

# High Level Meeting on the Role of Credit Rating Agencies in the implementation of the 2030 Agenda for Sustainable Development

## Background Note

United Nations, New York, 21 March 2022

### Issues for discussion

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 have experienced downgrades of their sovereign credit ratings, higher borrowing costs and intensified risks of debt distress.

These dynamics have led to a renewed focus on the credit rating agencies (CRAs) that make sovereign ratings. CRAs also garnered attention following the 2008 global financial crisis, which resulted in significant regulatory reforms to reduce mechanistic reliance on ratings and address CRA conflicts of interest. Yet, despite years of effort, progress on some of the structural challenges related the oligopolistic market for credit assessment remains limited, due to both technical and political difficulties. Recently, 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 system of credit ratings with a forward-looking approach that reflects a changing world. The current crisis creates an opportunity to do so.

#### *Challenge 1: Incorporating both long-term risk factors such as climate risk, and the positive impact of long-term sustainable investment*

Amid an increased recognition of the physical and transition risks arising from climate change, CRAs are already integrating climate risk into their ratings. In 2019, 36% of Moody's rating adjustments of emerging market issuers were informed by sustainability, particularly climate, risks.<sup>1</sup> As sustainability indicators are further incorporated into sovereign ratings, this will likely lower the credit ratings of many developing countries, leading to an increase in the already high cost of financing. A country's efforts to invest in the SDGs, including in resilience and climate adaptation, should conversely be viewed favourably in ratings. While SDG investments may increase public debt in the short term, in the long term, they should stimulate growth, improve resilience, and strengthen countries' ability to repay. Yet, it is not clear how long-term credit ratings could incorporate long-term positive benefits of debt, nor whether market actors would be driven to change investment behaviour if there were long-term ratings that better incorporate environmental and social factors.

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<sup>1</sup> Moody's (2020), "ESG Credit Risks More Prevalent in Emerging Markets than in Developed Markets" available at [https://www.moodys.com/research/Moodys-ESG-credit-risks-more-prevalent-in-emerging-markets-than--PBC\\_1254421](https://www.moodys.com/research/Moodys-ESG-credit-risks-more-prevalent-in-emerging-markets-than--PBC_1254421)

### *Challenge 2: Accurately incorporating international cooperation on debt into ratings*

International cooperation and debt relief programs can help strengthen countries' balance sheets and ability to repay debt in the medium term. Despite initial indications from credit rating agencies that participation in these programmes was unlikely to have rating implications, some developing countries, including those with elevated debt distress risks, have been deterred from joining them due to the fear that participation would trigger rating downgrades. Five countries that did choose to participate (notably including Ethiopia and Pakistan) were placed on a negative watch list and/or subsequently downgraded by one major CRA, which cited the G20's call for private sector creditors to participate in the DSSI on comparable terms as a contributing factor.<sup>2</sup> The method of incorporating such programs into ratings can thus have a negative impact on a country's long-term debt sustainability – regardless of whether the country joins a debt suspension initiative or not.

### *Challenge 3: The impact of credit ratings on a country's cost of borrowing*

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. CRAs would be expected to impact market prices if they are transmitting useful information. However, if they transmit inaccurate information and/or exacerbate market reactions and procyclicality may require a public policy response. Since sovereign ratings often act as a country-level ceiling for corporate ratings, they affect not only the cost of public borrowing but also the cost of corporate borrowing and thus overall investment in the SDGs.

Ratings actions during the COVID-19 pandemic revived questions of potential biases in ratings against developing countries. While more research is needed to determine whether this discrepancy was due to bias or fundamental risks, the perception of bias can undermine confidence in ratings' quality and accuracy. Ratings may also be linked to price volatility beyond what would be warranted by market fundamentals due to so-called **cliff effects**. This is potentially acute for so-called ‘fallen angels’ that have been downgraded from the lowest “investment grade” rating to the highest sub-investment-grade rating (or “speculative grade”). These fallen angels issuer may face a wave of forced selling of their debt from investors that may not hold speculative grade debt, due to either unreformed regulatory rules or rigid investment mandates. 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 1990s,<sup>3</sup> when countries need financing the most.

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<sup>2</sup> FT (2020), “Moody's clashes with UN over G20 debt-relief efforts” available at <https://www.ft.com/content/7d51d373-c12e-4440-a408-e61a939e3a3c>

<sup>3</sup> 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.

