

Inter-agency Task Force on Financing for Development Expert Group Meeting on “Engaging Credit-Rating Agencies in the Implementation of the 2030 Agenda”

Wednesday, 27 October 2021
9:00 – 12:00 EDT, MS Teams

Background

On 27th October 2021, the United Nations Department of Economic and Social Affairs (UN DESA) hosted a virtual expert group meeting under the auspices of the Inter-agency Task Force on Financing for Development, on the topic of “Engaging credit rating agencies (CRAs) in the implementation of the 2030 Agenda.” The meeting was held in preparation for the Task Force’s response to a request by Member States for a substantive analysis on this topic to be included in the 2022 *Financing for Sustainable Development Report* (FSDR).

The meeting was attended by 48 participants, including representatives from 15 Task Force member agencies. These include the IMF, Financial Stability Board, World Bank, South Centre, UNCTAD, UN Regional Economic Commissions, and several UN agencies. Two background papers provided the backdrop to the discussion, which focused on the role of CRAs, challenges related to developing country sovereign ratings, and potential reforms that can enhance the contribution of ratings to sustainable development.

Summary

A key theme of the discussion was the role CRAs play in financial markets. Broad concerns related to the provision of financing to developing countries include: the volume, the cost, and the stability of the market, as well as spillovers from financial market instability to the real economy. Credit assessments, including both ratings from CRAs and other types of assessments, affect all three of these elements as market pricing reacts to new information.

CRAs play an important role in providing information to investors and to financial markets. Participants agreed that investors need access to accurate and timely information if markets are to function efficiently and price risk appropriately. There is an ecosystem of private and public institutions that provide information that informs market pricing, but there are also gaps in information and access to it, as well as contradictions, that may undermine market efficiency and stability. One participant suggested that to increase investment flows to developing countries, investors need more accurate information about real risks.

During the meeting, Task Force members agreed with the diagnosis of challenges, in particular: (1) potential for ratings to enhance procyclicality in markets, rather than dampening it; (2) potential cliff effects from ratings downgrades, especially for so-called “fallen angels” that move from investment-grade to sub-investment-grade ratings; (3) inherent conflicts of interest; and (4) the insufficient incorporation of long-term perspectives into ratings.

Some participants questioned the strength of the evidence of the impact of ratings on the market. A few participants highlighted the need to acknowledge that there have already

been extensive reforms to the regulation and role of CRAs since the 2008 financial crisis. Others argued that past reforms have not been sufficient.

There was also discussion over the merits and feasibility of different policy options to address CRA-related challenges. Several participants highlighted the need for CRAs to update ratings methodologies and to enhance transparency, including through separating model-based and judgment-based aspects of ratings. In this context, the extraordinary profitability of the big three CRAs was discussed, as well as the oligopolistic market structure which may slow CRA efforts to increase transparency and uptake new methodologies or technologies on their own accord. A few participants cautioned that oligopolistic markets should not be tolerated, while others focused on the need for practical ideas to improve transparency that can be implemented within the current regulatory system. While participants agreed that there is a need for increased disclosure, questions were raised over to what extent regulation of CRAs should be tightened further after more than a decade of increasing regulation. In efforts to address challenges related to CRAs, some participants noted the importance of combining public and private action in an effective way.

There was a general agreement that rating methodologies need to incorporate long-term factors, such as environmental and social risks and improvements. This could help reduce procyclicality and, if well implemented, capture the positive effects of international debt relief initiatives or investments in climate and environmental resilience. Several participants noted that the short-term focus of CRAs does not provide a suitable assessment framework for developing economies, which require longer time horizons given their stage of development. One participant suggested that long-term ratings from trusted sources, such as CRAs, might increase the flow of long-duration investment to developing countries from institutional investors with long-term liabilities, for example pension funds.

Participants also highlighted the potential negative impact on credit accessibility of incorporating climate risks in ratings for developing countries, especially given the high exposure to climate risk of least developed countries (LDCs) and small-island developing States (SIDS). While the incorporation of climate risks into ratings methodologies is already in progress, a few participants cautioned that the absence of clear definitions, metrics, and taxonomies makes this difficult in the short term. Meanwhile, some pointed out that the climate crisis requires more urgent action, and that CRAs may not move with the speed needed given the grave threats of climate change. This is also highly relevant for corporates as they increasingly weigh climate risks into their investment decisions. Another participant suggested that the methodologies being used to quantify natural capital might be usefully added into the CRA's work.

In exploring policy options to address the oligopolistic market structure, some participants proposed the creation of new institutions, such as an international public CRA and a super-regulator of CRAs. They argued that these new institutions could contribute to increased transparency, improved quality of ratings, and a fairer system. Cautions were raised that while these new institutions may address existing conflicts of interest, new forms of conflicts and governance challenges would arise and market actors would not immediately trust new institutions. It was noted that there are more than a hundred CRAs globally, but

the big three still retain 90% market share, reflecting the natural oligopolistic tendencies of a marketplace in which trust is highly valued. Another idea was to introduce a licensing regime for CRA professionals to improve the standards in the industry and develop a self-regulatory professional body to oversee the conduct of CRA analysts. It was unclear if promoting new market entrants into the credit rating industry would materially impact the long-term aim of boosting stable, sustainable financing for developing countries.

There was some discussion on managing the cliff effects from ratings downgrades. There was agreement that the cliff effects relate to the use of ratings, both by investors and by some regulators that still retain some mechanistic reliance on ratings in some rules. Some participants proposed a more graduated rating system, with overlapping ratings tiers and a wider use of portfolio approaches to risk management to prevent mass selloffs when issuers or instruments become fallen angels. Participants agreed that these effects were most worrisome in relation to passive investors and index providers.

At the conclusion of the meeting, Task Force members were informed that a public discussion on this topic may be organised in the near future under the auspices of the Financing for Development Initiative of the UN Secretary General, which could enable an exchange of views between international institutions, regulators, and market actors.