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Rating the globe: reforming credit rating agencies for an equitable financial architecture

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UNU CPR

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Executive summary

This working paper provides a comprehensive overview of the role of credit rating agencies (CRAs) within the international financial architecture (IFA). It examines the structural issues affecting CRA practices and highlights the key drivers prompting calls for reform, along with the international community's proposed reforms. The paper also reviews regional initiatives in development intended to complement the CRA ecosystem and offers policy recommendations aimed at ensuring more inclusive representation and transparency, with a particular focus on African countries. The recommendations address systemic challenges faced by CRAs and their impact on Global South countries.

The CRAs play a crucial role in the IFA by assessing the creditworthiness of countries, companies and securities, significantly influencing investment decisions, bond interest rates and economic stability. In recent years, Global South countries have increasingly relied on CRAs to provide ratings for private creditors, such as pension funds and asset managers. These credit ratings are a critical first in obtaining private capital for countries' development needs.

Many Global South[1] countries have turned to private creditors for a variety of reasons such as declining levels of Official Development Assistance (ODA) compounded by various global crises, including the COVID-19 pandemic, economic downturns, climate change and global conflicts, which have narrowed fiscal space. For instance, the United Nations estimates a $4 trillion annual investment shortfall for developing countries to meet the Sustainable Development Goals by 2030, a 50 per cent increase from pre-pandemic estimates.[2]

The shift from concessional ODA to non-concessional loans has led to over 43 per cent of external debt in Africa now being owed to private creditors. Debt payments are projected to exceed $69 billion in 2024 on the African continent, surpassing the total aid received in 2021.[3] The continent's external debt as a percentage of GDP has been rising, and as of 2022, 20 low-income African countries are in or at high risk of debt distress (when a country cannot meet its financial obligations and needs to restructure its debt).[4]

The methodologies and decisions of CRAs have faced growing scrutiny, as their ratings have, at times, exacerbated debt distress or impeded access to necessary private capital for some Global South countries. This growing scrutiny highlights the need for reform to address challenges and improve the fairness of credit ratings.

The growing calls for reform

During the COVID-19 pandemic, numerous African countries, including Angola, the Democratic Republic of Congo and Ghana, faced credit rating downgrades, exacerbating their economic challenges. Leaders like Macky Sall (a former President of Senegal) and Ghanaian officials criticized these downgrades as biased and detrimental to their economies. The African Union's Africa Peer Review Mechanism (APRM) echoed these concerns, urging that CRA practices be re-evaluated to prevent further harm to vulnerable economies.

In response to these issues, international institutions and multilateral organizations elevated the debate on CRA reform. The United Nations, G20, Group of 24 at the International Monetary Fund, along with the World Bank, among others, made high-level recommendations for CRA reform. This dialogue was further advanced by the United Nations Secretary-General's Initiative on Financing for Development in the Era of COVID-19 and Beyond in September 2020 and the United Nations Independent Expert on Debt and Human Rights report on the human rights impacts of CRA practices a year later. They proposed specific recommendations including the creation of public-sector CRAs, improved methodological transparency, regulatory guidelines and incorporating environmental, social and governance criteria.

These efforts highlight a critical shift from a niche policy debate on CRAs to a broader global discussion, driven by the pandemic's impact and a growing recognition of the need for fairer and more transparent CRA practices.

Navigating systemic levers

To effectively address CRA reform, it is essential to understand the broader context in which CRAs operate. This includes considering two key factors: private creditors' fiduciary duties and the regulatory environments in the US and the European Union. Private creditors, particularly asset managers, have fiduciary responsibilities to prioritize their clients'

financial interests and also have diverse interests, which can lead to conflicts with sovereign debt relief efforts. Asset managers may find it challenging to participate in debt restructuring relief initiatives that might lower their returns, like the G20's Debt Service Suspension Initiative and its successor, the Common Framework. The complexities of managing diverse creditor interests and legal obligations highlight the challenges of achieving collective outcomes in debt restructuring.

In addition, the regulatory landscape in the US and European Union plays a crucial role in shaping CRA practices. Both regions have implemented stringent regulations post-Global Financial Crisis to hold CRAs accountable for reckless or fraudulent actions. The Dodd–Frank Act in the US and three pieces of European Union regulation impose liability on CRAs, influencing their behaviour. These regulations have made CRAs more cautious, sometimes leading to conservative ratings that may not fully reflect a country's fundamentals. As policymakers consider reforms, understanding these systemic risks and the incentives at play is essential for designing effective solutions that balance regulatory accountability with fair credit assessments.

Prevailing ideas for change

Since 2020, there have been several calls for reform from the international community that can be grouped in four key areas:

1. **Enhancing transparency**: There is a strong push for CRAs to improve transparency in their rating methodologies and data sources. This includes separating qualitative and quantitative factors and providing clear details on the data used in ratings.
2. **Enforcing regulatory frameworks**: There is a call to strengthen regulatory frameworks governing CRAs to ensure greater accountability and oversight. This includes proposals for establishing public CRAs, enhancing the role of international regulatory bodies and ensuring that CRAs adhere to higher standards of conduct.
3. **Incorporating sustainability-related data**: There is a growing demand for CRAs to integrate sustainability-related data into their rating methodologies to align financial assessments with broader sustainability goals. It is argued that this would provide a more comprehensive view of risks, especially with increasing climate crises that many countries are facing.
4. **Adjusting time horizons**: There are also calls for reforms for CRAs to adjust their time horizons in credit assessments. This involves revising the period over which risks and financial stability are evaluated to better reflect long-term economic and environmental changes. Adjusting time horizons would help CRAs provide more accurate and forward-looking ratings that align with evolving global challenges. Suggestions also include restricting CRAs from providing long-term ratings if they cannot be based on the appropriate time-horizon.

Gaining ground: emerging initiatives

In response to the growing concerns about CRA practices, a number of regional initiatives are emerging as complements to the existing ecosystem:

- **BRICS public CRA initiative**: The BRICS (Brazil, Russia, India, China and South Africa) countries have proposed creating a public CRA to offer an alternative to the "Big Three" agencies. Despite facing challenges due to differing national interests and the lack of a unified approach, this initiative highlights the desire for a more equitable credit rating system.
- **African Credit Rating Agency (AfCRA)**: The African Union has endorsed the development of AfCRA to provide an independent rating agency tailored to African needs, planned to launch in 2025. AfCRA is expected to enhance intra-continental integration, facilitate access to global capital markets and support capacity-building efforts across Africa, though its success will depend on overcoming diverse national interests and finding a suitable host for the agency.
- **Capacity-building**: Concurrently, to effectively engage with CRAs, it is crucial to enhance capacity-building initiatives, such as the APRM, the UNDP Africa Credit Ratings Initiative and the Africa Legal Support Facility which all help African countries develop the expertise for effective participation in credit rating processes. These initiatives help countries navigate the complexities of credit ratings and capital markets.

Policy recommendations

To address the issues identified, the following recommendations are proposed:

1. **Ensure African representation on the International Organization of Securities Commissions Committee 6**: This committee on credit CRAs is predominantly composed of representatives from the European Union and major CRA markets like the US, UK, China and India, with no current African member. Including an African representative would balance the composition and ensure that the perspectives and needs of African countries are better reflected in global credit ratings regulation.
2. **Mandate full disclosure of CRAs' data sources**: Requiring CRAs to fully disclose their data sources, including those related to sustainability, would enhance clarity in the rating process. This would address current limitations where data sources are vaguely referenced. This recommendation may be more acceptable to CRAs than full transparency, as it would address liability concerns under European Union and US law.
3. **Consider establishing African continental rating regulation**: In the long term, developing a continental credit-rating regulatory framework could address Africa's unique needs, hold CRAs accountable and enhance collaboration among African regulators. While it might be challenging due to the African continent's diverse political landscape, this step could strengthen regional capacity and create a more coherent regulatory environment.

By implementing these recommendations, the international community can work towards a more equitable and transparent credit rating system that supports sustainable development and financial stability in the Global South.

