

Credit Rating Agencies and Sovereign Debt: Four proposals to support achievement of the SDGs

The COVID-19 pandemic has inflicted significant damage on global economic activity, exacerbated fiscal challenges worldwide, and impeded countries' ability to respond to the pandemic and achieve the Sustainable Development Goals (SDGs). Many countries experienced downgrades of their sovereign credit ratings, higher borrowing costs, and intensified risks of debt distress.

Developing countries have borne the brunt (over 95%) of credit rating downgrades, despite experiencing relatively milder economic contractions. The fear of ratings downgrades also hindered some countries' participation in official debt relief programs, such as the G20's Debt Service Suspension Initiative (DSSI). Three challenges related to developing country sovereign credit ratings stand out: (i) the impact of downgrades on countries' cost of borrowing and on financial market stability, including whether there is perceived bias, increased volatility, and "cliff effects"; (ii) how official actions, including official debt restructurings such as DSSI, are incorporated into ratings analysis; and (iii) the integration of climate change and other non-economic factors into rating methodologies.

These dynamics have led to a renewed focus on the credit rating agencies (CRAs) that determine sovereign ratings. CRAs also garnered attention following the 2008 global financial crisis, when calls for reform included reducing mechanistic reliance on ratings, enhancing competition, and addressing CRA conflicts of interest. Significant regulatory reforms were enacted to help address mechanistic reliance on ratings and try to address the conflicts of interest. Yet, there are still concerns about market concentration, some structural conflicts of interest, and remaining regulatory and investment mandate mechanistic reliance on ratings. There is limited market pressure on CRAs to change their practices as the three largest CRAs (Moody's, Standard and Poor's and Fitch) hold over 90 percent of market share.

Yet, fast-evolving changes in technology, the growing nature of systemic risks, the impact of the pandemic on access to finance, and the increasingly complex linkages in the financial system have underscored the need to re-evaluate the informational ecosystem supporting sovereign borrowing with a forward-looking approach that reflects a changing world. The current crisis creates an opportunity to do so.

Key messages

- » Credit ratings play an important role providing information on sovereign borrowers. But financial markets, including credit ratings, often over-emphasize short-term economic concerns, and underweight longer-term issues, including environmental and social risks as well as investment in resilience and sustainability
- » Fast-evolving changes in technology and the growth of global systemic risks are changing the informational ecosystem around sovereign debt, including for credit ratings.
- » It is in the international community's interest to ensure that CRAs continue to adapt to these changes in ways that strengthen the quality of ratings and encourage investment in developing countries and in sustainable development.

CHALLENGES EXPERIENCED BY DEVELOPING COUNTRIES

CHALLENGE 1: THE IMPACT OF CREDIT RATINGS ON A COUNTRY'S COST OF BORROWING

Credit rating agencies provide information to investors and to financial markets to help them price risk, and thus can directly impact the cost of public investments aimed at delivering sustainable development. In particular, negative warning announcements by CRAs (i.e. "reviews," "watches," and "outlooks") have been linked to increases in the cost of borrowing, particularly for developing countries, at 160 basis points vs. 100 basis points for advanced economies. Valid criticisms of CRAs are not so much that they impact market prices (which would be expected), but whether they transmit inaccurate information and/or exacerbate market reactions and procyclicality. Since sovereign ratings often act as a country-level baseline for corporate ratings, they also affect the cost of corporate borrowing and investment in the SDGs¹.

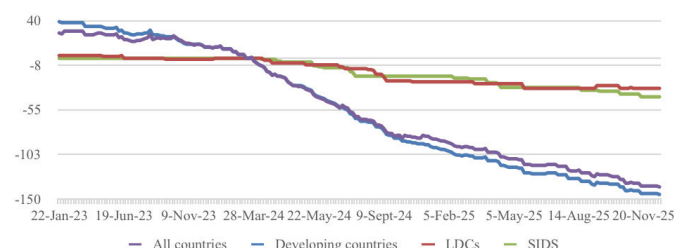
Authors: Shari Spiegel, Peter Chowla, Poh Lynn Ng and Philipp Erfurth, Financing for Sustainable Development Office, UN DESA. See FSDO Policy Paper, "Credit Rating Agencies and Sovereign Debt: Challenges and Solutions", for a more detailed discussion. This policy brief also builds on Griffith-Jones, S. and Kraemer, M. (2021), "Credit Rating Agencies and Developing Economies," DESA Working Paper, United Nations Department of Economic and Social Affairs.

