UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

Policy review

Credit rating agencies, developing countries and bias

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Abstract

This policy review explores the significant differences in the distribution of sovereign credit ratings between developed and developing countries and seeks to determine whether they are merely a reflection of higher probabilities of default, or whether they reflect biases against developing countries.

It finds that subjective indicators, judgements, and sentiment play an important role in determining the rating opinions of rating agencies, and that this creates significant scope for bias. Several studies have identified various types of ratings bias that have historically tended to work against the interests of developing countries. However, systemic and consistent ratings bias can be hard to prove and may be overshadowed by other forms of bias that are innate to the current global financial architecture. Variances in the yield spreads between developed and developing countries with the same credit ratings indicate that participants in global capital markets take account of much more than ratings. Ratings also assume less importance when countries adopt high quality, and transparent data and debt management systems and establish accountable and effective institutions.

The review concludes that focusing policy efforts on addressing perceived ratings biases may not be the most constructive way forward and explores alternative policy approaches, including the potential for a United Nations technical assistance process focused on developing countries that do not currently have sovereign ratings.

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Summary

1. Following a meeting of its Borrowers Club in February 2024, the United Nations Conference on Trade and Development (UNCTAD) was requested to investigate whether the sovereign credit rating processes adopted by the major global rating agencies, and the ratings that they give rise to, are biased against developing countries. If so, what is the impact of that bias on their costs of funding and ability to pursue their development agendas and what is an appropriate response?

2. A sovereign credit rating is an opinion issued by a rating agency that reflects its perception of the probability that the rated country will be able to fully, and timeously service their debts. To inform this opinion, rating agencies adopt methodologies and scorecards that incorporate both objective and subjective indicators, judgements, and sentiment. The role played by subjective assessment in the opinions of rating agencies means that scope for bias exists.

3. Bias represents a systematic and consistent divergence from what is implied by countries' critical economic and institutional fundamentals. Numerous studies have found that the ratings process has historically tended to favour developed countries over developing ones, and that this bias took various forms, including: home bias, bias designed to preserve the market power of the commercial rating agencies, bias arising from differences in how indicators used in rating scorecards are applied and interpreted, and bias arising from differences in the marginal impacts on ratings that changes in indicators give rise to.

4. However, like other forms of implicit or institutionalised prejudices, this bias can be difficult to prove and cannot automatically be assumed to consistently and systematically work against the interest of developing countries. There may be nuances and complexities that make generalised assessments of whether a systemic ratings bias exists largely unhelpful – especially if it is overshadowed by other biases that are innate to the current global financial system. In addition, since the way credit rating agencies decide on sovereign ratings and the regulatory environment under which they operate has changed over time, it is unclear whether past forms of bias identified in these studies persist, and to what extent.

5. Our examination of the relationship between sovereign ratings and market yield spreads (the difference between the prevailing return on a rated country's issued bonds and a comparative financial instrument such as United States Treasury Bills) suggests that capital markets take account of much more than credit ratings, and that the impact of these other considerations on bond pricing and borrowing costs tend to be more material than both the level of, and changes in, sovereign ratings.

6. The analysis also finds that market movements sometimes lead and sometimes follow ratings decisions and that reliance on ratings is reduced where the rated country acts to reduce prevailing information asymmetries by collecting and sharing high quality and relevant socio-economic data; by managing their sovereign debt in an effective and transparent manner; and by developing effective and independent institutions that ensure predictability and stability.

7. Comparisons of the yield spreads on 10-year government bonds of developing countries relative to similar US government bonds show that there can be significant differences in the pricing of sovereign bonds on financial markets, even when they have the same credit ratings and are from the same region. On average, markets also price the yields of developing countries higher than those of developed countries with the same credit rating.

8. This undermines the thesis of a consistent and systemic rating bias and indicates that financial markets tend to price the risks associated with countries' debt instruments independently – even when rating agencies assess their risks of default to be similar. It also suggests that other forms of bias that are innate to the current global financial architecture are at play.

9. Acquiring a credit rating is usually a prerequisite for a debt issuer to participate fully in global capital markets. As fund rules and other regulations often preclude portfolio managers and other investors from investing in debt instruments that do not have an investment grade rating, countries require a rating of BBB- or higher to access international capital at lower rates. In mid-2024, 68 developing countries had sub-investment grade ratings and therefore only had limited and/or relatively expensive access to global capital markets. By contrast, only 24 developing economies had investment grade ratings.

10. The high importance placed on reserve levels in developing countries by rating agencies may result in overinvestment in these low-yielding assets and negatively impact future economic growth prospects, creating a vicious cycle. By contrast, almost no importance is attached to reserve levels in developed countries.

11. More than two-thirds of developing countries have experienced a deterioration in their external and their public sector debt sustainability since 2017 due to successive global crises and higher borrowing costs. However, rather than seeking to restructure their debt, many debt-distressed countries are choosing to prioritise debt servicing over their development and climate agendas. This choice is driven in part by the inefficiencies and shortcomings of the available restructuring processes, but also out of fear of being downgraded by credit rating agencies who perceive requests to renegotiate a debt instrument with a private creditor as a clear indication that the country is in financial difficulty and headed towards full-blown default. This gives rise to a so-called "credit ratings impasse".

12. Proposals for credit rating agency reform by various entities and jurisdictions have included the unimplemented provisions of the Dodd-Frank Act (post the Global Financial crisis), as well as those that seek to change the treatment of credit rating agencies and shift the focus of ratings to longer term economic sustainability. Some proposals aim at improving ratings methodologies which may increase the acceptance and use of ratings and others can be interpreted as reducing market and public reliance on ratings – such as measures to improve data transparency.

13. Focusing policy efforts on addressing perceived biases, may not be the most constructive way forward. There are three main reasons for this:

- **i.** Firstly, financial markets consider much more than ratings when making pricing and investment decisions, so there is no guarantee that a narrow focus on addressing rating bias will result in lower borrowing costs and better access to global capital markets for developing countries. On average, developing countries paid around 200 basis points more for their internationally sourced capital than developed countries between the start of 2012 and May 2023. In some regions – such as Africa – the differential was significantly higher.

- **ii.** Secondly, given the nature of prediction, and subjective indicators, judgement and sentiment embodied in the ratings process, it is unlikely that ratings will always and everywhere correctly, consistently and objectively anticipate crises and default risks.
- **iii.** Thirdly, close to 50 developing countries[1] do not currently have a sovereign credit rating and are thereby excluded from material participation in global capital markets. Proposals to address any ratings bias will not automatically address this exclusion.

14. UNCTAD proposes several initiatives designed to improve the sovereign ratings process and limit negative impacts on developing countries, including:

- **i.** Giving priority to developing a more effective global financial safety net as a key element of fundamental reform of the global financial and debt architecture that can provide quick and automatic access to liquidity at relatively low cost. This would help to reduce the over-reliance of developing countries on high reserve levels.
- **ii.** Provision of expanded technical assistance (including indicative credit ratings and assistance aimed at establishing and improving data and debt management systems) targeted at developing countries that do not currently have sovereign ratings to enhance their access to financial markets in an incremental, and developmentally supportive manner. The idea here is that ratings may assume less importance in the presence of transparent and trusted alternative sources of data. Once operational, consideration could be given to extending this assistance to rated developing countries in debt distress, with a view to accelerating their recoveries.
- **iii.** Adoption of regulatory changes that serve to reduce the importance of sovereign ratings in investment decisions by emphasizing that they are opinions.
- **iv.** Developing a supportive rating approach for countries that choose to engage in debt restructuring, including under the G20 Common Framework, so that the “credit rating impasse” does not discourage debt distressed countries from restructuring their debt using the Common Framework or similar approaches.

15. Implementing these initiatives will require contributions from multilateral financial institutions, national regulators, commercial rating agencies and developing countries themselves. It also requires:

- The establishment of a UN-convened expert group to provide guidance and indicative sovereign credit ratings within a technical assistance programme at the request of the currently unrated developing countries. This would enable participating member states to identify and progressively develop the institutions, data and debt management systems and financial sustainability necessary to access domestic and global capital markets more formally in the future. This technical assistance could be run in conjunction with existing UN technical support programmes such as the Debt Management and Financial Analysis System (DMFAS) that currently serves more than 70 different debt management offices in national and provincial treasuries and central banks in 60 developing countries.
- Development of a new rating approach that is supportive instead of punitive for countries that choose to engage in the restructuring of their debt with private creditors, including through the Common Framework or any alternative debt restructuring process.

[1] Note this number varies over time.

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1. Introduction

The three dominant[2] global credit rating agencies – Moody's, S&P and Fitch - are private, profit-maximising entities whose authority in financial markets has increased over time due to shifts in global financial markets. This has seen borrowers eschew traditional, and more expensive, bank funding in favour of direct access to capital markets through the issue of bonds and other debt obligations.

The rating agencies claim that their primary role is to offer an opinion about the future probability of sovereign countries, state-owned enterprises and private corporations making full and timely repayment of the bonds, notes, commercial papers, and any other debt obligations they issue. However, the fact that they operate according to an issuer-pays model and provide a range of ancillary services such as environmental, social and governance (ESG) ratings, data and analytics, research and technology solutions, compliance and third-party risk, portfolio management, as well as underwriting, has given rise to claims of conflicts of interest.

Two diverging views of the role of credit rating agencies have emerged. The first centres on a "reputational capital" role that is linked to rating agencies' ability to generate and aggregate credible information about debt issues and to use this to bridge the information gap between debt issuers and investors - in a similar way to restaurant or movie reviewers. Marandola and Sinclair (2017) liken their primary role to the rating of restaurants in something like the Michelin Guide.

The second – referred to as the "regulatory license" role – derives from the increasing, and market distorting, reliance on credit ratings in substantive legal rules. According to this view, the importance of credit ratings is not due to their provision of valuable information. Rather, it arises because "regulatory reliance on credit ratings, and the associated sticky norms that have arisen, effectively convert ratings into a kind of financial 'license' that unlocks access to the markets, even if the ratings themselves have little or no informational value, specifically with regard to their ability to accurately and reliably assess the likelihood of a default of an issuer and the potential financial loss suffered in the event of a default." (Bruce, Cash, Darbellay et al, 2023).

In the case of countries, rating agencies use sovereign credit ratings that are based on a 21-level ordinal ranking scale that stretches from investment grade (AAA/Aaa to BBB-/Baa3) to speculative grade (BB+/Ba1 to C/D)[3] to signal this opinion to the various participants in financial markets.

The pro-cyclical nature of ratings referred to by Griffiths-Jones and Kraemer (2021) and others increases the risk of negative feedback effects: exogenous shocks often result in reduced ratings which, in turn, limit the ability of developing countries to deal with the shock's impacts. These negative feedback effects have been in evidence in the aftermath of the COVID-19 pandemic and subsequent crises, during which 37 developing countries[4] have received credit rating downgrades. As a result, there has been a notable increase in countries holding the lowest credit ratings – particularly in Africa and Latin America and the Caribbean.