Introduction

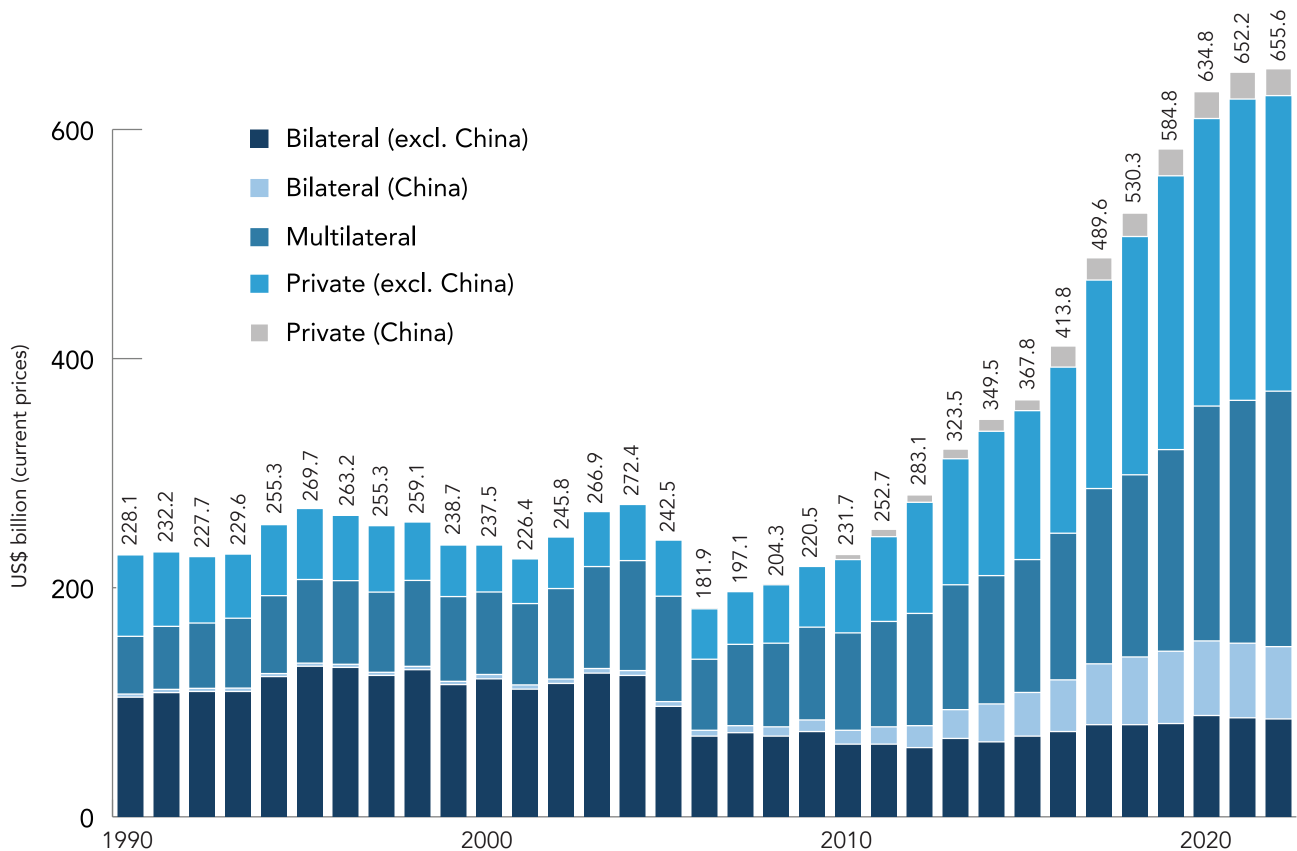
Various crises – such as the COVID-19 pandemic, climate change and global conflicts – coupled with countries' "collective failure to invest"[5] have hindered progress towards achieving the Sustainable Development Goals (SDGs) by 2030. The United Nations estimates that developing countries[6] face an annual investment shortfall of approximately $4 trillion to meet the SDGs – a 50 per cent increase from pre-pandemic estimates.[7]

Concurrently, Official Development Assistance (ODA) – government aid[8] designed to promote economic development and welfare of developing countries, and a traditional source of funding for Global South[9] countries – has been decreasing, by almost 4 per cent between 2019 and 2022 (excluding Ukraine and COVID-19 related funding).[10] This decrease is especially pronounced for African countries whereby the proportion of aid going to them (almost 26 per cent) is at its lowest point in over two decades.[11]

The United Nations Conference on Trade and Development (UNCTAD) estimates that an additional $30 trillion in investments[12] must be secured over the next several years to meet the SDG 2030 investment needs. Moreover, the International Monetary Fund (IMF) recently highlighted that the private sector would need to provide about 80 per cent of the required investment to meet emerging economies' climate goals alone.[13]

In turn, Global South countries have been turning to the international capital markets[14] to borrow for their development needs, issuing a variety of bonds to

Figure 1: Africa's changing financing landscape



Source: ONE, *Urgent Solutions for a New Era of Debt* (2024). See: https://data.one.org/data-dives/debt/.

Notes: ODA consists of bilateral and multilateral aid, and private capital consists of private creditors (i.e. investors). China is excluded in these categories as China self-classifies its contributions determining what is government and private capital.

private creditors – i.e. institutional investors,[15] such as pension funds and asset managers. These bonds are referred to as "sovereign bonds." Unlike ODA, which offers concessional financing with more favourable terms such as below-market interest rates or grace periods, these loans are considered non-concessional. Figure 1 highlights the significant shift from ODA to private capital in Africa over the last decade. Consequently, over 43 per cent of external debt in Africa is now owed to private creditors,[16] with debt payments on the continent projected to reach $69 billion in 2024 – surpassing total aid received in 2021.[17]

To engage with these private creditors, countries must issue "sovereign debt" products, denominated in a widely accepted currency, such as the Euro or the United States (US) dollar. Before doing so, they need to establish their creditworthiness through independent parties – credit rating agencies (CRAs) – which provide an objective score that helps private creditors understand if they will get their money back *on time* and *in full* (i.e. help them assess the level of investment risk).

The CRAs play a pivotal role in the international financial architecture (IFA), evaluating the creditworthiness of countries, companies and securities. The substantial influence of CRAs affects investment decisions, bond interest rates and state economic stability. However, for many Global South countries, CRA ratings over the past two decades have at times exacerbated debt distress or made it more challenging to secure private capital needed to meet development priorities, such as improving access to education and health care. Questions about CRA methodologies and decisions are multiplying and are fuelling calls for reform.

The push for change is situated within broader demands from the Global South and the international community to reform the IFA. A recent study by the United Nations University Centre for Policy Research (UNU-CPR)[18] synthesizes the Global South's change agenda into six desired outcomes:

- **Space**: Increased participation for underrepresented countries or groups in international financial institutions with the aim of amplifying their voice and increasing their representation.
- **Speed**: A more agile financial architecture that responds rapidly to complex global challenges. Agility is required in three dimensions: quickly halting resource outflows (extractive), quickly injecting/accessing resources (additive) and quickly adapting institutions to respond to global challenges and to reflect the changing global economic landscape (adaptive).
- **Scale**: Enhancing the funding available to meet global climate goals, maintain SDG commitments and address the ongoing debt crisis.
- **Sustainability**: Enhancing the global debt architecture, reducing debt service burdens, improving lending rates and enhancing transparency of financing instruments and processes.
- **Solidarity**: Working across diverse geographies more systematically to pool resources efficiently and fairly, notably through reforms to international taxation.
- **Self-reliance**: Supporting new institutions in the Global South that serve the Global South, including efforts to strengthen domestic revenue mobilization.

This paper provides an overview of CRAs in the IFA and the role they play, particularly in the Global South. It examines proposed reforms and offers additional recommendations that can be actioned now and over the medium term. The recommendations aim to help Global South economies attract capital and foster economic growth.

Box 1: Introduction to sovereign bonds

Bonds are tradable debt securities issued by a national government to raise money for their operations. They provide countries access to a wider pool of potential international investors. When investors purchase bonds, they provide financing to a country for a set period. In return, investors receive interest payments, typically based on a fixed "coupon" rate – a specified percentage of the bond's face value. The principal amount of the bond is repaid either in a single payment at maturity (known as a "bullet" payment) or according to an agreed amortization schedule.

Bonds can take various forms. Eurobonds, for instance, are defined as bonds issued outside the domestic market of the currency in which they were denominated. However, the term has since evolved to broadly refer to international issuances. The structures of bonds continuously evolve to allow issuers (both corporates and countries) to attract a wider universe of investors. Examples of bonds include social bonds, commodity-linked bonds, green and blue bonds, and sustainability-linked bonds.

The issuance of a foreign currency denominated sovereign bond has a well-established process, influenced by various factors such as the structure, legal documentation, target investor market, the nature of the involved parties and prevailing market conditions. The timeline for this process can vary, especially if it is the issuing country's first bond offering – referred to as a debut or inaugural issue – or if the bonds are being sold to investors in jurisdictions like the US, where investor protection laws are very developed. The bond issuance process typically has six stages: (1) pre-phase (2), selecting advisers and executors, (3) documentation, (4) investor communications and relations, (5) execution and (6) after-issuance phase. The CRAs come in stage 2 as the credit rating is considered a precondition for issuing a bond internationally and the rating affects the bond's price and issuance advice.

For more information on sovereign bonds: Patrick B G van der Wansem, Lars Jessen and Diego Rivetti, *Issuing International Bonds: A Guidance Note* (World Bank, 2019).

Africa Legal Support Facility, *Understanding Sovereign Debt: Options and Opportunities for Africa*, (2024).

Background and context: the role and workings of CRAs

A credit rating represents the creditworthiness of bonds, structured-finance products, companies or countries as determined by CRAs. The CRAs aim to provide an objective rating for private creditors indicating how confident the CRA is that private creditors (i.e. institutional investors) will receive their investment back in full and on time. The CRAs analyse both quantitative and qualitative data, which are often provided by the countries or corporates seeking ratings. The specific information required varies depending on whether the assessment is of a country or a company.

