streams of refugees such as Egypt, Kenya and Tunisia. Only in a few countries such as Scandinavia, Switzerland, New Zealand, Canada and Australia immigration has a long-term effect to better the public finances, e.g. by net transfers to the social security systems.

Happiness and Life Satisfaction

The Life Satisfaction Approach (LSA) and the World Database of Happiness are often mentioned as an alternative to the GDP. Although the definition of well-being, happiness and life satisfaction differs in all cultures and religions, we don't believe that they are adequate indicators to evaluate Sovereign Risk. Furthermore we know that there are successful countries with very unhappy people, but with excellent Social Capital.

GDP and growth rate

Both indicators are sufficiently assessed by current statistics. There is no need to consider them in an alternative rating approach. But they are considered by our Index Benchmark as well as in the GDP-wealth-ratio.

Peace, Sustainability, Environment, Education, Democracy and Health

We include major indices featuring these factors in our Index Benchmarks, giving them a high emphasis in our rating. By adding Social Capital as an indicator we contribute to the knowledge on non-material assets in societies.