2 Recent estimates suggest that they collectively account for between 90 and 95 per cent of global sovereign ratings. There are also a number of smaller rating agencies. In relation to Africa, the UNDP (2023) identifies 7 agencies that are based on the continent and that provide sovereign and corporate ratings.

3 This rating scale and its interpretation are included in the Annexure section at the end of this document.

4 21 of these countries are in Sub-Saharan Africa where only 26 of 48 countries are rated.

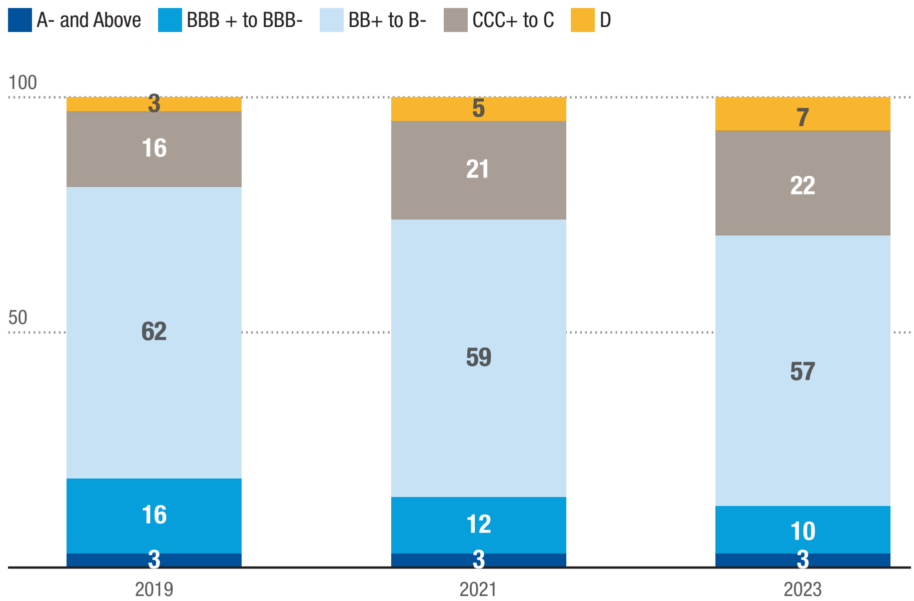
These rating shifts have the potential to negatively impact both public and private borrowing costs, debt restructuring efforts and investments – including those directed towards the attainment of Sustainable Development Goals (SDGs) and climate mitigation and adaptation initiatives.

Figure 1 reflects shifts in the ratings composition of countries in these regions between the end of 2019 and the end of 2023. In 2019, out of 58 countries with ratings, 11 had "investment grade" ratings, 36 had B grade ratings below investment grade and the remaining 11 had C and D grade ratings. At the end of 2021, the proportion of these countries with "sub-investment grade" ratings had increased from 81 per cent to 85 per cent, and by the end of 2023 it had risen further to 87 per cent.

Figure 1
Trends in sovereign credit ratings

The distribution of Latin American and Caribbean and African ratings* before, during and after the COVID-19 pandemic

Percent of total sovereign ratings



Source: Refinitiv

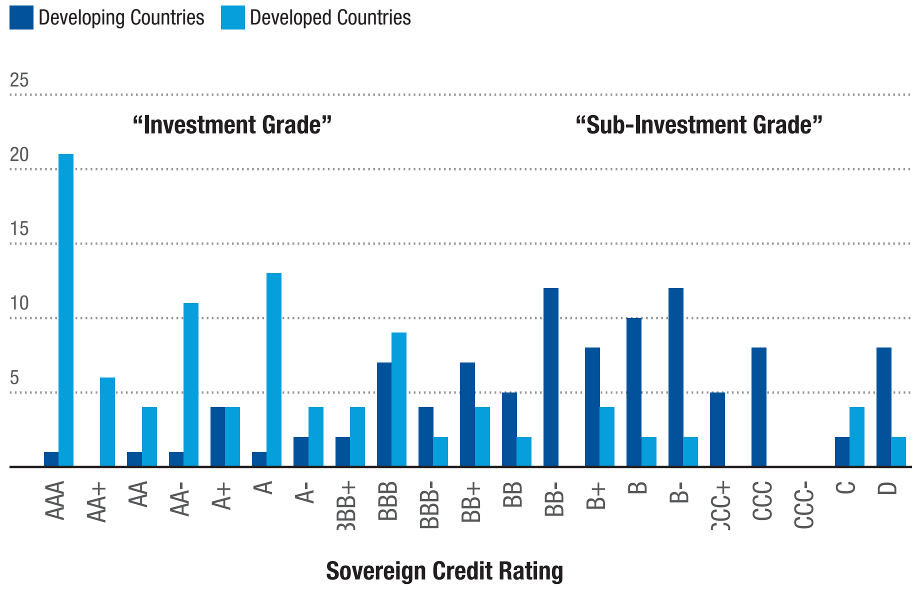
* While the rating scale shown reflects that used by S&P and Fitch, the analysis incorporates the equivalent ratings by Moody's

By the end of 2023, a much lower proportion of all developing countries had "investment grade" ratings, when contrasted with the ratings of developed countries – as indicated in Figure 2. At this stage 79 per cent of developed countries and 24 per cent of developing countries had "investment grade" ratings, while the shares with C and D grade ratings were 4 per cent and 15 per cent respectively.

Figure 2

Investment grade ratings favour developed countries

Distribution of sovereign credits ratings* among developed and developing countries
Percent of group sovereign ratings at the end of 2023



Source: Refinitiv

* Reflects the arithmetic average of ratings by S&P, Moody's & Fitch

The significant differences in the distribution of ratings indicated in Figure 2 raises the question of whether they are merely a reflection of higher probabilities of default, or whether they also reflect biases in favour of developed countries and/or against developing ones that increase the likelihood of the latter defaulting. This is the issue that this paper seeks to explore.

Box 1
Perennial concerns within UNCTAD over the governance of credit rating agencies and levels of competition

Concerns over the role played by credit rating agencies and how these should be addressed are not new and have evolved over time.

In a discussion paper prepared for UNCTAD, Elkhoury (2008) raised concerns about the stickiness of ratings and the fact that they tended to lag markets and overreact in their responses. This was in the wake of the Enron, WorldCom and Parmalat bankruptcies but prior to the 2008 global financial crisis. The levels of concentration within the credit ratings industry and lack of transparency in the rating methodologies applied were also raised as concerns – particularly within the context of an anticipated boost to the industry from the implementation of the Basel II recommendations on the capital adequacy of internationally active banks. The paper tentatively concluded that promoting competition within the industry and ensuring that rating agencies complied with the IOSCO Code might require policy actions and regulatory changes at the national level.

The Trade and Development Report (TDR) 2015 drew attention to the procyclical nature of rating assessments and the threat that their widespread use posed to financial stability. It found that "sovereign ratings are based much more on subjective assessments and prejudices (for instance, that government intervention reduces growth and efficiency) than on the 'fundamental' variables related to debt sustainability" but cautioned that alternative approaches to credit assessment "might reproduce the same flaws" as prevailing rating models (UNCTAD, 2015, p. 106). It recommended public oversight of rating agencies and their progressive substitution by more appropriate (but unspecified) mechanisms for risk assessment.

In the 2020 Trade and Development Report, UNCTAD once again identified the procyclicality of ratings assessments as a problem that "accentuates broader financial sector vulnerabilities". It found it inappropriate for rating agencies to simultaneously be "arbiters of responsible financial behaviour" and players in the same market they *de facto* regulate and interpreted the 2015 suggestion of a migration to more appropriate risk assessment mechanisms as a need for a different kind of credit rating agency, or for existing rating agencies to play a different role (UNCTAD, 2020, p. 131). In the Overview it noted: "Given the wide reach of private credit rating agencies and their decisive role in either facilitating or hampering progress on debt moratoria and relief, the time has come to proactively engage with the establishment of a publicly controlled credit rating agency." (UNCTAD, 2020, p. X)

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2. The impact of rating changes on sovereign borrowing costs

As a precursor to any discussion of whether there are biases either against, or for, developing countries in the sovereign rating process, it is worth examining whether such ratings matter. Do market participants base pricing, sales and purchase decisions on prevailing ratings, or changes in them? Or do sovereign credit ratings tend to follow financial markets rather than lead them?

While the various ratings cover a spectrum from AAA to C/D, the most significant distinctions are currently between those regarded as "investment grade" and those classed as "speculative" or "sub-investment grade". Placement in these groups may have a material impact on market behaviour and sovereign debt costs and may create "cliff effects" when countries move between one rating group and another. Countries that attain investment grade status typically have borrowing costs that are around a third lower[5] than those with a speculative rating.

In this context, it is interesting to contrast the experience of South Africa – a developing country that held an "investment grade" rating for an extended period and was then downgraded to "sub-investment grade" - with Zambia, which has consistently been rated "sub-investment grade", but which was one of the first countries to apply to restructure its sovereign external debt under the G20 Common Framework for Debt Treatment beyond the Debt Service Suspension Initiative (Common Framework).

Figure 3 contrasts the average yield spread[6] of, and the variance within, each sovereign rating for South Africa and Zambia. The variances within ratings were generally more significant than those relating to changes in ratings. For example, while it continued to be rated as A-, South Africa's yield spreads varied by 739 basis points, but when it was downgraded to BBB+, its average yield spread only increased by 25 basis points. There is little evidence of a "cliff effect" when South Africa was downgraded from "investment grade" to "sub-investment grade". Its average yield spread increased by 120 basis points (40 per cent) while it was rated BB+, which is close to the average measured by Jaramillo and Tejada (2011) for countries moving between investment and sub-investment grade. However, the average yield spreads in the month before the downgrade and the month following it only increased by just over 1 per cent, and much of the subsequent time at BB+ occurred during COVID.

Spreads in both countries were sensitive to global crises - such as the 2008 global financial crisis (when yield spreads jumped 725 basis points in South Africa) and the 2020 COVID-19 pandemic (when they increased by over 400 basis points in South Africa, and by almost 2'800 basis points - or 169 per cent - in Zambia).

After Zambia applied for debt restructuring under the Common Framework, its yield spread initially halved to around 1'800 basis points, but then rose sharply from May 2022 onwards, to peak at over 7'400 basis points as negotiations bogged down. An agreement reached with bond holders in late March 2024 saw spreads decrease to around 2'100 basis points.

While there is a correlation between ratings and yield spreads, capital market assessments of the risk of default in developing markets take account of other information sources, and do not rely exclusively – or even predominantly – on ratings. Market reliance on ratings appears to increase when the quantity of other data is limited and/or its veracity is questionable.

