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Reforming the international financial architecture

The role of credit rating agencies in the ‘debt crisis’

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Abstract: Credit rating agencies (CRAs) have been widely identified as playing a critical role in the modern international financial architecture. The proliferation of private credit being used by the Global South countries has brought the CRAs to the forefront of policy deliberation at the highest levels. Who the CRAs are, how they operate, and why they have the impact they have are all important to understand. Once there is a better understanding of the role of these influential players, amendments to the international financial architecture can stand a better chance of producing sustainable results. There is currently an increased focus on the 'cost of capital' and the effect that cost has on development for Global South countries. This background note provides a foundational understanding of the role of credit rating agencies in affecting that cost of capital.

Key words: credit rating agencies, international financial architecture, debt, credit, development

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Introduction

The impact of credit rating agencies (CRAs) on development—particularly their influence on interest rates for sovereign bonds and therefore the debt-financing costs for Global South countries—is increasingly being identified as a critical issue on the development finance agenda. The UN Secretary General's continued engagement with the CRAs was noted in the **Pact for the Future**, whilst the South African President **referred to the role of CRAs when launching South Africa's Presidency of the G20** which comes on the back of Brazil **focusing on the role of CRAs in aiding greater lending from multilateral development banks** (MDBs).

All this focus is aimed at one particular issue—the cost of capital. As capital is required for developing nations to meet their developmental needs, the cost of acquiring that capital is all important. How that cost is calculated and implemented is increasingly becoming a critical debate for the global agenda.

Due to their role in determining the cost of capital, credit ratings from the leading international CRAs—S&P Global, Moody's, and Fitch—are intrinsically important to national development prospects. CRAs exist primarily to provide opinions on creditworthiness. With respect to sovereign debt, these opinions are designed to be used by private creditors, banks and institutional investors like asset managers, pension funds, and insurance companies. Creditors use ratings to better understand and price the risk associated with investments in the fixed-income assets ('Eurobonds') of a particular country. While these are assets to investors, they are also debts for the low- and middle-income countries. These debts issued in a foreign currency in global capital markets are used to finance government budgets.

Credit ratings are part of the process which ultimately determines the cost of capital that developing nations are eager to acquire. These ratings are constructed by ratings analysts who use quantitative and qualitative data and a publicly available methodology to determine their rating recommendations. Analysts present their suggestions to a private Rating Committee, which decides on the final credit rating. This process, when conducted by a private third-party, is intended to provide the theoretical level of impartiality that all parties require to *trust* in the credit rating system.

Many thought private capital could replace or supplement bilateral aid to improve implementation of national development plans. African Leaders were **told by the US Secretary of State as early as 2002** that establishing a credit rating was a 'ticket' to the benefits of the global economy. **At the behest of UNDP and USAID**, in separate initiatives, CRAs were encouraged to rate African countries for the first time and bring them into the capital markets. From an initial five with ratings before the intervention, there are now more than thirty African countries with ratings.

This led to a subsequent growth in African debt issuances. In the post-COVID era, the CRAs ratings, particularly for Africa's sovereign bonds, have generated complaint and concern. Accusations of '**bias**' against the CRAs, particularly in their ratings of African countries are prevalent and, more widely, analysts have identified an African '**risk premium**' .

Other concerns relate to the (lack of) transparency of the rating process, the adequacy and appropriateness of the 'time horizon' CRAs consider when producing ratings, and how CRAs themselves are regulated. One of the main reasons for this growing focus on ratings is the arrival of the '**credit rating impasse**'. The phrase is used to describe how today's debt treatment facilities—multilateral initiatives intended to support countries in debt distress—**failed to secure much**

participation from governments in debt distress, due to the threat that joining these programmes would lead to ratings downgrades. This impasse has blunted progress towards a solution to the emerging global debt crisis, putting the issues discussed here at the centre of the global agenda in 2025.

The mechanistic role of the credit rating agencies

CRAs are historically linked to the world of private credit. For over 180 years, the sector has provided opinions on creditworthiness to investors. First in relation to companies requiring financing (corporate bonds), then for countries requiring financing (sovereign bonds). In the late 1960s, the CRAs changed from an investor-pays model to a model whereby the issuer of the debt pays for the credit rating: the issuer-pays model. Despite this change, the investor **has always been the intended audience of the credit rating opinion**.