Sovereign ratings are structurally different from corporate ratings in that analyst judgement plays a much greater role in sovereign rating decisions. Political risks and “willingness to pay”, which are critical to sovereign credit analysis, are more subjective than corporate rating methodologies. The more subjective nature of sovereign ratings has opened CRAs up to criticisms of potential bias.

First, ratings actions during the COVID-19 pandemic revived questions of potential biases against developing countries. Advanced economies received less than 5% of all downgrades (see figure)², while economic output of the advanced economies contracted at more than twice the pace of output contraction in emerging market and developing economies (-4.7% vs. -2.2%)³, while also experiencing a significantly greater increase in debt. While this discrepancy could be due to a range of factors, the perception of bias can undermine confidence in ratings’ quality and accuracy, underlining the importance of transparent methodologies.

Figure 1
SOVEREIGN RATINGS MOVEMENT OVER TIME, BY COUNTRY GROUPING

(index, 11 March 2020=0)



Source: DESA calculations, based on Moody’s Analytics

Note: This figure shows an index of rating actions by Moody’s analytics, with 0 on 11 March 2020, the date of declaration of the global pandemic by WHO. All sovereigns are weighted equally, each positive (negative) outlook is +1 (-1); a review for upgrade (downgrade) is +2 (-2); and a positive (negative) rating change is +3 (-3).

Second, ratings may also be linked to price volatility beyond what would be warranted by market fundamentals due to so-called cliff effects. When securities are downgraded from “investment grade” to “speculative grade” an issuer may face a wave of forced selling of its debt from investors that are not allowed to hold speculative grade debt.

Third, ratings can augment capital market volatility and procyclicality (with ratings rising in boom periods and falling during slowdowns), particularly during crises, such as the Asian and Mexican crises in the 1990s⁴, when countries need financing the most. A study that examined 27 African countries between 2007

and 2014 also found that there was an increased probability that Fitch and Moody’s upgraded ratings during boom periods and downgraded them during recessions.

CHALLENGE 2: ACCURATELY INCORPORATING INTERNATIONAL COOPERATION ON DEBT INTO RATINGS

International cooperation and debt relief programs, such as the DSSI, can help strengthen countries’ balance sheets and ability to repay debt in the medium term. Nonetheless, some developing countries have been deterred from joining these programs, despite elevated debt distress risks, due to the fear that participation in these programs would trigger rating downgrades. If the method of incorporating such programs into ratings discourages participation in a debt relief initiative, this can have a negative impact on a country’s long-term debt sustainability.

CHALLENGE 3: INCORPORATING LONG-TERM RISK FACTORS SUCH AS CLIMATE RISK

The current CRA “long-term” rating is meant to cover three to five years for non-investment-grade issuers and up to ten years for investment-grade issuers. In practice sovereign ratings use financial and economic forecasts up to three years, which may over-emphasize near-term economic business cycle expectations.

At the same time, the increasing frequency and magnitude of climate and other shocks has highlighted the impact of longer-term factors on a country’s debt sustainability. Amid an increased recognition of the physical and transition risks arising from climate change, CRAs are already integrating climate and other environmental, social and governance (ESG) risks into their ratings. According to Moody’s, 60% of its sovereign credit ratings of developing countries were negatively affected by ESG considerations in 2020⁵.

A country’s efforts to invest in the SDGs, including in resilience and climate adaptation, should conversely be viewed favorably in ratings. While financing these investments may increase public debt in the short term, in the long term, resilient and productive investment should stimulate growth, improve resilience, and strengthen countries’ ability to repay⁶. A longer-term outlook is needed to realize this and other positive long-term impacts in ratings.

AREAS OF ACTION AND POLICY SOLUTIONS

Solutions to these challenges include both voluntary actions and structural reforms. Below are four proposals for immediate action, followed by a reference to additional proposals for structural reforms. (See Table 1 for a summary of proposals.)