5 Jaramillo and Tejada (2011) proved that countries that attained investment grade status had borrowing costs that were, on average, thirty-six per cent lower, and that there was a further five to ten per cent reduction in bond spreads following a rating upgrade within investment grade. At the same time, they found that there was no impact on spreads for upgrades within the speculative grades – a conclusion also reached by Ismailescu and Kazemi (2010) in their analysis.

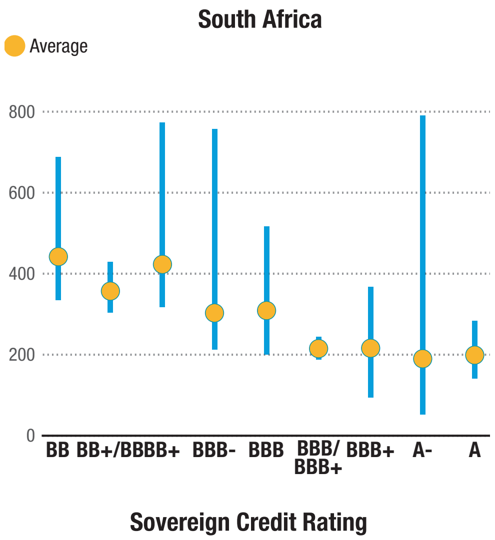
6 The difference between the prevailing return rates (market yields) paid on government bonds and those offered by United States Treasury bills.

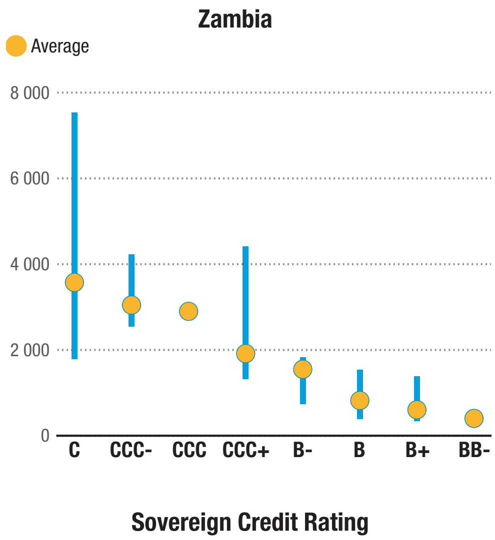
There is little evidence of a consistent, predictive relationship between the behaviour of financial markets and prevailing sovereign credit ratings in these countries, with markets sometimes appearing to lead, and on other occasions, to follow.

Figure 3

Contrasting country experiences

Range and average yield spreads for different ratings and variances within ratings for South Africa and Zambia
Basis points





South Africa's Sovereign Credit Rating*	Variance Within Rating (Basis Points)	Variance Between Ratings (Basis Points)
BB	352	85
BB+/BB	124	-67
BB+	456	120
BBB-	546	-6
BBB	316	94
BBB/BBB+	56	0
BBB+	274	25
A-	739	-8
A	143	

Zambia's Sovereign Credit Rating*	Variance Within Rating (Basis Points)	Variance Between Ratings (Basis Points)
C	5'748	527
CCC-	1'681	147
CCC	0	984
CCC+	3'097	367
B-	1'085	728
B	1'147	216
B+	1'041	202
BB-	283	

Source: Refinitiv

* While the rating scale shown reflects that used by S&P and Fitch, the analysis incorporates the equivalent ratings by Moody's

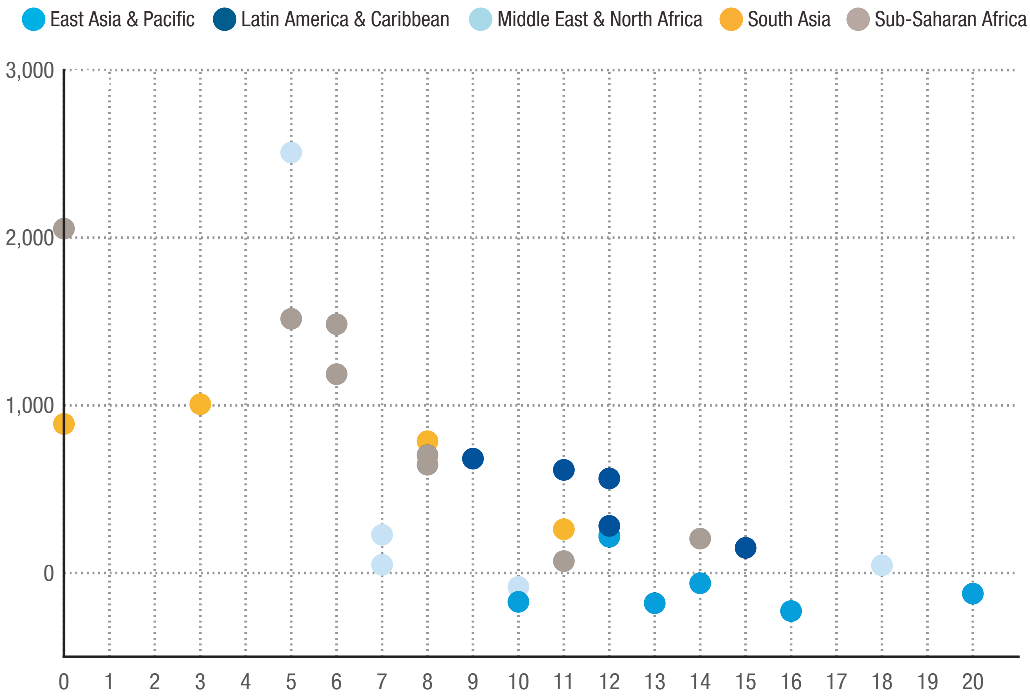
Figure 4 provides a static analysis as at the middle of April 2024 of the yield spreads on 10-year government bonds of developing countries relative to similar US government bonds - by credit rating. It indicates that there can be significant differences in the pricing of sovereign bonds on financial markets, even when they have the same credit ratings and are from the same region. It also indicates that in the East Asia and Pacific region the prevailing sovereign rating made almost no difference to market perceptions of default risk. A rating of AAA (20 in the figure) carried a slightly higher yield spread than a rating of BB+ (10 in the figure), and a rating of A+ (16 in the figure) was also perceived to have a lower risk of default than the AAA-rated country.

Figure 4

Variances in market-perceived risks within, and across, ratings

Comparative yield spreads relative to US 10-year government bonds of developing countries on 15 April 2024

Basis points



Source: www.worldgovernmentbonds.com

* Ratings reflect the arithmetic average of ratings for S&P, Moody's & Fitch. AAA rating = 20, D rating = 0

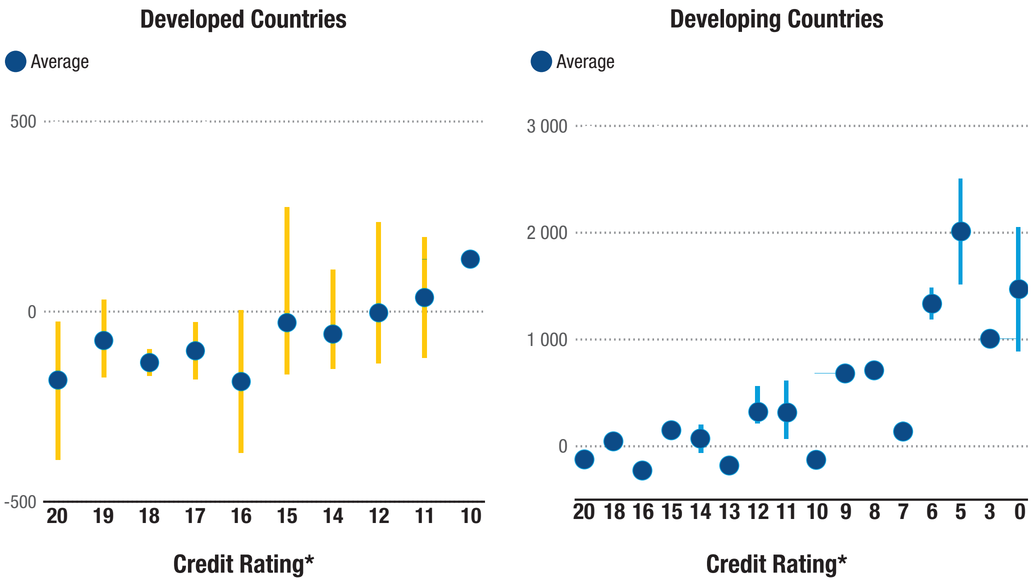
Figure 5 contrasts the differences in yield spreads for developed countries (left) and developing countries (right) with the same credit ratings at a point in time and shows that financial markets price the risks associated with individual country bonds independently of their credit ratings – even when the ratings assigned indicate a similar propensity for default. **It is notable that this variance between similarly rated countries is evident for developed as well as developing countries.** For example, developed countries with a BBB rating (12 on Figures 4 and 5) had yield spreads that varied by 372 basis points. Moreover, developed countries with an A- rating (14 on Figures 4 and 5) had a spread variance of 260 basis points. In the case of developing countries, yield spreads for BBB-rated countries varied by 348 basis points and those with A- ratings varied by 266 basis points.

However, the analysis also reveals that – on average – the markets price the yields of developing countries higher than those of developed countries with the same credit rating. For example, the average yield spread relative to US government bonds with the same maturity of developed countries with an A- rating (14 on the scale) on 15 April 2024 (shown on the graphs as the blue dot) was -59 basis points while that of developing countries was +72 basis points. Similarly, developed countries with a BB+ rating (12 on the scale) had an average spread of -3 basis points while the average for developing countries was +322.

For the ratings categories in which there was an overlap (from AAA to BB-, or from 20 to 10 in Figure 5), developing countries had yield spreads that were, on average, 77 basis points higher than that of developed countries.

Figure 5
Differences between developed and developing countries

Variances in the yield spreads of developed (left) and developing countries (right) with the same credit ratings as at mid-April 2024
Basis points



Source: www.worldgovernmentbonds.com

* Ratings reflect the arithmetic average of ratings for S&P, Moody's & Fitch. AAA rating = 20, D rating = 0

While this analysis does not shed light on whether ratings agencies are biased against developing countries, it suggests that the impact of any rating agency bias may be overshadowed by other factors, some of which may be systemic in nature.