The CRAs have a critical and fundamental role in contemporary society. As the modern society is centred around debt at all levels—individual, company, or country-level—a mechanism is required to understand creditworthiness. In essence, the sprawling nature of modern society means that *trust* is a commodity in short supply. Credit ratings provide a systemic mechanism to improve trust and enable credit issuance.

A CRA contains certain characteristics that allow it to bridge a critical gap, which is known as '**informational asymmetry**'. These key characteristics need only be theoretically visible for the CRAs to maintain their authority to opine on creditworthiness. First, the CRA's must be prospectively independent in their methodological process for devising ratings. Second, the CRA must have enough reputational capital to have its rating, or its *signal* understood and recognized by various parties.

The CRA's authority has been severely tested throughout history, particularly during the Financial Crisis of 2007–8. In the late 1960s, CRAs began to test the limit of their authority by changing their remuneration system from investor-pays to issuer-pays. This was controversial because the whole ethos of a CRA is to provide on opinion on how likely the *creditor* is to be repaid. The sentiment here is that the CRA has always been a service *for* creditors. With the change in remuneration policy, the CRA was now being paid by the entity they had to rate, an obvious conflict of interest. Fast-forward to the 2000s and **US Congressional investigations** would confirm that CRAs were actively participating in financial schemes alongside issuers (debtors) against investors (creditors). In 2015 and 2018, the two largest CRAs would settle with the US Department of Justice for record amounts, totalling more than USD 2 billion. Since then, the CRAs have **recorded record profits and revenues year after year**. The reason for this is because their utility for the financial system is not particularly in their rating content, but in the ***signalling power*** of their ratings.

To understand this concept better, one must analyse the different actors in the system of debt. Looking particularly at sovereign debt for a moment, sovereign debt was historically dominated by official creditors—countries and multilateral lenders—who did not rely on the ratings of a CRA in their decision-making process. Up until the 2000s, sovereign debt was primarily the concern of the official creditor.

This changed when high-income countries like the US started to **actively encourage low-income countries (and especially African countries) to offer debt products on private capital markets**.

This was done for a variety of reasons, but many of these countries had just been through multiple stages of debt treatment and, as a result, had plenty of capacity to borrow on their governmental balance sheets. While official creditors were not concerned with credit ratings, the private capital markets were This is because participants in these markets are institutional investors. These are institutions that bring together asset holders to pool their wealth to invest it more efficiently.

Today, institutional investors are the primary form of investment. Their composition reveals key understandings. The institutional investor is defined by the **principal/agent relationship**, whereby the principal (asset owner) collectively hires the agent to perform on their behalf. Quite often, the agent will have technical skillsets and capabilities that the principal may not necessarily have. This puts the principal at a potential disadvantage, rectified by a set of mechanisms designed to protect the principal. These include legal protections, both fiduciary duties which constrain agents and consumer protection laws. Another protection is the credit rating agencies.

Because this relationship between principal and agent has its own ‘informational asymmetry’ to resolve—how does the principal know the agent will invest in the right type of asset according to the principal’s risk averseness? How does the agent communicate their actions to a diverse group of principals? —there is a need for a signalling mechanism, the rating. Ratings offer an easy-to-understand ranking system (rating scale) that is theoretically independent, that has a long history (and therefore reputational capital), which a diverse principal base can all work with. This mechanism is therefore critical to institutional investors, and, without the institutional investor, the modern finance is not possible. That is the level of importance of the CRA, a systemic **gatekeeper**.

In the world of sovereign debt, this underlying foundation reveals itself in the everyday decisions being taken. **The largest holder of developing world debt is now the private creditor**. The largest type of private creditor within that group is the **non-bank institutional investor**—pension funds, asset managers, and insurance agencies, those constrained by the principal/agent relationship. Institutional investors, when investing in sovereign debt markets that are not very well established and contain periods of default in recent history, require the CRAs’ credit ratings to participate in the investment because of the perceived risk to the principals. The signalling power of a credit rating is therefore critical to this market.

The recent focus of the global agenda is now on whether those signals are appropriate, whether they need to be formulated differently, or whether they are needed at all. This is because those signals play such a large part in determining the cost of capital for sovereign borrowers. While CRAs are **not the only determinant in the process of pricing risk**, they are mechanistically critical.