Although there are 117 active CRAs in the world, the CRA marketplace can be characterized as an oligopoly dominated by the "Big Three" agencies: S&P Global, Moody's and Fitch Ratings (all headquartered in the US). Each continent has its own rating marketplace, where the Big Three maintain varying degrees of influence. For example, in Africa, there are between seven and ten active CRAs[19] and the largest African-based agency, GCR Ratings, is fully owned by Moody's as of 2024.

Assessing a country's creditworthiness

Attracting external capital for a country is a complex process. A country can issue debt products for its domestic market or for international investors (referred to here as private creditors). Sovereign bonds are used as a mode of financing alongside a government's primary revenue source, such as taxes.[20] Debt products must be denominated in a widely accepted currency – typically in a currency other than the issuing country. This foreign currency bond is known as "Eurobond," which initially was defined as bonds issued outside the domestic market of the currency in which they were denominated. However, the term has since evolved to broadly refer to international issuances, now commonly defined as bonds issued in a currency other than that of the issuer (such as CHF, EUR, GBP, JPY or USD).[21]

Prior to issuing a sovereign bond for private creditors, countries need a credit rating. By maintaining good

credit ratings, a country can access the international bond market more easily, potentially attracting a steady flow of capital. Conversely, countries with low ratings face higher interest rates in international markets and a downgrade in a rating can deter private creditors from investing.[22] This potential outflow of private capital from a country demonstrates the impact that rating agencies' decisions can have.

Unlike companies, which are governed by commercial laws that can compel them to repay debts, there is no specific authority that compels countries to repay their debts. As a result, CRAs have to ascertain the country's *willingness* to pay, in addition to its capacity to pay.[23] The CRAs use data from the country, along with information from multilaterals like the World Bank and IMF, and their own "expert discretion." They assess factors listed in the table below, such as economic performance, political stability and other relevant elements.[24] This evaluation occurs near the end of the sovereign bond issuance process (see Box 1 for the stages of the bond issuance process), with the CRA rating influencing the bond's price and issuance advice.[25]

Table: The Big Three agencies' indicators

Indicators considered by the three dominant credit rating agencies			
		Fitch	
Economic assessment	Fiscal assessment	Structural features	External finances
Real GDP growth Real GDP growth volatility Inflation	Fiscal deficit Public debt Interest payments Public foreign currency debt	Money supply GDP per capita Government effectiveness Status of reserve currency Years since last default	Commodity dependence Current account balance plus net foreign direct investment Gross external debt of the general government External interest service Foreign exchange reserve
		Moody's	
Economic assessment	Fiscal assessment	Institutional assessment	"Event" risk
Real GDP growth Real GDP growth volatility World Economic Forum Global Competitiveness Index Nominal GDP GDP per capita Diversification Credit boom	Public debt Debt burden Debt trend General government foreign exchange debt/General government debt Other public sector debt Public sector financial assets	Government effectiveness Inflation Inflation volatility Track record of default	Domestic political risk Geopolitical risk Gross borrowing requirements Non-resident share of general government debt Market implied ratings Baseline Credit Assessment Total domestic bank assets/GDP Banking system loan-to-deposit ratio Current account balance + foreign direct investment External vulnerability indicator Net international investment position

Indicators considered by the three dominant credit rating agencies				
S&P				
Economic assessment	Fiscal assessment	Institutional effectiveness	External assessment	Monetary assessment
GDP per capita GDP per capita trend growth Diversification Credit boom	Change in general government debt Net general government debt Interest payment General government liquid financial assets, volatility of revenues Foreign currency government debt, remaining maturity Non-resident share of general government debt Flexibility of tax regime United Nations development index Demography Other public sector debt Sovereign exposure of banking sector	Effectiveness, stability, predictability and transparency of policymaking and political institutions Geopolitical and external security risk Debt payment culture	Status of reserve currency Local currency in circulation Current account balance Net international investment position International terms of trade	Exchange rate regime Credibility and effectiveness of monetary policy Inflation Real exchange rate stability Level of financial intermediation credit market

Source: Imre Ligeti and Zsolt Szorfi, "Methodological Issues of Credit Rating – Are Sovereign Credit Rating Actions Reconstructible?", *Financial and Economic Review*, vol. 15 (2016), pp. 7–32.

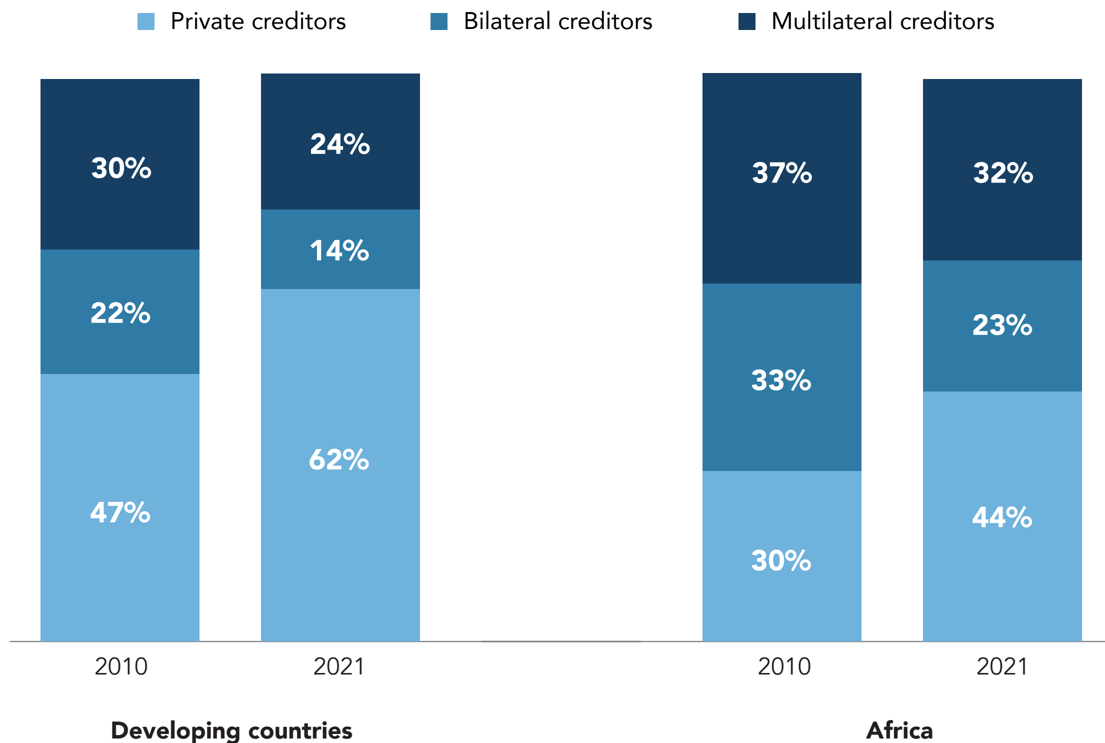
The rise of private creditors in the Global South and implications

Figure 2 illustrates that private creditors' investment in the Global South has been increasing since 2010 and they now hold a substantial portion of global sovereign debt (62 per cent in 2021).[26] This is especially pronounced in Africa, where private creditors held 44 per cent of total debt on the continent in 2021.[27] The African continent's external debt as a percentage of GDP rose between 2014 and 2020, and as of 2022, 20 low-income African countries are in or at high risk of debt distress (when a country cannot meet its financial obligations and needs to restructure its debt).[28]

The growing debt owed to private creditors is constraining the fiscal space of many African countries, leading to difficult policy decisions, such as shifting spending from development goals towards debt repayment. Even prior to the COVID-19 pandemic, more than 30 African countries were allocating more funds to debt service (interest plus principal payments on public and publicly guaranteed debt) than on health care.[29] UNCTAD notes that low-income countries spend five times more on debt servicing than on climate adaptation annually, undermining their resilience and growth prospects.[30] For example, in 2022 interest payments in Ghana consumed 70–100 per cent of government revenues,[31] and it is estimated that Nigeria will spend 59 per cent of its government revenue to debt repayment.[32]

With the increasing influx of private creditors into the Global South, countries are becoming more reliant on CRAs for their credit ratings. The dominance of the Big Three amplifies CRAs' influence, given that credit ratings affect investment decisions and can impact financial stability, as observed in African countries during the COVID-19 pandemic. The potential incidents of debt distress and the constrained financial resources of these countries, due to debt repayments, has prompted the international community to request a review of CRA practices and reform.

Figure 2: External debt: creditor composition (2010 and 2021)



Note: External Public and Publicly Guaranteed (PPG) debt.

Source: UN Global Crisis Response Group calculations, based on World Bank International Debt Report 2022.

The growing call for CRA reform

> "The concern is that the [credit rating agencies'] methodologies employed may not be consistently applied across the board, particularly for African countries."
>
> *Wale Edun, Finance Minister, Nigeria, March 2024*

The Global South, along with multilaterals and multilateral development banks (MDBs), is advocating for CRA reform due to two key factors: (1) the growing reliance on these agencies and (2) the impacts of credit rating downgrades on many Global South countries. This call for reform is part of a broader movement for IFA reform.