10x/22

3. Determinants of sovereign credit ratings

Rating agencies use sovereign ratings to communicate their opinion of the likelihood that a sovereign borrower will be able to repay their obligations fully and timeously. To construct these ratings, they make use of rating methodologies and scorecards that draw on a variety of indicators which are then assessed by ratings committees within each agency. A recent study by Slapnic and Lončarski (2023) extended traditional regression analysis with sentiment and subjectivity scores obtained using textual sentiment analysis methods[7] to determine the significance of different factors that rating agencies consider. In addition to so-called "soft information" relating to institutional strength and governance, cultural and proximity variables, and textual sentiment and subjectivity variables, the analysis focused on the following macroeconomic and fiscal strength indicators:

- GDP per capita
- Real GDP growth
  Inflation
- Current account balance to GDP
- Trade balance to GDP
- External debt
- Level of economic development (IMF classification)
- Default history
- International reserves
- Government debt to GDP
- Budget balance to GDP

These indicators can, in turn, be linked to specific elements of the rating scorecards used by credit rating agencies. While rating agencies each develop and apply their own rating methodologies, they tend to follow similar approaches which incorporate both objective and subjective elements into a "scorecard-indicated outcome". This is then considered by members of a ratings committee, who also take account of other considerations in determining the assigned rating.

Figure 6 indicates the method adopted by Moody's. Different indicators are associated with each element of the scorecard. Some of these – such as economic growth, per capita income, fiscal balance, public sector debt levels, and international reserves - are quantitative and relatively objective, while others – such as institutional and regulatory quality, governance and the rule of law – cannot easily be measured quantitatively.

The scope for discretion, judgement and sentiment enters ratings not just in relation to the institutions and governance strength components, but also in respect of data gaps and data quality differences around other scorecard components and in rating committee consideration of other factors. Ferri (2004) showed that the relatively higher cost of acquiring relevant information in developing countries increased the likelihood of a rating agency's underinvestment in information acquisition. Their lower confidence in the quality and scope of data – which is likely to be more common in relation to developing countries generally, and lower income countries in particular (as noted by Luitel et al. (2016)) - allowed assessors to rely more on 'expert' judgement.

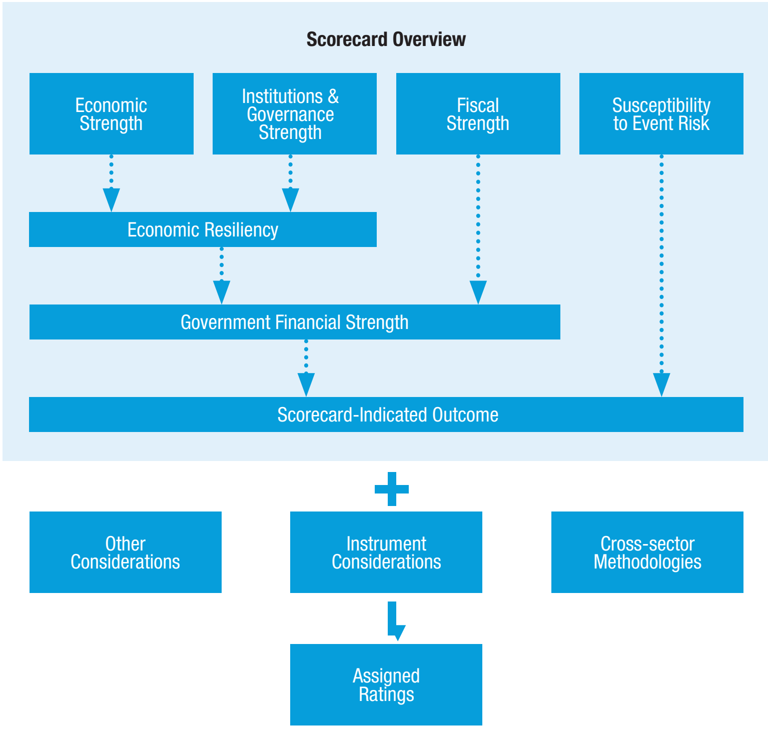
Sovereign ratings bias is defined as:

"(W)hen a credit rating agency's sovereign credit rating assignment systematically diverges from the implied changes in a sovereign's critical economic and institutional fundamentals."

Tennant & Tracey (2020)

[7] The textual analysis incorporated analysis of rating action and full reports drawn from a sample of 97 countries for the period of 2002–2018 by S&P, 98 countries for the period of 1999–2018 by Fitch, and 100 countries for the period of 1995–2018 by Moody's.

Figure 6
Moody's approach to sovereign ratings



Source: Moody's (2022)

> Despite increased transparency of the (objective) credit rating procedure, they (S&P) state that qualitative assessment still plays a significant part in the process, as they consider various adjustments, trends and other factors that can cause a deviation from the indicative rating.
>
> Slapnic and Lončarski (2023)

Moreover, while the initial indicators used to determine economic and fiscal strength – for example - may rely on quantitative indicators that embody some level of objectivity, how these indicators are interpreted by rating committees in their consideration of economic resiliency, government financial strength and susceptibility to event risk will not be the same for all countries and will also require some judgement. Slapnic and Lončarski (2023) note that all three major rating agencies acknowledged that qualitative judgements played a significant role in their ratings. The subjective nature of these judgements creates scope for bias.

However, bias is a relative concept that can work against, or in favour of, a particular entity. For example, in a comparison between the default rates of B-rated Sub-Saharan Africa countries between 2010 and 2023, and long-term global default rates for B-rated countries, Kraemer (2024) found that the default rate for the African group was – based on Moody's data - double (29.6 percent) the global average (14.9 percent). On the basis of this, he concluded that *"(t)he actual, objectively-observed bias in sovereign ratings has been in favour of Africa".* While there are limitations to this analysis[8] – some of which are acknowledged by the author - it highlights the fact that **bias cannot automatically be assumed to be consistently and systematically against developing countries.**

[8] The author acknowledged that the sample of rated Sub-Saharan Africa (SSA) countries was small and that many had only been rated relatively recently – coinciding with major international shocks. Also, the comparison period for the SSA countries (2010 to 2023) and the global average (long-term) appear not to be the same. The latter could incorporate periods of greater global stability.

4. The nature of bias in sovereign credit ratings

There are, nevertheless, numerous studies that indicate that ratings agencies have historically exercised a negative bias against developing countries and that it took different forms, including:

- "Home" bias – also referred to as cultural bias or proximity bias.
- Bias designed to preserve the market power of the "big three" global rating agencies.
- Bias arising from differences in how indicators used in rating scorecards are applied and interpreted.
- Bias arising from differences in the marginal impacts on ratings that changes in indicators give rise to.

4.1. Home bias

Gültekin-Karakaş et al. (2011) argue that ratings are subject to a "home" bias because rating agencies assign relatively more favourable ratings to their home country and countries that display similar economic, political and cultural attributes. These findings are echoed by Luitel et al. (2016) and Fuchs and Gehring (2017). In this regard it is worth noting that the "Big Three" rating agencies (Moody's, S&P and Fitch) are headquartered in the United States and have a limited permanent presence in developing countries[9]. Similarly, Zheng (2012) found that Dagong – a Chinese rating agency – tended to rate non-Western countries more highly than S&P. Slapnic and Lončarski (2023) find evidence of an economic proximity/trade proximity bias, but not a cultural proximity bias, in their analysis of rating agency behaviour.

4.2. Bias arising from the preservation and exercise of market power

Marandola and Sinclair (2017, pp. 488 - 489) note that *"the key element in the rating business is global reputation, which represents a very significant barrier for new entrants. Incumbents' reputation also negatively affects investors' demand for the product of start-up credit rating agencies. For example, portfolio managers, who do not directly bear the risk of debt defaults, seem to prefer to stick to the 'big three' even at the expense of quality. Indeed, they would incur some costs if they had to justify recourse to minor (and thus non-standard) agencies' ratings."*

In an analysis of sovereign bond issuances between 1994 and 2019, Hung, Kraft, Wang et al. (2022) found that S&P and Moody's dominated global rating issuance over this period, with Fitch's market share tending to lag. Most new bonds issued in foreign markets were accompanied by ratings from both S&P and Moody's, while Fitch often served as a second or third opinion for bonds already rated by the other two.

They also found that the **motive of rating agencies to build reputation was stronger outside the United States than within it**, where their market shares were already high and where growth opportunities in the bond market were limited. This heightened the likelihood that these

> "…(C)redit rating as a mental process and set of behaviors continues to be headquartered in the US and it is this to which all newcomers are compared. As long as this mental framework persists there is a strong incentive for all new firms to adopt these norms as this is what customers expect. But the adoption of 'global' US norms denies the new firms any substantial claim to adding value to this US-dominated industry".
>
> Marandola and Sinclair (2017, p. 482)

[9] Moody's Investor Services has offices or affiliates in 5 Latin American developing countries, 3 Asian developing countries and 2 African developing countries. S&P has offices or affiliates in 3 Latin American developing countries, 6 Asian developing countries, and 1 African developing country. Fitch Ratings has offices or affiliates in 5 Asian developing countries and 9 Latin American developing countries. In some cases, a ratings agency has more than one office in a particular developing country.

agencies would favour more stringent ratings that reduced the reputational risks of being wrong about a default over the short-term revenue gains that could be derived from more favourable ratings under the prevailing issuer pays model. **This increased stringency is likely to impact developing countries as a group relatively more than developed countries – based purely on market share.**

4.3. Bias arising from variations in the significance of different rating variables

Jeyi (2021) found that the levels of significance of different variables in explaining ratings often differ across developed and developing countries. These are summarized below:

Indicator	Developing Countries	Developed Countries
Real GDP growth	Positively correlated	Negatively correlated in certain models
Domestic credit (proxy for indebtedness)	Positively correlated	Not very significant
Total reserves	Highly significant	Very low to no significance
Institutional strength	Different elements emphasized by different rating agencies	Very significant positive correlation
Net FDI inflows	Negatively correlated	Negatively correlated
Fiscal balance	Strong negative correlation (but less so than developed countries)	Strong negative correlation
Inflation	Negatively correlated	Negatively correlated (but less than developing countries)

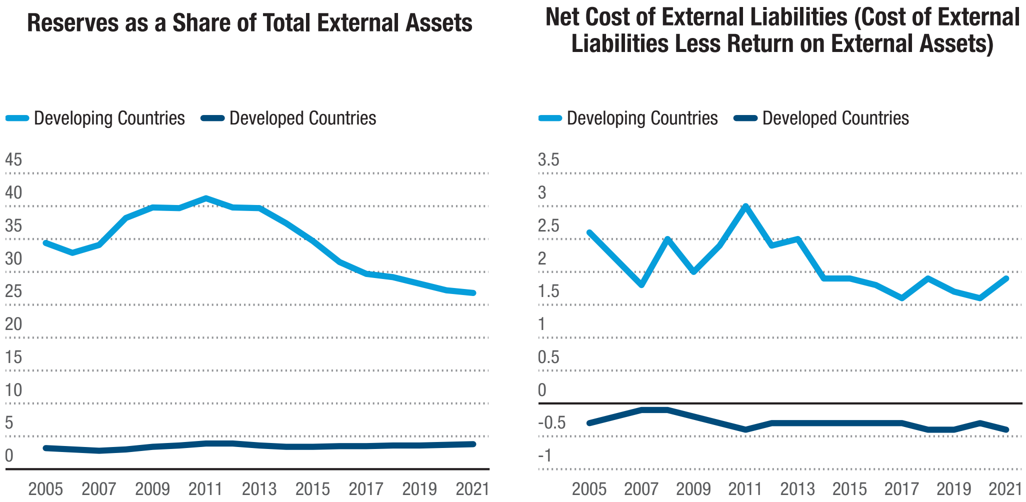
These differences may account for observed variances in ratings between developed and developing countries with similar economic and fiscal performance, but also have wider implications. The finding that reserves are highly significant for developing countries but have low to no significance for developed countries is consistent with that of Erdem and Varli (2014, p. 11) and Afonso, Gomes and Rother (2007, p.22). In this regard, it is worth noting that the publication of reserve data for developed countries by the IMF is a comparatively more recent phenomenon, reflecting its perceived limited significance to those countries.