The impact of CRAs on the debt crisis

The integral role of CRAs is at the fore because of the ‘Debt Crisis’ engulfing the developing world. Many low-income and vulnerable countries cleared their balance sheets after global efforts like the ‘**Heavily-Indebted Poor Countries**’ (HIPC) debt treatment initiative launched by the World Bank and IMF in 1996 and the associated ‘**Multilateral Debt Relief Initiative**’ (MDRI) launched in 2005. This effectively cancelled all ‘official debt’ advanced by multilateral institutions (like the IMF or the World Bank) and bilateral partners (like other countries). In parallel, the same countries were **encouraged** to participate in the capital markets. Finally, there was an **investor class chasing yield in traditionally riskier markets due to the depressed market environment in the post-Financial Crisis era**.

That amalgamation of factors took place before the onset of the COVID-19 pandemic. As the pandemic unfolded, the CRAs took immediate action. **In 2020 alone, 51 countries, including 44 emerging economies, experienced a ratings downgrade**. In Africa alone, **21 countries were downgraded in 2020**. The pandemic was the main driver for the ratings downgrades, but the impact was felt across the credit profile of the sovereigns in question. Across the board, there was deterioration in economic fundamentals, including a decline in GDP, an increase in budget deficits and rising public debt pressure, a reduction in fiscal consolidation, and depreciating currencies.

To inject some breathing room, the G20 launched the '**Debt Service Suspension Initiative**' (DSSI) in May 2020. The purpose of the DSSI was a simple one: provide a framework for indebted countries to suspend servicing their debts for temporary periods, to provide for flexibility and the retention of financing to better combat the impacts of the pandemic. Critically, the G20 only *encouraged* private creditors to participate, based on 'comparable treatment', meaning whatever was agreed between the debtor and official creditors should also be agreed between the debtor and private creditors. Because of the lack of insistence, only one private creditor participated. It was widely understood that the fiscal space created by the DSSI was not enough to slow the economic deterioration felt across the developing world. Also, debt service repayments were not cancelled but only suspended, meaning payment would come due eventually.

Recognizing the need, the G20 launched the '**Common Framework for Debt Treatment beyond the DSSI**' (Common Framework). The objective of the Common Framework was to restructure entire debt piles, rather than suspend payments. To enable this and to appease official creditors, who complained of being the only class of creditor shouldering the responsibility, the G20, this time, insisted on comparable treatment between creditors. The result was immediate.

Private creditors voiced serious concerns, saying that **comparable treatment should be voluntary to respect fiduciary duties and other legal and contractual constraints**. CRAs made clear that *any attempt* to restructure an agreed-upon contract between a debtor and private creditor would be taken as a **signal that a default on original terms was imminent**. Under those conditions, the CRAs argued, they would be forced to downgrade a country to 'default'. Unsurprisingly, various countries made public statements, confirming for the markets, that they had **no intention of applying to the Common Framework**, despite the obvious need. To date, only four countries have applied to the Common Framework—three of whom were in default at the time of application, and the other who is unrated. This, in a nutshell, is the ***credit rating impasse***.

The global public debt situation before the onset of the COVID-19 Pandemic was approaching being unsustainable—**more than thirty African countries were allocating more funds to debt servicing than to health care**. Post-Pandemic, the situation continues to worsen. Today, a **record** 54 developing countries spend more than 10% of their revenues on debt servicing. **3.3 billion people live in countries that spend more on interest payments than on education or health**. This unsustainable situation has led to calls for reform to the debt architecture, with CRAs receiving a substantial amount of that attention.

Calls for change

Despite the identification of credit ratings as being a constituent part of the challenge, very little reform has taken place. Yet, there has been a plethora of suggestions on the subject. Reform proposals range from large-scale architectural reform to incremental field-specific reforms. The main types of proposals can be grouped into those focusing on transparency, regulation, alternative models, and capacity building.

Transparency

Two UN DESA reports tackle this issue specifically. The first, authored by Stephanie Griffith-Jones and Moritz Kraemer, former Head of Sovereign Ratings for S&P Global, propose that CRAs should be **compelled to publicly separate the quantitative and qualitative elements of their rating actions**. The authors argue that this would help clarify where the subjectivity lies in the rating and would, therefore, allow users to better see how the rating was constructed. A follow-up UN DESA report continued this proposal, adding that **CRAs should also be compelled to release scenario analyses and simulations of debt dynamics under various economic and non-economic assumptions**. UN DESA concluded that this would help to understand how climate transition pathways are factored into ratings, leading to a sharpening of direction for such investments.