This section explores the key drivers behind the push for CRA reform. African leaders have been especially forceful in expressing discontent with CRA methodologies, notably in response to the downgrades their countries received during the COVID-19 pandemic. This has contributed at least in part to multilateral institutions moving the CRA reform up on the international agenda.

Credit rating downgrades in Africa raise concerns

The COVID-19 pandemic in the first half of 2020 and the subsequent global economic crisis[33] led African countries like Angola, the Democratic Republic of Congo, Ghana and Mali[34] to near immediate experience downgrades to their credit ratings – mostly due to the perception that the pandemic would strain their fragile economies.[35] Angola was downgraded by Fitch and Moody's for a combination of factors. As an oil-producing country, with oil and gas accounting for 90 per cent of exports,[36] the global decline in oil prices significantly impacted its economy which was compounded by rising government debt and reduced external liquidity.[37] The Democratic

Republic of Congo experienced a similar downgrade linking its troubled oil industry with a national budget deficit.[38] Zambia became the first country to default on its debt obligations after failing to settle a coupon on a $1billion Eurobond due in 2024.[39]

The African Union's Africa Peer Review Mechanism (APRM) noted with concern that CRAs were downgrading the same country multiple times in a short space of time, all based on the same rating drivers.[40] In a speech at the United Nations in 2022, the President of Senegal, Macky Sall, attributed the decline in investment to CRAs' actions, saying *"the perception of risk continues to be higher than the actual risk"* and suggested CRA bias against African countries.[41] Outside of Africa, the European Securities and Markets Authorities (ESMA) cautioned CRAs against deepening the crisis through 'quick-fire' downgrades as the outbreak was threatening to push many Global South countries into economic crises and recession.[42]

Ghana echoed the criticism by Senegal when Moody's downgraded the country, noting they were "*at odds to understand Moody's assertion of the deterioration of Ghana's institutional strength*" and that they had indeed addressed Moody's concerns.[43] Ghana, with the support of the APRM, argued that key processes were unfair, citing the deployment of a lead analyst without the required experience.[44]

Multilateral institutions and the wider international community responds by urging CRA reform

Prior to 2020, the regulation of CRAs was considered a niche domain of policy debate. From 2020, we have witnessed a growing appreciation of the role and impact CRAs have on development due to the COVID-19 pandemic and subsequent economic downturn. While many African leaders began expressing dissatisfaction with CRA practices, they also urged the international community to consider championing an agenda of CRA reform. The Group of 77 (G77) at the United Nations, the G20 and the Group of 24 at the IMF, as well as institutional leaders at the World Bank, IMF and the United Nations, responded swiftly by offering reform proposals, emphasizing the need for greater engagement with CRAs and "rationalizing the role of CRAs" within the broader IFA reform agenda.[45]

While many statements do not provide a detailed diagnosis of the challenges associated with CRAs or propose specific solutions, there was a shared understanding among these stakeholders that improving the Global South's access to finance in a sustainable and fair manner was essential to achieving the SDGs, and credit ratings were getting in the way. Elevating this issue on the global stage was a pivotal step on the journey to reform. The impact of their statements shows how the engagement of key multinational institutions and government coalitions can help drive the development of more nuanced solutions and compel key stakeholders within the sector to respond.

In May 2020, Canada, Jamaica and the United Nations Secretary-General launched the Initiative on Financing for Development in the Era of COVID-19 and Beyond to identify and promote financing solutions for the COVID-19 crisis. Six discussion groups were convened to address key financial challenges, including global liquidity and financial stability as well as debt vulnerability. This resulted in a comprehensive menu of short-, medium- and long-term policy options to reflect the views of Ministers of Finance from "all continents" and presented to global leaders at a high-level meeting in September 2020.[46] The Menu of Options for the Considerations of Ministers of Finance offered the first set of high-level recommendations for CRA reform, which included the following:

- creating public-sector CRAs
- establishing new regulatory guidelines for the inclusion of environmental, social and governance (ESG), climate and SDG-related information
- developing new methodologies contextualized for developing nations[47]

A year later, as the economic impact of the pandemic deepened, Yuefen Li, the former United Nations Independent Expert on Debt and Human Rights, highlighted the urgent need for CRA reform,[48] focusing on the human rights impact of sovereign debt. The report emphasized how CRA practices, particularly downgrades and negative credit alerts, can limit a country's fiscal space, citing Global South economies' experiences during the COVID-19 pandemic, which can make it more difficult for governments to invest in essential services like health care. The report identified structural flaws in CRAs:

- conflicts of interest stemming from the "issuer pay" model, where the entity being rated funds the rating, potentially compromising objectivity
- the dominance of the Big Three agencies, leading to an oligopoly
- a lack of transparency in the methodologies and criteria used for assigning ratings

The report urged comprehensive reforms at international, regional and national levels, challenging the international community to do more. Like the United Nations Menu of Options, the report concluded with recommendations to improve ESG criteria, though in line with human rights norms, and enhanced methodological transparency.[49]

These broad proposals and high-level recommendations are a critical first step to achieving meaningful CRA reform. However, translating broad proposals into actionable policies can be challenging given the complexity of the issues involved. While multilateral institutions agree on the need for change and offer similar proposals, more detailed, context-specific analysis was required. This detailed analysis emerged in December 2021, with the diagnosis by the United Nations Department of Economic and Social Affairs (UN DESA) of CRAs' methodological problems and policy solutions for regulators, CRAs and policymakers, ranging from increasing methodological transparency, enforcing stronger regulations by establishing a global "super-regulatory" body and adjusting CRA's credit rating's time horizons – discussed in the "Prevailing Ideas for Change" section.

Navigating systemic levers: private creditors' motivations and regulatory impact

Before examining the specific reforms proposed by the international community, it is crucial to understand the broader ecosystem within which CRAs operate. This ecosystem can present structural-level risks that can constrain reform measures, impacting their effectiveness. Two key factors are relevant: private creditors' incentives and the regulatory environments in the US and the European Union that CRAs must navigate.

Private creditors' fiduciary duties can impact sovereign debt management strategies

Within the sovereign bond market, non-bank private investors, primarily asset managers, dominate the group of private creditors. An asset manager invests money on behalf of their clients. Their goal is to maximize the value of an investment portfolio over time while mitigating risk, according to their clients' risk tolerance. These clients include a diverse range of institutional investors, such as pension funds, endowment funds and insurance companies, each with varying incentives and risk tolerances but all generally seeking a *return* on their investments. Asset managers have a fiduciary responsibility to their clients to act in their clients' best interests and make decisions on their behalf in good faith, which includes prudent risk management and adherence to regulatory requirements.

While some Global South countries have been able to negotiate debt repayment schedules or restructuring debt with official creditors (i.e. other countries, multilateral institutions and MDBs), the obligations of asset managers can create challenges for the debt relief and restructuring process.

1. **Fiduciary responsibilities**: An asset manager's legal obligation to act in their client's best financial interest can conflict with the concessions required in sovereign debt relief. Unlike official creditors, who might have more flexibility or broader geopolitical goals, many asset managers are primarily focused on maximizing returns and minimizing losses for their investors. This duty can make them less willing to agree to terms that could lead to restructuring that lowers the return on investment.

2. **Investment return expectations**: Asset managers typically invest in sovereign debt arrangements with the expectations of returns based on the evaluated risk and market conditions, using credit ratings as one of several tools to understand their risk exposure. When a country seeks debt relief, the potential reduction in returns (through lowered interest rates or extended maturities) can directly impact the financial performance of these investments. This may be challenging for asset managers who must justify these outcomes to their clients. This can make asset managers more resistant to participating in debt relief efforts.

As a practical example, these obligations have influenced private creditors' participation in two recent debt relief initiatives: the G20's Debt Service Suspension Initiative (DSSI) in May 2020 and its successor, the Common Framework, established six months later.[50]

The DSSI aimed to suspend up to $12.9 billion in debt service repayments for 73 eligible countries by inviting both official and private creditors to participate. However, despite initial interest from the Institute of International Finance,[51] a financial industry association, only one private creditor (a national development bank technically classified as a private creditor) joined.[52] Evidence suggests[53] a key obstacle for private creditor participation was the requirement for "comparable treatment" to official creditors – meaning they would need to agree to debt payments on similar terms potentially incurring losses for their investors.

The G20 Common Framework shifted focus from debt service suspension to debt restructuring. The Common Framework *mandated* comparable treatment for official and private creditors, potentially reflecting the challenges encountered with private creditor participation in the DSSI. While four countries have engaged with the Common Framework thus far, they are either already in default or are not rated,[54] rendering the threat of credit downgrades irrelevant.