The impact of these differences may be profound. As the graphs below indicate, developing countries hold a significantly higher proportion of their external assets as reserves because of their higher vulnerability to external shocks (Figure 7 LHS). **Over the period 2012 to 2022 these averaged almost 32 per cent - nearly 9 times the average level of developed countries over the same period.** This higher share of reserves contributes negatively to the return that developing countries earn on their external assets – which are significantly lower than the costs they incur in servicing their external liabilities (Figure 7 RHS). As a result, there was **a net transfer of resources from developing countries to developed countries that averaged US$475 billion per year between 2012 and 2022**[10]**.**

[10] IMF Balance of Payments and International Investment Position database, January 2024

Figure 7
Differing attitudes to reserve levels

The link between higher reserve holdings (left) and lower returns on external assets (right) in developing countries
Per cent



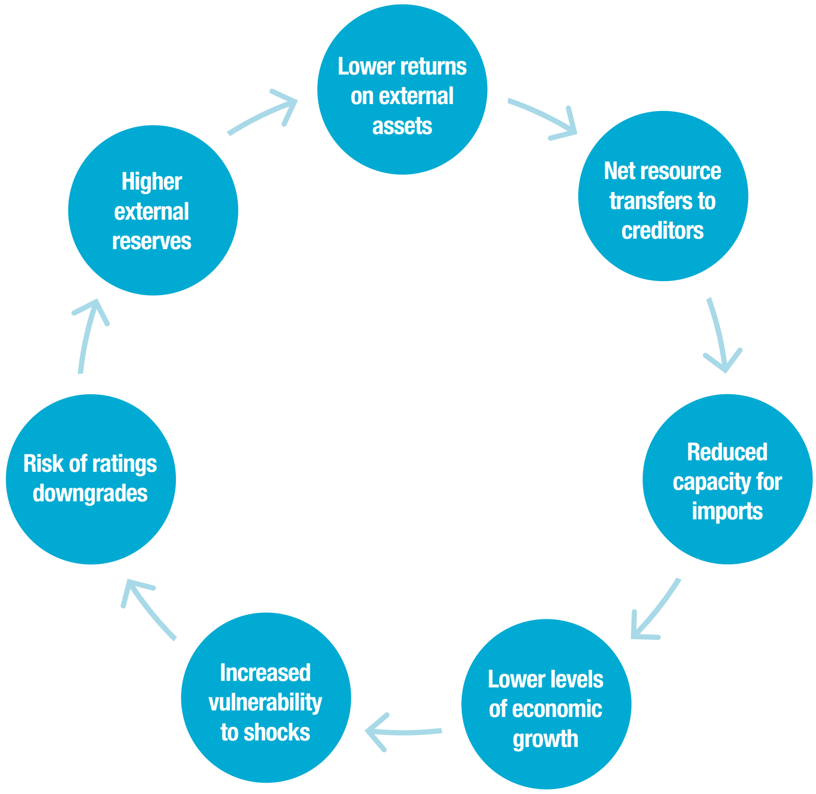
Source: IMF Balance of Payments and International Investment Position database, January 2024

UNCTAD Policy Brief No. 78 of May 2020 argues that the persistence and size of this transfer is closely related to financial liberalization and the rapid growth of private capital flows to developing countries since the mid-1990s. It notes that since developing countries are typically creditors in safe assets and debtors in risky ones, the returns on external assets received are generally lower than the payments made on external liabilities, resulting in an ongoing net transfer of financial resources from developing to developed countries. (UNCTAD, 2020).

This gives rise to a potentially vicious cycle for developing countries which is illustrated in Figure 8. Increased vulnerability to external shocks gives rise to enhanced risks of rating downgrades, which, in turn, results in developing countries maintaining higher levels of reserves than they may otherwise choose. These higher reserves result in lower returns on external assets and higher net transfers from developing countries to their creditors, which reduces their capacity for imports. This constrains the levels of economic growth and diversification that can be sustained and impedes necessary structural transformation, which in turn, increases their vulnerability to shocks.

Developing countries that choose not to invest as heavily in low-yielding reserves are likely to receive relatively lower credit ratings and incur higher debt servicing costs as a result.

Figure 8
The focus on high reserve levels in developing countries
Implications of sovereign credit ratings that ascribe significant importance to high levels of external reserves for developing countries



4.4. Impact of differences in the significance of indicators on marginal shifts in ratings

Jeyi (2021) also found that differences in the significance of indicators used to calculate rating scorecards translated into differences in the marginal shifts of sovereign ratings that changes in those indicators caused. For example:

- Changes in fiscal strength indicators, general government debt, domestic credit and current account balances had the most considerable marginal effects on rating categories. A percentage increase in domestic credit and the current account balance increased a developing country's probability of being in the BB, BB+, BBB- and BBB ratings category (or their Moody's equivalents) and a percentage point increase in government debt decreased that probability.
- Total reserves had the highest marginal effects in the case of event risk, suggesting that for a possible increase into the BB, BB+, BBB- and BBB categories (or their Moody's equivalents) the rating agencies expected developing countries to have significantly large amounts of gold and foreign exchange reserves available.
- The most significant estimates with the most considerable marginal effects for institutional strength indicators were the rule of law and regulatory quality. A point increase in regulatory quality increased the probability of a

developing country being in BBB-[11] by 23 per cent for Fitch, 25 per cent for Moody's and 19 per cent for S&P. Moreover, a point increase in the rule of law increased the probability of a developing country being in BBB-[12] by 12 per cent for Fitch, 14 per cent for Moody's and 13 per cent for S&P. Jeyi's results indicated that credit rating agencies' bias against developing countries emanated largely – but not exclusively - from how rating agencies perceived variations in the qualitative determinants of institutional strength across country development levels. They also arose from differences in the relative importance attached to particular quantitative indicators used to construct ratings.

The relative significance of rating agency bias against developing countries may be overshadowed by other factors – which could include other forms of bias that are innate to the current global financial architecture.

While the technical possibility of bias exists, there is a big gap between that possibility and proving such bias:

"Technically, it would be possible for a ratings agency* to 'hide' any overt bias by assigning worse qualitative assessments – in a credit risk sense – for some countries than others. Indeed, it would be possible to construct a sovereign rating methodology that implicitly incorporated this bias, for instance by assigning lower 'institutional and governance' factor scores to African countries than for other countries. And given the entirely qualitative nature of these scores, it is impossible – given publicly available data, at least – to identify how much of any qualitative judgement reflects 'true' conditions versus conscious or unconscious bias."

"Results from the quantitative analysis are clear and unambiguous. For each year from 2016 to 2020, there is no statistically significant sign of anti-African bias in the distribution of Moody's ratings, once quantitative factors such as growth, debt and volatility are accounted for. Interestingly, not all of the quantitative factors listed by Moody's are statistically significant or consistent in the cross-sectional results: in part, this may speak to the considerable flexibility that rating analysts enjoy in forming their credit opinions. But the critical result from this analysis is that there is no evidence of bias against African countries."

Ellis. C. (2022, pp 31 and 35)

* Reference to a particular rating agency has been replaced with a more general reference since the "possibility of bias" exists across all ratings agencies.

Since the way credit rating agencies decide on sovereign ratings and the regulatory environment under which they operate has changed over time, it is unclear whether all the different forms of bias identified in these studies persist, and if so, to what extent.

[11] Or its Moody's equivalent.
[12] Or its Moody's equivalent.

5. Proposals advanced for reform of rating agencies by other entities and jurisdictions

Following the 2008 global financial crisis, various reforms relating to credit ratings and rating agencies were proposed. These focused on structural factors governing aspects such as competition, incentives and regulations but few were implemented due to political and technical challenges. In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted in 2010[13] included some limited provisions designed to make rating agencies more accountable and the removal of rating-based regulations to reduce reliance on ratings for both regulatory and behavioral purposes. Federal agencies were required to replace regulatory references to credit ratings with "appropriate" substitutes and securities laws were amended to enhance the accountability and transparency of credit rating agencies. A new Office of Credit Ratings was established within the Securities and Exchange Commission to oversee them. The additional supervisory provisions in the Dodd-Frank Act were justified on the basis that *"rating agencies are fundamentally commercial, thereby implying that they have to be subject to stricter regulatory standards similar to other gatekeepers such as auditors and securities analysts"* (Darbellay and Partnoy, 2012, p.15).

However, proposals that Nationally Recognised Statistical Ratings Organisations (NRSROs) should be classed as experts and thereby be subject to liability under Section 11 of the Securities Act of 1933 were resisted by the rating agencies (Bruce, Cash, Darbellay et al, 2023, p. 12).

For its part, the European Union created the European Securities and Markets Authority (ESMA) to supervise rating agencies within its jurisdiction. It also adopted regulations[14] designed to reduce reliance on credit ratings, increase the transparency of sovereign debt ratings, improve the quality of the rating process, make rating agencies more accountable for their actions and reduce conflicts of interest and facilitate market entry for new entrants. (European Union, 2013). In April 2024, ESMA launched a round of consultations on possible amendments to this regulatory framework, following a request from the European Commission. The focus of these consultations is on possible legislative amendments designed to ensure that relevant environmental, social and governance (ESG) risks are systematically captured and reflected in credit ratings and rating outlooks. (European Securities and Markets Authority, 2024).

While both the United States and European Union regulations now provide for credit rating agencies to be held liable for their actions, the threshold of proof is high: a claimant needs to prove that the agency knowingly acted recklessly, and that it knew who was going to be harmed by its actions (Cash and Khan. 2024, p. 15).

Li (2021 p.17) noted that: *"Despite various proposals having been made over recent decades, the structural defects of credit rating agencies, the market distortions they create and the errors in their assessments have yet to be amended."*

[13] Subtitle C – Improvements to the Regulation of Credit Rating Agencies, Sec. 931 – 939H.
[14] This consists of a regulation (Regulation No 462/2013) and a directive (Directive 2013/14/EU).