1. Enhance transparency and update ratings methodologies making use of technological innovation

First, CRAs should be encouraged to strengthen transparency. While the big three CRAs publish an overview of their methodologies on their websites, many aspects of the methodologies remain opaque, such as the underlying assumptions. Second, a clear distinction between the model-based and discretionary components of ratings can help investors better assess the quality and objectivity of ratings. CRAs could publish the model-based assessments and then superimpose a “qualitative overlay” of analytical judgment. Transparent publication of this process could help address concerns over biased ratings and increase confidence in ratings’ accuracy, while highlighting the value-added of different CRAs. Third, credit assessments should be less about predicting the future than about understanding how well countries respond to risks that are largely unknown, making use of technological innovation. CRAs should be encouraged to incorporate and publish scenario analyses and simulations on debt dynamics under different economic and non-economic assumptions, including climate transition pathways, as a core part of their methodologies.

2. Develop long-term ratings

Longer-term ratings, which could be published as a complement to existing assessments, would benefit long-term investors, issuers, and the global community. The use of scenarios for both economic and non-economic risks could make long-term assessments more manageable to produce. If well implemented, long-term sovereign credit ratings could: help investors more reliably gauge their risk exposure; lengthen investment horizons; support the issuance of longer-term bonds; and potentially counteract pro-cyclicality and short-term bias of financial markets. If CRA methodologies incorporate the positive effects of SDG investment, long-term ratings could also create incentives for such investment and help countries raise long-term capital for that purpose. Such ratings would also be better able to capture the positive effects of debt relief programmes, such as the DSSI.

3. Increase dialogue of CRAs with the public sector

Dialogue with the public sector could enable a deeper understanding of government policies, especially international official programs. These engagements would not be meant to influence rating decisions, but instead to close any informational gaps CRAs may have about the scope and terms of new initiatives or facilities, which would in turn improve the quality of ratings. This is particularly important when debt relief, debt suspension, or other debt sustainability initiatives, such as the DSSI and the Common Framework, are launched. In addition, the international community could support countries to quickly return to capital markets following a restructuring, working with CRAs. A standing framework for dialogue would also help level the playing field, as compared to current approaches, which can prioritise discussions with larger jurisdictions.

4. Move from a cliff-edge to a graduated approach

Regulators, standard setters, investors and CRAs need to work together to soften the cliff-edge dichotomy between investment-grade and below-investment-grade issuers. CRAs themselves do not promulgate the investment-grade cliff, which is an artifact of the regulatory approach since the 1930s. However, CRAs can more explicitly create overlapping tiers of ratings, providing a transitional time when a country’s debt will not necessarily fall out of investment mandates. From the investor side, mandates should be based on the average rating of a portfolio rather than on rating of individual instruments. In the case of a downgrade, this would allow investment managers to maintain a sufficiently high average credit quality without forced selling of specific assets. Regulators could also adopt a more dynamic approach to risk weighting to correspond to a more gradual and graduated categorization of credit ratings to allow a smoother adjustment.

STRUCTURAL PROPOSALS

There are also proposals for structural reforms, such as publicly owned, not-for-profit, or cooperative CRAs to encourage competition and avoid the conflict of interest faced by private CRAs. Public CRAs would, however, also face conflicts of interest, and an open question is whether markets would trust ratings by any new agencies. One option would be for new (or existing) public institutions to develop pure model-based sovereign ratings for all countries, enabling investors to use this as a benchmark to help better distinguish between model-based ratings and value-added judgement inherent in CRA ratings. Indeed, the International Monetary Fund (IMF) already publishes macroeconomic projections for countries. These are not intended as credit assessments, but markets do react to IMF pronouncements.

CONCLUSION

Fast-evolving changes in technology and the growth of global systemic risks are changing the informational ecosystem around sovereign debt, including for credit ratings. It is in the international community’s interest to ensure that CRAs continue to adapt to these changes in ways that strengthen the quality of ratings and encourage investment in developing countries and in sustainable development. While institutional reforms to CRAs would require political will and strong commitment from the international community, the 4 proposals outlined in this policy brief are ripe for action. However, these solutions may not spontaneously manifest. Long-term investors, such as pension funds and insurance companies, can encourage the development of long-term ratings. There may be a role for a private sector group, such as the Global Investors for Sustainable Development (GISD) Alliance, to collectively prompt such changes. International Organizations can also play a role if needed, such as in providing a benchmark to distinguish between model-based ratings and value-added judgement. But political leadership will also be needed to see changes through to conclusion.