The threat of a credit downgrade associated with debt relief programmes highlights the complex interplay between asset managers' fiduciary obligations and CRAs' rating decisions. Research shows that some countries were deterred from participating in the DSSI and the Common Framework because of the threat of credit rating downgrades.[55] For instance, both S&P and Fitch downgraded the credit rating of Ethiopia in 2021 after the country indicated it would be the first with sovereign bonds to utilize the new G20 Common Framework initiative.[56] The former Senior Vice-President and Chief Economist of the World Bank Group underscored this challenge:[57]

> "Countries will weigh that in… especially those countries which are still hoping to access private capital, to tap capital markets. The prospect of being downgraded is going to be a deterrent [to participate in the Common Framework]."
>
> *Carmen Reinhart, World Bank*

While debt restructuring is essential for countries facing financial difficulties, the G20 initiatives highlight the challenges of coordinating a large, diverse creditor base with varying interests and legal obligations to achieve a collective outcome that benefits a single debtor.[58] Individual creditors may be more likely to prioritize their interests over the broader group. Future debt relief and restructuring initiatives will want to consider how to incentivize private creditors' participation, in light of their legal obligations and financial incentives. David A. Grigorian, a senior fellow at Harvard University and a former economist at the IMF specializing in sovereign debt restructuring, has suggested a two-tier comparability of treatment formula, one for official creditors and another for all external private creditors, to create more options for creditors and faster resolutions.[59]

The section titled "Prevailing Ideas for Change" will explore other proposals from the international community that may help ease the debt burden, such as a stronger regulatory framework and adjusting time horizons in credit ratings.

The threat of legal liability in the US and the European Union

The Big Three CRAs originate from New York City[60] and are deeply embedded in the US and the European Union markets. The S&P operates 18 of its 88 global offices in the US and 16 in the European Union.[61] According to Moody's 2023 Annual Report, nearly 84 per cent of its revenue is generated from the US and Europe, Middle East and Africa region with most of this revenue coming from Europe, and their report primarily references European Union and US regulatory frameworks.[62] The combined factors of the agencies' physical presence in and significant revenues from the two regions underscore the pivotal role these regions play in shaping CRA operations and the potential for regulatory reform.

Over the last two decades, the US and the European Union have successfully passed legislation that imposes liability on CRAs, which holds them accountable for damages, losses or other consequences resulting from reckless or fraudulent actions. While liability was mostly enshrined within the US court and in individual European Union Member States' court systems pre-Global Financial Crisis (GFC), these laws were not stringent enough. In 2009 and 2010 the European Union and US, passed more stringent legislation aimed at CRAs.

More specifically, the US passed the Dodd–Frank Act Wall Street Reform and Consumer Protection Act (Dodd–Frank Act) in 2010. It is widely regarded as one of the most significant US regulatory reforms since the Great Depression.[63] Among other issues, the Act

addressed CRA transparency. This includes features such as mandates for annual reports on internal controls, management of conflicts of interest, form disclosure of performance statistics, methodologies and data underlying credit ratings and more.[64] More specifically, the Act established civil responsibility, which holds a CRA legally liable for losses if its activities are proven to be reckless or fraudulent in character.

In 2011, the European Union created the ESMA to regulate its financial markets including CRAs. After many European countries experienced credit rating downgrades post the Eurozone Debt Crisis in 2011, the European Commission created the most extensive regulatory framework for CRAs globally by implementing measures like preventing ad hoc rating action (i.e. requiring CRAs to publish a ratings calendar and provide advance notice), applying liability (this type of liability did not exist in the European Union prior to this regulation), enforcing transparency, increasing competition and more.[65]

Both the US and European Union regulations state that if a CRA acts in a fraudulent manner which adversely impacts a private creditor (i.e. if an investor incurs financial loss), the CRA can be held liable for their actions, if a private creditor can prove the following:

- the CRA must knowingly have acted recklessly
- the CRA must know who was going to be harmed (i.e. who exactly was going to use the rating they issued)

The European Union and US regulations cover both sovereign and corporate credit ratings, and there is legal precedent for investors suing CRAs over financial losses. In 2009, the California Public Employees' Retirement System (CalPERS) sued the Big Three agencies, alleging that they assigned AAA ratings to bonds backed by sub-prime mortgages. Similarly, in 2013, the US Department of Justice (DOJ), representing 19 states and the District of Columbia, filed lawsuits against S&P and Moody's for the same reason. These cases were financially settled by S&P and Moody's, while Fitch provided information to CalPERS for discovery, avoiding a financial settlement. The details of both lawsuits are provided in Box 2.

Compared with practices prior to the GFC, CRAs today are more inclined to issue a downgrade when there is a perception of risk, in part because of these more stringent regulations that hold the CRA liable if it does not react swiftly to new risk information. The cases that were lodged against them may have also created weariness among CRAs. For instance, empirical analysis indicates that the Dodd–Frank Act has made CRAs more "protective of their reputation."[66] More optimistic ratings (i.e. "inflated" ratings) could invite legal and regulatory scrutiny. For this reason, CRAs may lower their ratings "beyond a level justified"[67] by a country's fundamentals.

Policymakers should consider the structural risk posed to future proposed reforms when evaluating the potential effectiveness of proposed reforms. The actionable recommendations offered in this paper aim to mitigate this risk while also improving the credit ratings landscape.

Box 2: Legal impact on CRAs: insights from CalPERS and DOJ lawsuits

In 2009, CalPERS filed a lawsuit in California against Moody's, S&P and Fitch Ratings centred on structured investment vehicles, which include complex packages of loans and debt, such as sub-prime mortgages and collateralized debt obligations (CDOs). CalPERS purchased $1.3 billion in debt from structured investment vehicles that the CRAs rated AAA, and CalPERS alleged these ratings were inflated, leading to substantial losses ($1 billion) starting in 2007 when the value of these investments collapsed.[68] The pension fund sought unspecified damages for the losses incurred. This case was part of a broader legal and regulatory response to alleged misconduct by CRAs during the GFC, such as the lawsuit filed by the DOJ.

In 2016, Moody's paid $130 million to CalPERs to settle allegations of negligence related to their ratings of sub-prime mortgage-backed bonds, and concurrently CalPERS settled with S&P for $125 million.[69] In 2011, CalPERS dismissed its claims against Fitch, after Fitch agreed to provide certain discovery as a third-party witness in a related case.[70]

The settlements are the largest known recoveries from Moody's and S&P in a private lawsuit for civil damages, and also led to a landmark appellate court opinion, which established CRAs can be held liable for negligent misrepresentations under California law, specifically in relation to their ratings of privately placed securities.[71]

Similar to the CalPERS case, the DOJ, representing 19 US states and the District of Columbia, accused S&P and Moody's of misrepresenting the objectivity and independence of its ratings, noting they were influenced by its business

relationships with investment banks, leading to inflated ratings for Residential Mortgage-Backed Securities and CDOs. S&P, for instance, is alleged to have ignored warnings from analysts and maintained positive ratings on securities despite deteriorating conditions. The DOJ settled with S&P in 2015, with $687.5 million paid to the federal government (paid as a penalty) and $687.5 million distributed among the 19 states and the District of Columbia.[72] S&P acknowledged that its rating decisions were affected by business considerations and agreed to adhere to consumer protection statutes and respond to information requests from the settling states. Moody's reached a $864 million settlement in 2017, resolving allegations that its ratings of Residential Mortgage-Backed Securities and CDOs were flawed and misleading.[73]

As a result of the settlements with DOJ, Moody's, for instance, agreed to implement several reforms, including separation of commercial and credit rating functions, independent review of rating methodologies and enhanced oversight and documentation of rating procedures.

These legal actions reflect broader concerns about the role of CRAs in the GFC and their practices related to rating structured financial products and underscored the need for greater transparency and accountability in credit rating practices. Additionally, the settlements highlight the efforts to enhance regulatory oversight and prevent similar misconduct in the future.

Prevailing ideas for change

The past three years have prompted assessments and actionable recommendations that could drive change in CRA operations. These developments are likely due to a combination of factors such as the COVID-19 pandemic's significant effect on a country's access to finance; the evolving risks and opportunities presented by technology that can affect rating methodologies and innovation;[74] and various global crises (climate, economic and violent conflicts) that contribute to rising systemic risk. These recommendations can be categorized into four themes:

- a push to enhance transparency in CRA's methodologies
- stronger regulatory frameworks
- incorporating sustainability-related information in credit ratings
- adjusting credit ratings' time horizons

This section will outline key proposals for reform and challenges associated with their implementation.