More recent proposals for changes to the treatment of credit rating agencies tend to follow one of two tracks:

i) Those that seek to increase confidence in the accuracy of sovereign ratings and promote their use as a mechanism to enhance the stability of the global financial system and encourage investment in sustainable development; and

ii) Those that argue that ratings are opinions, not certifications, and that they will – as a result – never be able to match expectations of correctly anticipating crises and all attendant default risks. The policy focus should therefore be on reducing financial market reliance on them – much like the G20-endorsed Financial Stability Board (FSB) view published in 2010[15], and the provisions of the Dodd-Frank Act and European Union regulations referred to above.

While there are some common aspects to the two tracks, their implications for how the issue of rating bias should be addressed are quite different.

The former approach implicitly seeks to **increase** the reliance that financial markets place on ratings by increasing confidence in their accuracy. To the extent that any biases exist, they undermine the quest for greater accuracy and should be addressed accordingly. Interestingly, the Final Report of the International Organization of Securities Commissions (IOSCO) changed the definition of "credit rating" from *"an **opinion** regarding the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations, expressed using an established and defined ranking system"* to *"an **assessment** regarding the creditworthiness of an entity or obligation, expressed using an established and defined ranking system"* – apparently *"to reflect the fact that under the provisions of the IOSCO CRA Code, CRAs should strive to determine credit ratings: (1) using methodologies that are rigorous, among other things; (2) that reflect all information known, and believed to be relevant at the time when the credit rating is determined; (3) using analysts that have appropriate knowledge and expertise; and (4) that are free of bias and not influenced by conflicts."* (IOSCO, 2015).

By contrast, the second approach seeks to place greater responsibility on investors and issuers to exercise due diligence and care and - in the process - to make financial markets **less reliant** on sovereign ratings. To the extent that these efforts are successful, they would automatically reduce the negative impacts of any rating agency bias.

Various policy proposals have been advanced in support of these two approaches, some of which are discussed below.

5.1. Proposals aiming to increase the accuracy and acceptance of sovereign credit ratings

Advocates of this approach have suggested that rating methodologies should be updated to incorporate scenarios for economic and non-economic risks and to make the process more transparent by publishing model-based scorecards (UNDP Regional Bureau for Africa, 2023, p. 42; Zhou, 2023) and assessments with "qualitative overlays", so that countries being rated are able to evaluate the approach and markets can compare the quality of offerings by different rating agencies. It is

[15] Following initial publication of this view, the FSB embarked on an extensive process to accelerate progress in reducing mechanistic reliance on credit rating agencies. This culminated in a thematic peer review aimed at assisting national authorities to implement a Roadmap with this purpose. It had two parts: a stocktake of references to rating agency ratings contained in national laws and regulations, and action plans developed by national authorities to implement the Roadmap. (Financial Stability Board, 2014).

argued that this increased transparency will also help to eliminate any biases that exist.

In addition, long-term sovereign ratings should be issued that incorporate the country's financial sustainability, with a view to reducing the rating's procyclical nature and ensuring a better match between ratings and investment horizons. It has also been suggested that overlapping rating tiers should be created to reduce the "cliff-edge" effect of moving from investment to sub-investment grade. Investors and regulators would need to adjust investment guidelines and behaviour to give effect to this.

Proposals have also been made for the creation of new and/or public rating agencies to compete with existing agencies and address their perceived shortcomings. Most recently, the UNDP Regional Bureau for Africa (2023) recommended creating both a multilateral credit rating agency accountable to supranational organisations such as the United Nations, and a pan-African agency, involving the African Union and national monitoring and regulatory agencies. These calls echo an earlier call made in the 2020 Trade and Development Report by UNCTAD (UNCTAD, 2020, p. X) for the establishment of an international public credit rating agency to provide objective, expert-based ratings of the creditworthiness of sovereigns and companies.

The African Peer Review Mechanism and the United Nations Economic Commission for Africa publish a biannual African Sovereign Credit Rating Review which presents a comparative analysis of the consistency in application of methodologies and rating services and makes recommendations on how credit ratings can be improved. In its 9th Edition, it urges African regulators to establish a common regulatory framework to ensure consistency in the oversight of rating agencies (African Peer Review Mechanism and United Nations Economic Commission for Africa, 2024, p.8).

5.2. Proposals aiming to emphasize the subjective nature of ratings and reduce reliance on them

Proponents of this approach – which views rating agencies as "reputational intermediaries" that bridge the information gap in ways similar to restaurant or movie reviewers - argue that attempts to regulate the performance and behaviour of rating agencies are bound to fail because they do not recognize that **they are opinion-providers, not certifiers.** If anything, attempts to regulate the industry in the wake of the 2008 global financial crisis have served to entrench and enhance the market power of the "Big Three" and provided their ratings with a sense of legitimacy and infallibility that is undeserved. Marandola and Sinclair (2017, pp 491 – 492) argue that *"(t)he problems are not regulative but constitutive, and change needs to be pursued at this much more architectural level"* and suggest three interventions:

i) To clarify the business of ratings and force credit rating agencies to stick to only this role, in much the same way that accounting firms were forced by the Sarbanes-Oxley Act of 2002 to divest from non-audit businesses such as advisory and legal units.

ii) To force rating agencies to openly declare and acknowledge that they provide subjective judgements about what might probably happen in the future – similar to health warnings on food and tobacco products. This would serve to increase the awareness of all parties of the challenges inherent in rating, and encourage issuers, investors and the rating agencies themselves to exercise more care and act more judiciously in relation to those ratings.

iii) To encourage and facilitate the adoption of self-regulatory 'community norms' through compulsory membership of regional and/or national industry associations – along the lines of the

"In the past due diligence has not been effectively promoted by the (non-binding) regulatory regime and the insistence by CRAs that their ratings only measure credit risk seems to have been ignored by many investors. More is needed in this regard. Moreover, the acceptance of external credit assessment for the determining of capital requirements has effectively resulted in the 'outsourcing of regulatory judgment', whereby not the CRA bears the final risk, but rather the taxpayer that may have to come to the rescue of a failing systemic relevant institution."

De Haan & Ambtenbrink (2011)

Association of Credit Rating Agencies in Asia (ACRAA). Such associations should be responsible for setting and communicating minimum ethical and other standards among members and for the ongoing training of analysts. This should – at least partly – address the criticism that US-dominated global agencies are unable to adapt their standards and assessment benchmarks to non-US contexts.

They also argue against suggestions for the establishment of public sector allocators of ratings, or a new international supervisory organization of the industry, as these will not – in their view - prevent rating shopping and will entrench the perception that the ratings are approved, or certified, by these organisations – resulting in an ongoing failure by investors and issuers to exercise due care. The latter increases the potential impact of systemic shocks.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6. Reforms to address the needs of developing countries

The two approaches relating to reform of credit rating agencies and the sovereign rating process outlined above are very different. Deciding which approach to support depends critically on whether one believes it is possible to "perfect" the ratings process and ensure that it is objective, accurate and able to deal with all eventualities. The evidence to date suggests otherwise. While new rating agencies may be able to correct some of the flaws associated with existing ones, it is unlikely that they will be able to totally escape subjective judgement. This means that scope for bias will persist. As the 2015 Trade and Development Report cautioned: new rating approaches may reproduce the same flaws as existing models (UNCTAD, 2015, p. 106). Reliance only on objective indicators could also work against developing countries that wish to be judged on their future potential, not just their current state, and has implications for the quality and consistency of their data systems.

Despite their limitations, rating agencies still have a role to play in addressing information asymmetries – particularly for new entrants to global capital markets - but there is a risk that the first approach will tend to increase their importance and relevance and perpetuate the "outsourcing of regulatory judgment". The conundrum is that – **within the current architecture of the global financial system - having a sovereign rating facilitates access to international capital markets in ways that are not available to countries without ratings.** The approach outlined below is therefore designed to a) place priority on a fundamental reform of the global financial and debt architecture; b) use an appropriately designed rating support process to enhance the future access of countries – especially the 46 developing countries that do not currently have a rating – to financial markets in an incremental, and developmentally-supportive manner; c) reduce the importance of sovereign ratings to investment decisions; and d) develop - in conjunction with ratings agencies – a ratings approach for countries that choose to engage in debt restructuring under the G20 Common Framework (or any similar restructuring process) that is supportive instead of punitive.

6.1. Comprehensive and consistent reform of the global financial architecture

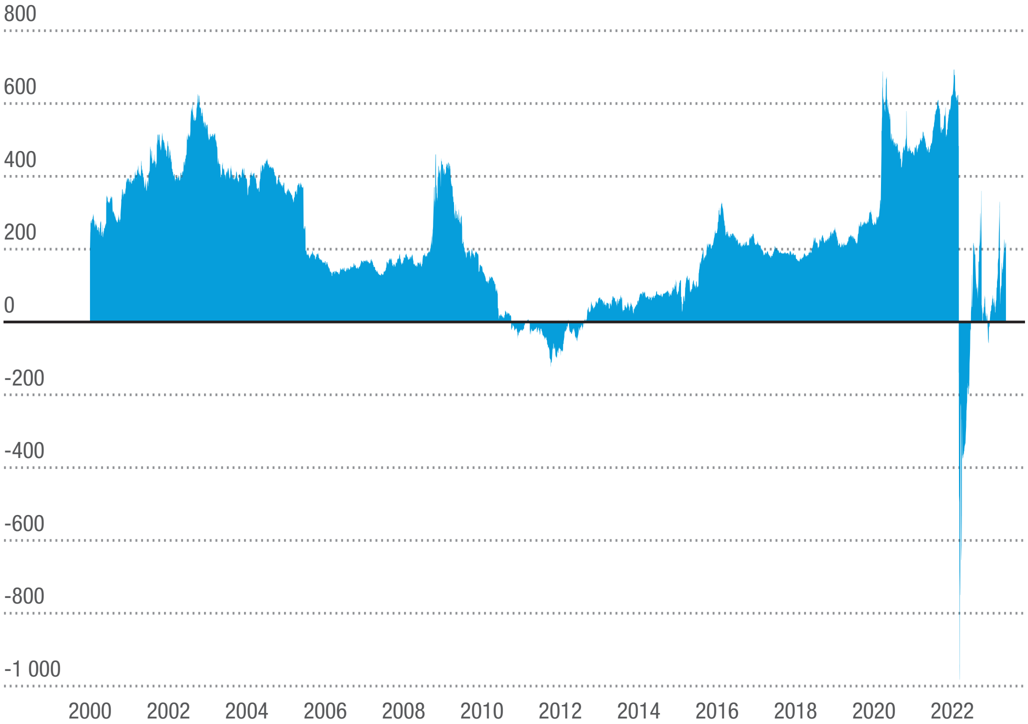
As Figure 9 indicates, developing countries tend to pay more than developed countries for internationally sourced capital. Based on the spread in yields on secondary capital markets between developing countries and developed countries on the one hand, and United States treasury bills on the other, this premium averaged around 200 basis points between the start of 2012 and May 2023, and increased to an average of 525 basis points between the start of the COVID-19 pandemic and March 2022, when the war in Ukraine caused the yield spreads of European countries in particular to spike. This led to lower, and sometimes negative, differentials.