A report by the UN University's Centre for Policy Research instead argued that CRAs **ought to publicly declare which specific public information they are utilizing for each and every sovereign rating**. Currently, CRAs merely refer to which types of public data may be useful. The paper argues that declaring which sources are used each time would help sovereign debtors better understand their data disclosure requirements.

Regulation

How CRAs are regulated and supervised is an obvious consideration. Before the mid-2000s, the CRAs were effectively unregulated. This changed in the aftermath of the Financial Crisis, with both the **US** and the **EU** enacting sweeping regulatory frameworks which today dominate the regulatory landscape for CRAs. Yet, this has not stopped proposals calling for further regulation. The first UN DESA report calls for a global '**super-regulator**', which would contain global representation and complement national regulators. It is suggested that the proposed super-regulator could compel increased levels of disclosure, focus on standardizing the training of analysts, and produce comparability reports for the global market.

Leading civil society groups have echoed this request and **suggest that the UN would be the natural home of such a regulator**. It has been noted however that political influence would likely be a factor with this request, meaning that the US and the EU would be unlikely to want to cede the power and influence they currently hold over the influential credit rating sector.

Alternative models

Another proposal focuses on representation. The UNU-CPR paper identifies that while the '**starting pistol**' for global regulation—the International Organisation of Securities Commissions (IOSCO)—has a **dedicated committee for credit rating regulatory proposals and standard-setting**, not one seat is held by an African representative, and very few are held by Global South representatives. The paper **calls for this to be immediately rectified**, with the suggestion that South Africa—the only jurisdiction in Africa to host any of the Big Three CRAs and the incumbent President of the G20—would be an ideal addition to the IOSCO Committee on Credit Ratings.

Whilst the model of providing credit ratings has been untouched for nearly 125 years since **John Moody launched his first agency**, new developments suggest that public credit rating agencies could be an alternative. Currently, in the African Union, plans are in place for the development of an African public credit rating agency called **AfCRA**. AfCRA is due to launch in the middle of 2025 and attempts to bring together African expertise to provide an alternative view on ratings for African countries. This is not the first attempt to set up a public CRA, as it follows unsuccessful attempts by the **BRICS nations**, and **entities within the EU** who decided after **review** that the proposed costs could not be justified.

Seemingly, the lack of that theoretical impartiality and independence was ultimately prohibitive. Yet, that has not stopped calls for a global public CRA. Schroeder **details extensively** what a 'multilateral credit rating agency' would look like. The collective 'Civil Society Financing for Development Mechanism' adds to this by calling for a Commission to be formed under the UN Economic and Social Council (ECOSOC) to **formally investigate whether a UN-backed public credit rating agency would be feasible**.

Capacity building

At the opposite end of the spectrum, there is a focus on building capacity to better navigate the current credit rating process. On the African continent, the **Africa Peer Review Mechanism** has been mandated for several years to provide credit rating support to member states. This takes the form of training, advocacy on member states' behalf, and **bringing together national regulators**. More recently, UNDP launched its **Credit Ratings Initiative** which contains an informative web portal, a 'Concilium' of former ratings analysts who are deployed to partner countries to provide support, and a Community of Practice containing information, workshops, and multimedia interventions.

Capacity building has been identified as a potential '**gamechanger**' because of the relative inexperience of Global South countries in the international capital markets. On that basis, it has been suggested that a **global capacity builder** in the field of credit ratings could be an option, **likely under the auspices of the United Nations**. UNCTAD has called for a UN entity to be developed to provide capacity support for unrated countries, to enable them to get rated in a more sustainable manner.

Targets

With respect to the global agenda on CRA-related issues, there is one guiding path in trying to reduce the 'cost of capital,' best encapsulated by the G20's plan to establish a **Cost of Capital Commission**. This Commission aims to review the issues impacting the cost of capital for developing countries. At the heart of this initiative is the concept of fairness. Not every country can be AAA-rated, but every country should be rated *fairly*.

Given the **importance of this system to the lives of billions of people throughout the developing world**, asking for and obtaining this standard of fairness ought to be a central goal of the global agenda.