Opening the black box: the push to enhance transparency

When some African countries experienced credit rating downgrades during the pandemic, their leaders claimed the CRAs were "biased" against them. Outside of Africa, other government officials, especially after the GFC, have raised similar concerns. For instance, the Chief Economic Adviser of the Government of India implied that subjectivity in CRA assessments can lead to cognitive biases.[75] The G77 Ministers encouraged CRAs to adopt independent ratings based on "accurate" and "sound analytical methods."[76]

There is a difference between bias and subjectivity. Bias can be conscious or unconscious but is based on discrimination while subjectivity is an integral part of the credit rating analysis. Sovereign credit rating analysis incorporates a high degree of subjectivity, given the need to ascertain the willingness of a country to repay the debt, as well as the ability to repay. While there is no evidence that specifically confirms bias against the Global South in CRA methodologies,[77] there is evidence to suggest that subjectivity in assessments negatively impacts countries' ratings. For example, a Brookings Institute study demonstrated that CRAs have added unfair "risk premiums" to African countries' ratings,[78] and a 2023 UNDP study found that the qualitative elements in a CRA's methodology can introduce subjectivity in their assessments. The UNDP study raised concerns that the underlying assumptions about countries may be disconnected from actual events on the ground. It concluded that African governments could save almost $75 billion with more objective ratings.[79]

Publicly disclosing CRA methodologies

As far back as 2004, the International Organization of Securities Commissions (IOSCO) attempted to offer to address this transparency challenge and produced a voluntary code of conduct that recommended CRAs publish their methodologies, among other principles.[80] However, the 2008 analysis by UNCTAD of the CRA response to the IOSCO Code revealed that CRAs simply published "lengthy research reports and publications" to explain their processes and published *some of their criteria*, but concluded that CRAs' methodologies remained opaque.[81]

UN DESA proposed more specificity to IOSCO's voluntary code, arguing that CRAs should be compelled to publicly separate the quantitative elements of a rating from the qualitative elements in their reports. This would clarify the subjective aspects of the rating, such as considerations of a country's governance and politics, in contrast to the more quantitative evaluation of default risk. UN DESA noted this separation could also help CRAs distinguish their methodologies from one another and demonstrate the value they add as a service provider. A year later in 2022, UN DESA strengthened this recommendation, adding that CRAs should be encouraged to include and publicly share scenario analyses and simulations of debt dynamics under various economic and non-economic assumptions, such as climate transition pathways.[82]

Legislation requiring improved transparency in methodologies

The US and European Union passed legislation after the GFC to increase transparency in credit rating methodology. As a result, CRAs provide additional guidance on how their methodologies are constructed; however, research suggests that CRAs make broad references to data sources and do not include specific explanations as to how they are used. In 2024, the ESMA proposed to amend the Credit Rating Agency Regulations to focus on increasing transparency through the consistent application of credit rating methodologies, improved inclusion of ESG factors in the credit rating methodologies and disclosure to the public.[83]

Academics have underscored the need for a comprehensive regulatory framework for CRAs, cautioning that a sole focus on transparency may lead to unintended consequences, such as inflated ratings.[84] This is particularly the case if transparency is prioritized over other critical components, including the issuer-pays model and CRA competition.

Challenges to enhancing transparency

There are numerous advantages to improving methodological transparency, such as clarifying how qualitative elements are incorporated in decision-making, highlighting the data sources and analytical methods used in ratings and how sustainability-related information, progress on SDG goals and country context are tailored into rating assignments (if at all). This can reduce subjectivity and help countries understand how they might improve their ratings. However, data transparency also presents risks for CRAs in the post-GFC regulatory environment, namely legal liability that CRAs face under US and European Union law.[85]

Full disclosure of CRAs' methodologies, including qualitative data interpretation and expert judgment, could expose them to increased liability under the Dodd–Frank Act and European Union law. With greater transparency into the data and decision-making process, private creditors may find it easier to substantiate claims of reckless rating behaviour. As the burden of proof lies with claimants under European Union and US law, this increased transparency could embolden creditors to challenge ratings, alleging that CRAs knowingly inflated ratings.

While improved transparency is an important element of CRA reform, subjectivity may be required in CRA methodologies for CRAs to exercise their expert judgment and sell their product. This paper proposes that mandating the disclosure of data sources – both qualitative and quantitative – can both increase transparency and maintain legal protections for CRAs within the current legal framework.

Enforcing a stronger regulatory framework

There have been various proposals to strengthen regulatory frameworks, which can be broadly categorized into two themes:

- strengthening African nations' national regulatory frameworks
- establishing a global regulatory body

Strengthen domestic regulation

On the African continent, the APRM and the United Nations Economic Commission for Africa (UNECA) have convened the Network of National Regulators of Credit Rating Agencies,[86] which brings together all the

national regulators on the continent. It has been tasked with overseeing credit rating activities. The APRM and UNDP have urged the regulators to do more to develop stronger regulatory frameworks in their respective jurisdictions.[87, 88]

Strong national oversight, as the European Union and US regulations illustrate, can lead to stricter disclosure requirements, provide tools to sanction CRAs for non-compliance, and broaden regulatory authority over CRA activities. Furthermore, collaboration between national regulators can enhance regulatory effectiveness by fostering information-sharing and coordination.

Enhance national capacity for effective oversight

Analysis supports that effective regulations may be hard to enforce because of a lack of technical and political capacity on this topic specifically.[89] The APRM aims to address these challenges by building the technical capacity of African countries to engage in CRA processes and also the decisions themselves – such as comparability of analytical treatment.[90]

Supersize supervision: establishing a global "super-regulator"

UN DESA has suggested that a global "super-regulator" should instead be pursued.[91] Their model would have representatives from all regions participate in this initiative, which would ultimately complement national regulators to monitor ratings and ensure comparability. UN DESA argues that the global super-regulator could specifically mandate comparable rating methodologies globally and require CRAs to disclose detailed information about their decision-making processes, including comprehensive committee meeting minutes. They also suggest that the global regulator could assess the quantity and quality of CRA analysts, using objective metrics to avoid potential issues such as bias that has been raised by the international community.[92]

Similarly, the Civil Society for Financing Development Mechanisms has encouraged the United Nations to establish a multilateral legal framework headed by a universal, intergovernmental commission at the United Nations Economic and Social Council. The suggestion is that such a committee would examine the required institutional innovations needed to correct the "adverse impact" of the CRAs on the Global South, and could lead on initiatives like promoting competition, reducing conflicts of interest and promoting a global public CRA.[93]

To be an effective super-regulator, a number of challenges would need to be addressed and clarified: defining the scope of the regulator; obtaining buy-in and consensus among countries that may have different national interests, particularly in light of the significant US and European Union regulatory influence on CRAs; enforcement challenges (due to different legal systems); resource allocation and potential resistance from CRAs.

Another proposal that has been suggested in the literature is to pass legislation that *removes* liability in particular areas of the CRAs' business.[94] For example, removing the legal constraints that undermine the efficacy of the DSSI and the Common Framework. Special legal protections could be established for CRAs under specific conditions, such as when a country from a designated list seeks to join the Common Framework. These protections could shield CRAs from liability for not downgrading a country, even in cases where it may lead to investor losses.[95] The creditor committees, however, would have to endorse such applications to the Common Framework.

Alternatively, this paper recommends that African countries work towards establishing a Pan-African regulatory body that can serve as a super-regulator for the region. This body would represent the diverse interests of member countries, oversee CRA activities and build capacity in African countries. Further details on sthis proposal are discussed in the "Policy Recommendations" section.

Rating for the future: integrating long-term sustainability metrics into CRA ratings

Over the past two decades, ESG investing has evolved, which integrates sustainability criteria into business and investment decisions.[96] As climate-related crises and societal concerns grow, there is increasing support for incorporating ESG data into sovereign credit ratings. Many advocates argue that material ESG factors – those that could significantly impact a country's financial performance and economic outlook – should be considered alongside traditional financial metrics.[97]

There are two specific examples that reflect this growing interest:

a. The United Nations Principles for Responsible Investment have created an initiative that works closely with 28 CRAs and 180 investors (as of July 2024) to support systematic and transparent

integration and have had success. Now CRAs are more regularly documenting how they are integrating material ESG issues (for corporate ratings),[98] and the initiative is now exploring how CRAs can extend their ratings to cover longer time horizons (i.e. beyond five years)

b. The ESMA's proposed overhaul of the Credit Rating Agency Regulations has a focus on enhanced disclosures by CRAs on the relevance of ESG in ratings and outlooks and recommends systematic documentation of the relevance of ESG factors in methodologies.[99]

Hurdles to incorporating ESG data

There is mixed evidence on the successful integration of ESG data in sovereign credit ratings. The challenges can be categorized into three themes:

1. Challenges in defining and measuring ESG criteria

A key challenge to CRAs' success in integrating ESG criteria lies in the lack of a universal definition of "sustainability." The IMF points out that this complicates the development of a coherent ESG investment strategy for issuers (i.e. countries) and most existing sovereign ESG scores tend to assess sustainability risks through the lens of financial returns rather than emphasizing positive sustainability outcomes.[100] This limited focus narrows the scope of ESG integration, as the emphasis remains primarily on financial performance, often neglecting broader sustainability goals.

For instance, an Asian Infrastructure Investment Bank (AIIB) report further notes that developing economies can get better debt pricing if they illustrate GDP growth, even if it means their ESG scores are lower and thus ESG criteria must be better priced in.[101]

> "We have to incorporate long-term sustainability metrics into economic growth and credit rating frameworks, so that the investment community can understand the short GDP boost that comes at the expense of capital resources has a cost."
>
> *Jang Ping Thia, AIIB, COP28*

This suggests that traditional financial metrics, such as GDP growth, are still prioritized over sustainability considerations.