The differences in borrowing costs are more significant in respect of particular developing regions. For example, the differential in yield spreads between African countries and developed countries averaged 350 basis points between the start of 2012 and May 2023, and rose to over 900 basis points between the beginning of the COVID-19 pandemic and March 2022[16].

These variances in yield spread underscore the inequalities entrenched in the current global financial system. They also highlight the implications of the growing funding gap for sustainable development goals (SDGs) and climate-related commitments – which is currently estimated at around US$4 trillion per year.

Rising to the challenge will force developing countries to take on more debt, but the conditions under which they are able to access global financial markets will – in their current configuration – be more costly and more tenuous and carry high opportunity costs in terms of other development priorities that cannot be sustainably pursued.

Figure 9
Developing country interest premium
Differences between developing and developed countries yield spreads
Basis points



Source: Refinitiv

Addressing the systemic reasons behind these differentials would have a much more profound impact on the ability of developing countries to access sufficient global capital at prices and terms that are consistent with their development needs and objectives than a narrow focus on ratings bias. However, in the search for things that can be done quickly, it is important to ensure that even partial solutions are consistent with a long-term vision of a reformed, development-focused international financial system.

In its 2023 Trade and Development Report UNCTAD argued, amongst other things, for:

[16] See also Figure 10 on page 23 of UNCTAD's Trade and Development Report Update April 2023. Trade and Development Report Update (April 2023) (unctad.org)

i) Increased mobilization of concessional finance through greater capitalization of multilateral and regional development banks and new issuances of special drawing rights.

ii) Improved transparency around how financing is used, including the digitization of loan contracts and rules relating to collateralized sovereign bonds to protect developing countries.

iii) Ensuring access to a truly global financial safety net.

iv) International and domestic rules for a standstill on debtor obligations in cases of climate, health and other external crises.

v) Establishment of a more robust debt workout mechanism and statutory global debt authority and discussions around the balancing of borrower and lender rights.

UNCTAD (2023, p. 140)

For example, ensuring access to an effective global financial safety net would limit the need for developing countries to maintain unnecessarily high levels of low-yielding reserves[17] to deal with balance of payments crises brought on by external crises. The existing system could be improved by the effective rechanneling of (more) unused Special Drawing Rights; revised IMF quota limits that replace the existing skewed and outdated ones and help to recapitalize the IMF; the abolition of tiered interest rates on the IMF's Resilience and Sustainability Trust to support climate-related projects; and the elimination of IMF surcharges. These improvements could be adopted relatively quickly and with limited cost.

6.2. Using a new sovereign rating process to enhance access of developing countries to international capital markets over the longer term

As noted, having a sovereign rating can facilitate a degree of access to both domestic and global capital markets. **There are currently 20 African, 8 Latin American and the Caribbean and 18 Asia-Pacific region developing countries that are effectively excluded from these markets because they do not have a credit rating.** While several quantitative and qualitative indicators and a significant amount of judgment are used by rating agencies to determine a country's credit rating, **the length of time that developing countries spend in the rating system is also positively correlated with their current ratings** – as reflected in Figure 10.

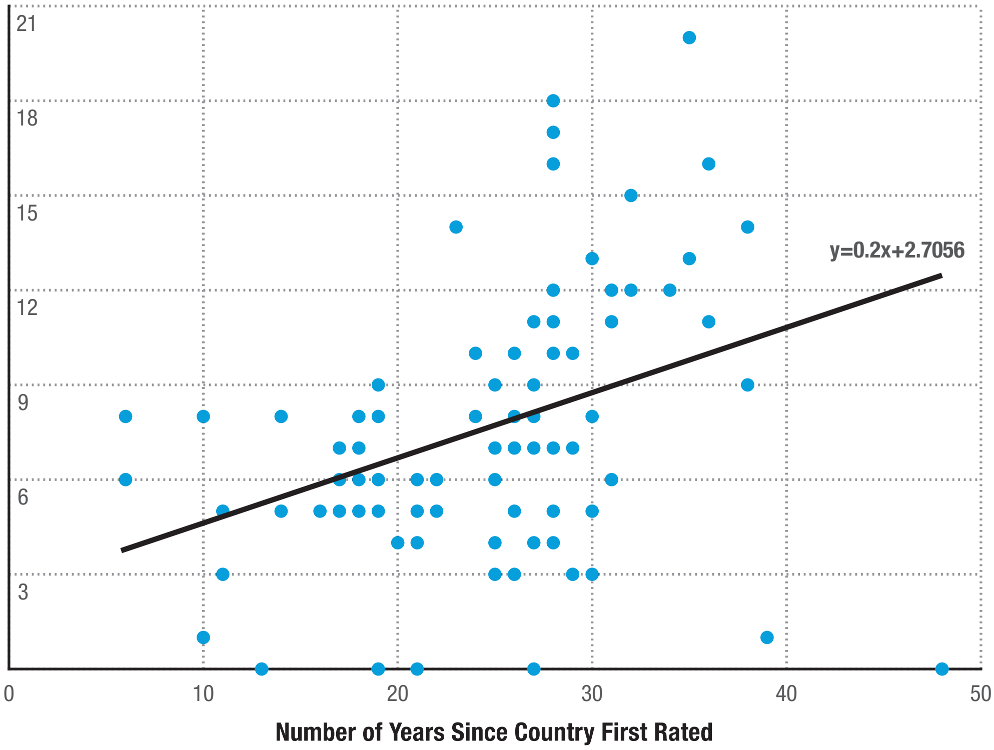
Most of the currently excluded countries would probably have relatively low ratings if they were to be rated by the existing commercial rating agencies, and it would be comparatively expensive for them to acquire them. In the short term at least, the benefits of such ratings may also be limited.

[17] The IMF (2023) notes that international reserves are costly, but although they have risen rapidly, the level of self-insurance they afford individual countries is highly uneven and low-income and vulnerable emerging markets are often underinsured and vulnerable to shocks. In 2022, 97 per cent of the roughly US$14 trillion international reserves were held by around half the world's economies, but the other half (comprising low-income and vulnerable emerging markets) only had access to the remaining 3 per cent as a first line of defence. Pooled resources such as the IMF, swap lines and regional financing arrangements are a far more efficient way of insuring against crises.

Figure 10
Time in the ratings system matters

Correlation between developing countries' duration with sovereign ratings and the ratings themselves

Sovereign Credit Rating at End 2023 (21 Point Scale*)



Sources: www.worldgovernmentbonds.com, S&P Global, Fitch Ratings, Moody's, Trading Economics, www.news.un.org.

* Ratings reflect the arithmetic average of ratings for S&P, Moody's & Fitch. AAA rating = 20, D rating = 0

Establishing – at the request of member states - a UN-convened credit rating technical assistance process that provides guidance and issues rating opinions would allow unrated member states an opportunity to obtain their first indicative ratings. Moreover, it could enable the member state to identify and progressively develop the institutions, data and debt management systems and financial sustainability necessary to access domestic and global capital markets more formally in the future. This technical assistance could be run in conjunction with existing UN technical support programmes such as the Debt Management and Financial Analysis System (DMFAS) that currently serves over 70 different debt management offices in national and provincial treasuries and central banks in 60 developing countries in six different languages. Such indicative ratings could also support improved access to a range of concessional and development financing options and help to raise the profile of participating countries within global financial markets. In this way, some of the existing information asymmetries would be reduced. These ratings would also serve as both a mechanism to encourage financial innovation and as a counterpoint to possible future ratings of participating countries by commercial rating agencies.

The proposed technical assistance programme would involve contracting a team of experts to develop an appropriate rating methodology for annual application to currently unrated developing countries on request. A technical team, drawn from a collegiate of experts, could then advise participating countries on ways to progressively improve their ratings within the framework of the methodology, as well as the level of debt that could be sustainably serviced. Once operational, consideration could be given to extending this assistance to rated developing countries in debt distress, with a view to accelerating their recoveries[18].

The appetite of the unrated countries for this approach, as well as financing mechanisms for the technical assistance, would need to be established before embarking on this route.

6.3. Reducing the reliance on, and importance of, sovereign ratings to decision-making in global capital markets

This suggested approach proceeds from the hypothesis that credit rating agencies and the sovereign rating process will never be able to meet the expectations of infallibility and objectivity being placed on them. Credit rating agencies should not, however, be let off the hook. Requirements for them to divest from advisory and legal services that create potential conflicts of interest and to publish clear "health warnings" that emphasise that their ratings are opinions, need to be pursued. Greater transparency in the structure of the models used would also serve to emphasise the subjective nature of the ratings process and enable greater scrutiny by investors and issuers. The establishment of regional rating industry associations that engage in standards setting and training, and of which rating agency membership is compulsory, should also be considered. This will go some way to sensitizing rating agencies to regional economic and developmental nuances and reduce the scale and impact of any biases that may exist.

Developing countries also need to play their part. One of the reasons for the overreliance by financial markets and investors on ratings is the deficit in transparent and reliable data on which investors can make decisions. Rating agencies can be seen to exploit (or fill) this gap. **The adoption of better, more transparent, data and debt management systems and improving the quality of supporting institutions will not only serve to reduce the importance of rating agencies but will aid improved policy formulation and decision making by the countries concerned and, in the process, help to reduce investment risk premia.** Technical assistance from international institutions, such as the IMF, World Bank and UN Trade and Development, has played a critical role in improving data system accuracy and transparency and debt management performance in developing countries and should be scaled up, particularly for low and lower-middle income countries.

6.4. Establishing a sovereign rating process for countries choosing to engage in debt restructuring

Between 2010 and 2022, the exposure of Emerging Market Economies[19] to private creditors increased from 50 per

[18] Of the 34 PRGT-eligible countries listed by the IMF as being at high risk of, or in, debt distress in April 2024, 28 (or 82 per cent) had been stuck in this situation since at least 2019.