APPENDIX: POLICY OPTIONS TABLE

Policy options <i>(including both voluntary and institutional actions)</i>	Benefits	Implementer	
		Market actors / International organizations	Governments / regulators / norm-setters
<p>Update ratings methodologies</p> <ul style="list-style-type: none"> ➢ Incorporate scenarios for economic and non-economic risks ➢ Better use of technology to improve model accuracy <p>Enhance ratings transparency</p> <ul style="list-style-type: none"> ➢ Publish model-based assessments, with a “qualitative overlay” 	<ul style="list-style-type: none"> • Ratings will better reflect a rapidly changing global environment and growing systemic risks • Addresses concerns over biases • Highlights the quality and value-added of each CRA’s qualitative evaluations 	<ul style="list-style-type: none"> • Voluntary actions by the CRAs • Investors could advocate for changes, e.g. insurance companies and pension funds advocate for long-term ratings 	<p><i>Additional measures could include:</i></p> <ul style="list-style-type: none"> • <i>Norm-setting bodies, e.g. (IOSCO), could include policies as standards for CRAs</i> • <i>regulators incorporate measures into national regulations</i>
<p>Issue long-term sovereign ratings</p> <ul style="list-style-type: none"> ➢ Develop ratings for long-term investment horizons, which incorporate sustainability into ratings; scenario analysis can make these more manageable to produce 	<ul style="list-style-type: none"> • Can reduce pro-cyclicality in ratings • Captures the positive effects of international support (such as DSSI) and long-term instruments (such as SCDI) • Encourages governments to invest in resilience and sustainability • Matches investment horizon of long-term investors 	<ul style="list-style-type: none"> • Alternatively, international organizations, such as the International Monetary Fund (IMF), could publish model assessments as a benchmark to compare CRA ratings 	
<p>Increase dialogue between the CRAs and the public sector</p>	<ul style="list-style-type: none"> • Improve understanding of international official programs, (e.g. DSSI) • Levels the playing field compared to bilateral discussions 	<ul style="list-style-type: none"> • Dialogues between CRAs and the public sector 	<ul style="list-style-type: none"> • Government and national regulators to engage in discussions with the CRAs
<p>Move from a cliff-edge to a graduated approach</p> <ul style="list-style-type: none"> ➢ Create overlapping ratings tiers ➢ Portfolio approach to investment mandates ➢ Adjust regulatory regimes (e.g. risk weighted asset regulations, temporal graduation) 	<ul style="list-style-type: none"> • Reduces the risk of sharp selloffs after a rating downgrade 	<ul style="list-style-type: none"> • CRAs explicitly create overlaps of rating tiers • Investors adjust investment guidelines 	<ul style="list-style-type: none"> • Norm-setting bodies adjust regulatory standards • Regulators introduce necessary changes to national regulatory frameworks
<p>Creation of new institutions</p> <ul style="list-style-type: none"> ➢ National or regional publicly owned CRAs ➢ Non-profit institutions ➢ Cooperative institutions 	<ul style="list-style-type: none"> • Encourages competition • Removes existing conflict of interest (but create new conflicts and would need to establish credibility with investors and governments) 	<ul style="list-style-type: none"> • Cooperative institutions would be a financial sector-led process 	<ul style="list-style-type: none"> • Public CRAs would be a government-led process

- 1 Kiff, et. al., 2012, op cit; Kaminsky, Graciela, and Sergio L.Schmukler, "Emerging market instability: do sovereign ratings affect country risk and stock returns?." The World Bank Economic Review 16.2 (2002): 171-195.
- 2 Griffith-Jones, S. and Kraemer, M. (2021)
- 3 International Monetary Fund (2021), "World Economic Outlook Database," available at <https://www.imf.org/en/Publications/WEO/weo-database/2021/April>
- 4 Ferri, G., Liu, L., Stiglitz, J. (1999), "The Procyclical Role of Rating Agencies: Evidence from the East Asian Crisis" Economic Notes, vol. 28 pp 335-355. Reisen, H. (2002), "Ratings Since the Asian Crisis" OECD Development Centre.
- 5 Marc Jones, "Climate and ESG risks hurting 60% of developing countries' ratings -Moody's", Reuters, 2021.
- 6 United Nations, Interagency Task Force on FFD, 2021 Financing for Sustainable Development Report