Furthermore, simplified ESG metrics, which aggregate various issues into a single measure, can undermine the analytical accuracy of these assessments,[102] and fail to capture the nuanced and multidimensional nature of ESG risks, leading to less reliable evaluations.

2. Governance as the primary ESG focus

Studies show that governance (the "G" in ESG) is the component most consistently integrated into sovereign credit rating methodologies.[103] The CRAs themselves acknowledge that governance and institutional strength have historically been central to their evaluations.[104] However, the rate of integration of governance factors remains inconsistent across different agencies and regions, leading to variability in how governance is weighed in credit assessments.[105]

3. Inconsistent evidence on broader ESG integration

There is mixed evidence on how well CRAs capture broader ESG performance beyond governance. Some studies suggest that strong ESG performance is often reflected in credit ratings, with CRAs recognizing both the risks and opportunities presented by ESG factors.[106] For instance, increased exposure to climate-related issues is occasionally accounted for in credit assessments. However, other studies find little correlation between a firm's ESG performance and its credit rating, attributing this to the short time-horizon typically used in credit ratings. This inconsistency highlights a gap in integrating long-term ESG risks,[107] particularly those related to environmental and social factors, into sovereign credit ratings.

Proposals for improved ESG integration

Despite the growing recognition of ESG's importance, there have been limited specific proposals for integrating sustainability into credit rating methodologies beyond calls for greater transparency. Improving the transparency of rating methodologies and clarifying ESG criteria are viewed as initial steps towards better ESG integration. The IMF recommends that ESG sovereign scoring methodologies should better reflect the developmental stages of countries and should clearly distinguish between impact-oriented objectives and financial materiality within ESG frameworks. This distinction is essential for ensuring that ESG assessments align with investor goals and country-specific contexts.[108]

Additionally, the Institute of Energy Economy and Financial Analysis, a markets-based research firm, advocates for increased transparency at the final stage of the credit rating process – the credit rating committee – by making the constitution and deliberations of the

rating committee public. They also recommend including an independent sustainability expert from a rotational panel on every credit rating committee to improve the objectivity and accuracy of ESG integration in credit assessments.[109]

The long view: adapting time horizons for credit ratings

Typically, CRAs use a time-horizon of three to five years for their ratings. As the time-horizon extends, a CRA's calculations will incorporate more uncertainty and risks, including ESG-related ones. The resulting rating will affect an issuer's ability to generate cash flow. Consequently, CRAs tend to concentrate on shorter to medium-term assessments where there is greater clarity and predictability. However, there are discussions about the need to adjust these time horizons to both better reflect long-term sustainability and effectively assess long-term risks and opportunities.

The United Nations Secretary-General has said that "more favourable long-term" ratings are needed.[110] UN DESA propose an innovative recommendation suggesting that CRAs should either be (a) compelled to make more explicit longer-term ratings or (b) be prohibited from rating bonds over and above a certain maturity, e.g. 10 years.[111] If CRAs were prohibited from rating longer maturity bonds, their ratings then may exclude a significant portion of the bond market from evaluation, impacting private creditors, like pension funds, who rely on long-term ratings. Conversely, if CRAs were compelled to make more explicit longer-term ratings it may increase the exposure of CRAs to liability as their risk assessments would be based on data that may not be as accurate and they could thus be subject to "reckless" decision-making as per the Dodd–Frank Act and ESMA.

At the same time, UN DESA recognizes that shorter time horizons may enhance the accuracy of ratings by focusing on more immediate and relevant information and allow for more focused ratings by avoiding the complexities associated with very long-term bonds. They have argued that the actual rating time-horizon should not be beyond two or three years, given the complexity of the growing economic and environmental landscape.[112]

Adjusting time horizons in credit ratings involves a trade-off between short-term accuracy and long-term insight. While proposals to shorten time horizons or restrict maturities could enhance focus on immediate risks and potentially lead to more sustainable outcomes, they may also limit the scope and stability of long-term investment strategies. Balancing these considerations is crucial for aligning credit rating practices with broader financial and developmental goals.

Gaining ground: emerging initiatives

In response to growing concerns about the biases and limitations of private CRAs, several regional initiatives have either emerged or are in development to provide an alternative framework. Efforts such as the Brazil, Russia, India, China and South Africa (BRICS)[113] Public Rating Agency and the African Public Rating Agency (AfCRA) aim to enhance self-reliance and provide these countries with a stronger voice in shaping credit rating policies. This section explores the potential benefits and challenges associated with these initiatives.

A public CRA

The idea of establishing a "public CRA" is not new. Dating back to 2001, scholars considered the constraints and opportunities of a public CRA. The idea resurfaced after the COVID-19 pandemic[114] because of the accompanying economic crisis.[115] In 2020, UNCTAD strongly advocated for an international public CRA to provide objective expert-based ratings of the creditworthiness to countries.[116] This idea was recently repeated by the Civil Society Financing for Development Mechanism, which argues that a public CRA should be established within the United Nations.[117] A public CRA can offer a benchmark against the ratings of the Big Three agencies, providing a new way of interpreting these private ratings.[118]

Additionally, such a public CRA could provide ratings to small and medium enterprises (SMEs),[119] which are critically important to Global South economies. Globally, SMEs – both formal and informal – account for about 90 per cent of all businesses and 50 per cent of employment – yet they are often locked out of the formal financial

system as they do not have access to financial services and products like bank accounts or credit scores.[120] It is worth noting that Banque De France developed a confidential rating process that allows SMEs access to credit in France with much success.[121] Similar initiatives are in progress in parts of Africa and there are early signs of successful adoption, indicating that they have the potential to scale funding to SMEs and mobilize domestic resources.[122]

Challenges with a public CRA

While a public CRA can improve methodological transparency compared to private CRAs, research suggests that it also some limitations. For instance, ratings could not rely on confidential information unlike private CRAs' ratings, which use such data to "alleviate concerns over liabilities that may arise from the ratings."[123] Misheck Mutize, the Lead CRA Expert at APRM, along with an academic at the University of Cape Town, identifies three potential hurdles:

- gaining the trust of international investors in the public CRA
- generating enough influence to attract subscriptions or issuers to generate revenues
- overcoming investor scepticism about the public CRA's ability to compensate for losses if litigation arises[124]

An attempt to establish a public CRA

In 2012, Markus Krall, along with the consulting firm Roland Berger, attempted to establish a European CRA. Their vision was to create an institution funded privately but structured as a foundation, with an initial focus on sovereign ratings. Although the project garnered early support from German politicians and the European Commission, it faced significant criticism. Concerns were raised about the financial resources, and the potential for conflicts of interest, as well as the agency's ability to maintain independence. Additionally, legal and liability issues emerged, particularly regarding the implications of state endorsement of such an initiative in private markets and the risk of international investors pursuing litigation against the agency in foreign jurisdictions like the US.

A study by the European Parliamentary Research Services claimed that while one of the objectives of supporting the European CRA was to inject positive bias for European countries, this would introduce a legal risk, as "Incorrect reporting – or the voluntary introduction of bias – fall under laws sanctioning market manipulation."[125] In the same year, the Bertelsmann Foundation tried to create the International Non-Profit Credit Rating Agency. The initiative failed to materialize for similar reasons.[126]

A public CRA can support the development of domestic credit markets by filling in the gaps left by the absence of private CRAs, can help build solidarity among countries and potentially increase countries' representation in global discussions. Nevertheless, any perceived influence of a state (or a multilateral institution) could prevent private creditors' willingness to use a public CRA's assessment, potentially making it challenging to compete with the Big Three agencies.

BRICS public CRA initiative

There are two globally significant attempts to establish public CRAs. The BRICS governments announced their intention to establish a public CRA in 2015. A study by the University of Waterloo (Canada) notes that the BRICS tried to work with global structures, like the G20 and IOSCO, but were frustrated with "quite limited" post-GFC reforms.[127] For instance, the G20 required CRAs to follow a revised code of conduct from IOSCO; however, this code – and a further revision in 2015 – mainly focused on transparency, rather than addressing more critical issues like how they are funded or rating methodology. Additionally, the G20 committed to reducing market reliance on credit ratings, and in 2010, the Financial Stability Board created principles to guide this effort, but progress on reducing dependence on ratings has been slow.

The idea to create a public CRA for the BRICS emerged from the Indian Government's criticism of the Big Three CRAs in the aftermath of the GFC. The Indian authorities argued that CRA approaches did not adequately understand India's situation, the ratings exhibited pro-US bias and thus their ratings threatened national sovereignty.[128] Soon after, Russia accused the Big Three of "political bias" and argued that their downgrades were acts of aggression.[129]

Even though Indian and Russian criticism of CRAs intensified after 2012, BRICS members could not agree on a way forward. Some of these reasons follow:

- BRICS members have an uneven appetite for reform as the countries have different credit ratings reflecting their economies. For instance, Russia created its own CRA – the Analytical Credit Rating Agency – to assess the creditworthiness of its domestic banking system in response to changes in the US legislation and sanctions that caused CRAs to leave the market.[130]

- The BRICS countries are very different from one another in terms of national interests, priorities and economic systems. Each member faces unique challenges and pursues distinct goals, reflecting their varied approaches to business, economic development and geopolitical strategies. These differences underscore the complexity of aligning their diverse agendas within the BRICS framework.