[19] Developing economies that began accessing global capital markets in the 1990s. This comprises a group of 28 countries, including: Argentina, Bahrain, Brazil, Chile, China, Colombia, Dominican Republic, Ecuador, Egypt, India, Indonesia, Kazakhstan, Kuwait, Lebanon, Malaysia, Mexico, Morocco, Oman, Panama, Peru, Philippines, Qatar, Saudi Arabia, South Africa, Trinidad and Tobago, Türkiye, United Arab Emirates and Uruguay.

cent to 67 per cent, that of Frontier Market Economies[20] from 17 per cent to 32 per cent, and Other Developing Economies[21] from 13 per cent to 17 per cent. Much of this increased exposure was facilitated by expanded access to global capital markets through bond issues underpinned by sovereign credit ratings. Successive global crises and higher borrowing costs are resulting in high levels of debt stress among many developing countries – especially Frontier Market Economies. However, rather than seeking to restructure their debt, many debt-distressed countries are choosing to prioritise debt servicing over their development and climate agendas.

This choice is driven in part by the inefficiencies and shortcomings of the available restructuring processes, but also out of fear of being downgraded by credit rating agencies. Such downgrades are justified by the rating agencies' view that the request to renegotiate a debt instrument with a private creditor demonstrates that the country is in financial difficulty and headed towards full-blown default. The same approach is not applied to restructuring negotiations with official creditors. The Credit Rating Research Initiative (2021) refers to this as a 'Credit Rating Impasse' and contests the widely held view that this is a symptom of a complex global financial architecture. Instead, it argues (pp. 5 – 6), "the complexity comes in the many actors who want to continue profiting from the investment into the poorer countries we will analyse, as well as those who serve that investment arena."

It proposed (Credit Rating Research Initiative, 2022) that consideration be given, and further efforts be made, to:

i) Encourage private creditor groups to provide the impetus and their approval for rating agencies to change their credit rating processes for countries seeking to restructure their debt under the Common Framework (or similar processes) in a temporary and focused manner.

ii) Accommodate a number of restructuring elements – aligned with multilateral initiatives - that "allow debtor countries to negotiate with their creditors, and also become more progressive within the credit rating dynamic".

iii) Turn the credit rating process into a positive process that benefits both the debtor country and its creditors in the medium to long term, rather than the punitive process that it currently is.

It envisaged a "credit rating overlay" (or track) that would be applicable to countries entering the Common Framework or any future multilateral-designed debt treatment programme. This alternative track would remain in place during restructuring with the understanding that participating countries would be returned to the normal rating system if they failed to comply with the measures put in place by the programme. If implemented, such a shift could help to resolve the "Credit Rating Impasse" and enhance the resilience and sustainability of debt-stressed countries.

For this to occur, UNCTAD believes it will be necessary to engage with rating agencies to develop a supporting rating approach for countries choosing to enter the G20 Common Framework or any equivalent process, including a possible separate rating track that is conditional on a more efficient and rapid conclusion of the debt restructuring process.

[20] Developing economies that began to access global capital markets after the 2008 Global Financial Crisis. This comprises a group of 36 countries, including: Angola, Armenia, Azerbaijan, Barbados, Benin, Bolivia, Costa Rica, Côte d'Ivoire, El Salvador, Ethiopia, Gabon, Georgia, Ghana, Guatemala, Honduras, Iraq, Jamaica, Jordan, Kenya, Maldives, Mongolia, Mozambique, Namibia, Nigeria, Pakistan, Papua New Guinea, Paraguay, Rwanda, Senegal, Sri Lanka, Suriname, Tajikistan, Tunisia, Uzbekistan, Viet Nam, Zambia

[21] Developing economies that have little to no integration into global capital markets and are largely reliant on official capital flows. These are countries that are neither Emerging Market Economies nor Frontier Market Economies.


65.025
89.614
85.204
54.326
44.021
37.215
24.827
18.965
24.025
12.541
15.354

7. Conclusion

UN Trade and Development proposes several initiatives that could improve the sovereign credit rating system. This includes giving priority to those elements of a fundamental reform of the global financial and debt architecture that can be implemented relatively quickly and at relatively low cost – as reflected in the 2023 Trade and Development Report (UNCTAD, 2023).

The proposal to establish a technical assistance programme under the United Nations that would apply an appropriately designed rating process to countries that do not currently have sovereign credit ratings aligns with earlier UNCTAD calls (UNCTAD, 2020) for a public credit rating agency, but differs in important ways from what was previously conceived. Most notably, by adopting a developmentally supportive process targeted at countries without ratings, it does not seek to compete directly with existing commercial rating agencies.

Adopting measures - both regulatory and behavioural - aimed at reducing the importance of sovereign ratings to investment decisions is consistent with the view that the credit rating process can never be perfected, but also aligns with the aims of the Financial Stability Board (FSB, 2010) as endorsed by the G20, the Dodd-Frank Act in the United States and European Union legislation.

Engaging with established commercial rating agencies to develop a rating approach for countries that choose to engage in debt restructuring (under the G20 Common Framework or any alternative mechanism) is an attempt to address one of several identified shortcomings of the current system.

Implementing these proposals will require contributions from multilateral financial institutions, national regulators and commercial rating agencies. Above all it would require the engagement and request by developing countries themselves to engage with a UN-convened technical assistance programme with the aim of providing indicative sovereign credit rating opinions for those member states that do not currently have sovereign ratings and advice on how these ratings could be improved.

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9. Annexures

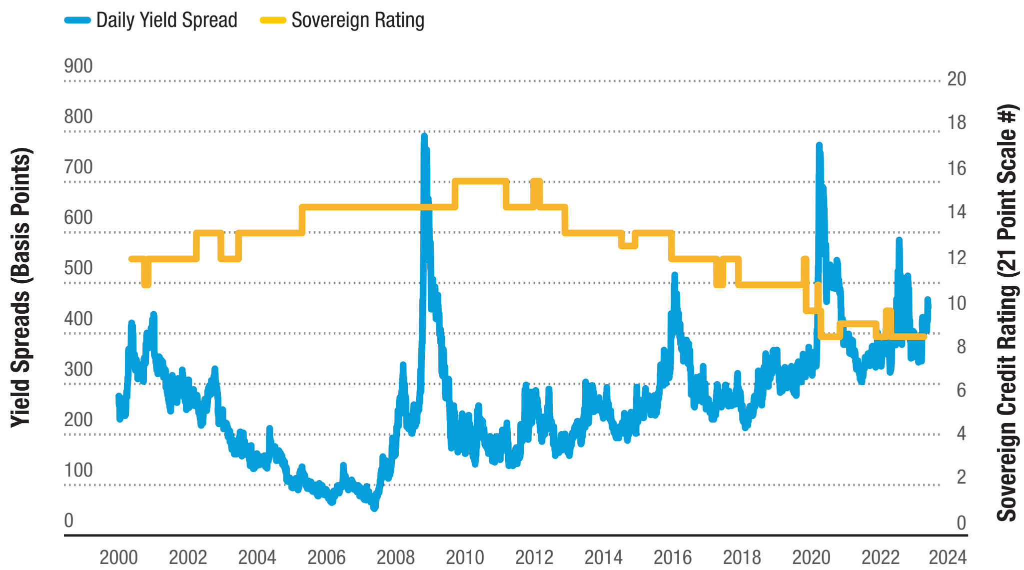
9.1. Credit ratings

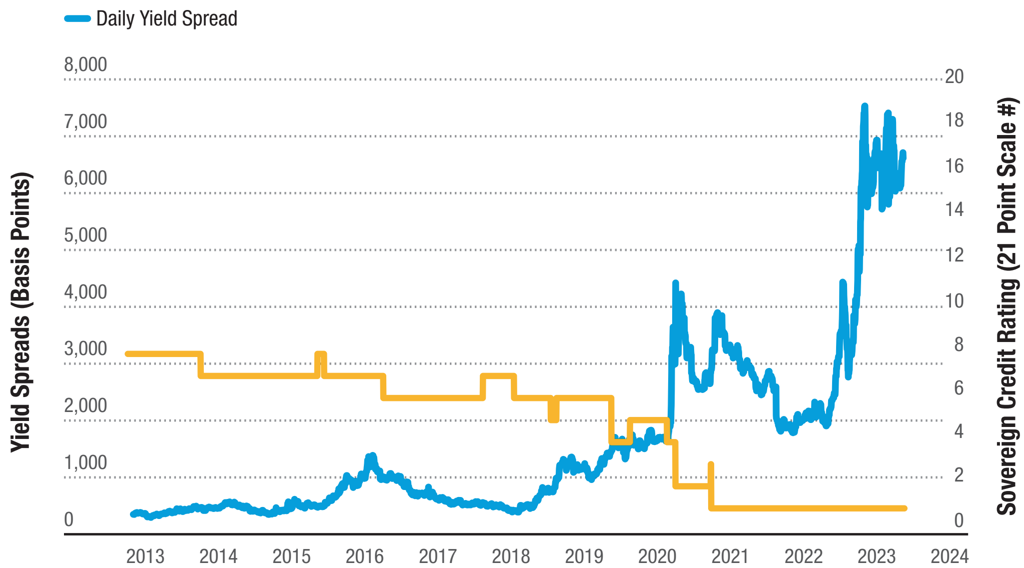
Interpretation	Fitch & S&P	Moody's
Highest quality	AAA	Aaa
High quality	AA+	Aa1
	AA	Aa2
	AA-	Aa3
Strong payment capacity	A+	A1
	A	A2
	A-	A3
Adequate payment capacity	BBB+	Baa1
	BBB	Baa2
	BBB-	Baa3
Likely to fulfill obligations, ongoing uncertainty	BB+	Ba1
	BB	Ba2
	BB-	Ba3
High-risk obligations	B+	B1
	B	B2
	B-	B3
Vulnerable to default	CCC+	Caa1
	CCC	Caa2
	CCC-	Caa3
Near to, or in, bankruptcy or default	CC	Ca
	C	C
	D	D

Sources: IMF (2010)

9.2. Yield spreads and sovereign ratings analysis for South Africa and Zambia

Figure 11
Comparative trends in sovereign ratings and yields spreads for South Africa (top) and Zambia (bottom)





Sources: Refinitiv

* Reflects the arithmetic average of ratings for S&P, Moody's & Fitch

Value of 20 reflects a rating of AAA, value of 11 reflects rating of BBB-, value of 9 reflects a rating of BB, value of 4 reflects rating of CCC+, value of 0 reflects rating of D.

South Africa's average yield spread between when it held an "investment grade" rating and when it dropped to "sub-investment grade" increased by 169 basis points.

While it maintained a BB- rating, Zambia had an average yield spread of around 400 basis points. This jumped to around 600 basis points when it was downgraded to B+ and to 820 basis points when it dropped to B. However, when it was downgraded to B- its yield spread increased by almost 90 per cent to average around 1'500 basis points. After it applied for debt restructuring under the Common Framework, its yield spread initially halved to around 1'800 basis points, but then rose sharply from May 2022 onwards, to peak at over 7'400 basis points.

Both South Africa and Zambia experienced greater volatility in yield spreads within particular ratings, than they did in relation to ratings changes – although, in Zambia's case, each notch downgrade was accompanied by an average yield spread increase of almost 450 basis points.

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