China ultimately blocked the BRICS public CRA initiative at the Goa Summit in 2016.[131] China enjoys a high credit rating relative to its BRICS peers, and any sovereign debt downgrade rarely affects its domestic bond markets, due to the limited participation of foreign investors inside China, as well as the large reserves and domestic savings within the country.

A study by the University of Waterloo on the BRICS CRA argues that for a new international structure to be developed, there must be two distinct elements: a template to utilize and a common purpose among those seeking to design the new entity.[132] The BRICS public CRA had neither of these two elements: there is no successful public CRA to date to use as a model, and individual members have not been able to reach consensus. Scholars further add that foreign investors need to be able to *trust* the impartiality of a public CRA and given its connection to the State (even if designated as a private entity) it can be challenging to establish that trust.[133]

As Russia assumes presidency of BRICs in October 2024, its Central Bank Governor noted that one of the key initiatives is the formation of a CRA that would be "supranational"[134] (covering all countries, not just BRICS members). The Governor also noted that while the idea of a supranational CRA was "promising," it involved a lot of "complex issues," and that "*mutual recognitions of ratings will be faster and more practica*l."[135]

Unlike the European Union, which benefits from a shared currency and geographic cohesion, the diverse national interests within the BRICS coalition can complicate the establishment of a public CRA. Nonetheless, the BRICS experience offers valuable lessons for other efforts, such as the AfCRA.

African Credit Rating Agency (AfCRA)

In 2020, African leaders adopted a declaration stating that a public CRA should be created.[136] The African Union appointed the APRM to develop the AfCRA.[137] Since then, interest and support for the initiative has increased. In 2024, the President of the African Development Bank (AfDB) reiterated the need for AfCRA to "*accelerate structural transformation and finance its implementation.*"[138] This led the African Union to request AfDB and Afreximbank to support the APRM in developing and operationalizing AfCRA.[139] In March 2024, the APRM held an operationalization meeting in Zambia to discuss final details and launch the proposed logistics and timeline for the creation of the public CRA.[140] The APRM announced that AfCRA will be launched at the beginning of 2025 (see Figure 3 for a detailed timeline).

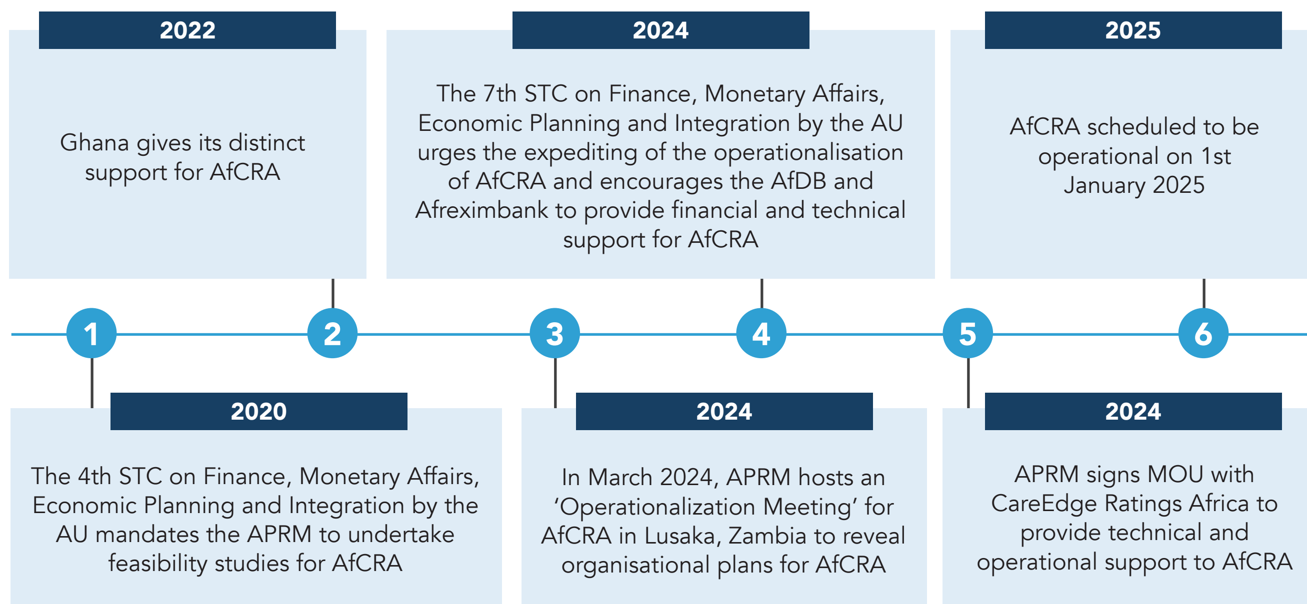
The AfCRA intends to be independent, funded by shareholders and owned by Pan-African MDBs, domestic CRAs (five to date, who have no ties to the Big Three) and domestic and international investors. The proposal also indicates that it will have an independent shareholding and governance structure, and comply with the legal constraints of the jurisdiction it will be domiciled in. In May 2024, shortly after the meeting in Zambia, APRM signed a memorandum of understanding with Mauritius-based Care Edge Ratings (Africa) to provide support for the development of AfCRA, such as helping to develop methodologies and rating models.[141]

> "An Africa Credit Rating Agency is an important step towards intra-continental integration that would enable African governments to access capital and integrate the continent with global financial markets."
>
> *Dr. Misheck Mutize, APRM*[142]

The AfCRA has a lot of potential. It can foster collaboration on the African continent by way of formalizing partnerships under the umbrella of the public CRA. For instance, it could partner with the Network of Credit Rating Regulators that has been developed to inject knowledge and training. The AfCRA could also become an umbrella organization for capacity-building initiatives across the continent, like those developed by APRM and UNECA. The AfCRA could also institutionalize a greater focus on SME ratings, which is an increasingly important sector on the African continent.[143]

However, like the BRICS CRA, when nation States collaborate without a formal and convergent political and economic structure that governs the pathway forward for the bloc (like the European Union), competing interests may hold the initiative back, demonstrated by the influence of China in the BRICS CRA. Not every African country may need AfCRA, as some countries are performing well (i.e. Botswana and Mauritius) and

Figure 3: The Journey for AfCRA



others are developing their internal capacities and seeing incremental upgrades as a result. To date, there is no natural host for AfCRA on the continent.

Capacity-building measures

While establishing new CRAs could be important for Africa and other regions, maintaining engagement with established international CRAs will continue to be crucial, given the important role these CRAs play in the IFA. It is therefore essential to consistently ensure the capacity to effectively participate in the credit rating process. This section reviews two specific capacity-building initiatives related to CRAs: the APRM and the UNDP Africa Credit Rating Initiative.

Capacity-building is widely regarded as essential for fostering sustainable socioeconomic development, especially in developing and emerging countries. The African Capacity Building Foundation (ACBF) defines it as the collective ability of people, organizations and society to effectively manage their affairs and achieve successful outcomes, and notes that capacity-building should be a continuous effort to be impactful.[144] Scholars have identified several challenges in capacity-building initiatives, including power imbalances between international organizations and local communities, a lack of tailored solutions that address local contexts and insufficient funding or leadership to ensure sustainability. Despite these issues, capacity-building is concurrently also widely recognized as a crucial "missing link" in Africa.

Capacity-building is crucial for effectively engaging with CRAs, given the specialized and technical nature of credit ratings. In turn, countries need in-depth knowledge and experience to interact successfully with these agencies. This underscores the need for more specialized capacity-building initiatives to address these technical requirements effectively. Weaknesses in capacity can translate to undercutting economic policy reforms by short-circuiting efforts, failing to provide a robust platform or not building the physical and social infrastructures.[145]

> "African countries need to engage with credit rating agencies to understand their methodologies and make sure the assessments are in line with macroeconomic fundamentals."[146]
>
> *Dr Daouda Sembene, Managing Director of AfriCatalyst (UNDP Africa Credit Rating Initiative Partner)*

Two major initiatives are addressing this need. The APRM, established in 2003, supports African countries with credit rating issues through training workshops, country visits and convening experts and members from the credit rating community to engage with country officials on pressing matters. The latter focuses on improving the technical capacity of staff to engage effectively with CRA analysts and their assessments.[147] The APRM also works closely with UNECA to biannually publish the only dedicated research document on credit ratings from an African perspective.

Additionally, the UNDP Africa Credit Ratings Initiative offers resources such as a public web portal containing methodological information, data and research on credit ratings, a private portal for direct specialist engagement and a Community of Practice that shares best practice and fosters collaboration regionally and internationally.

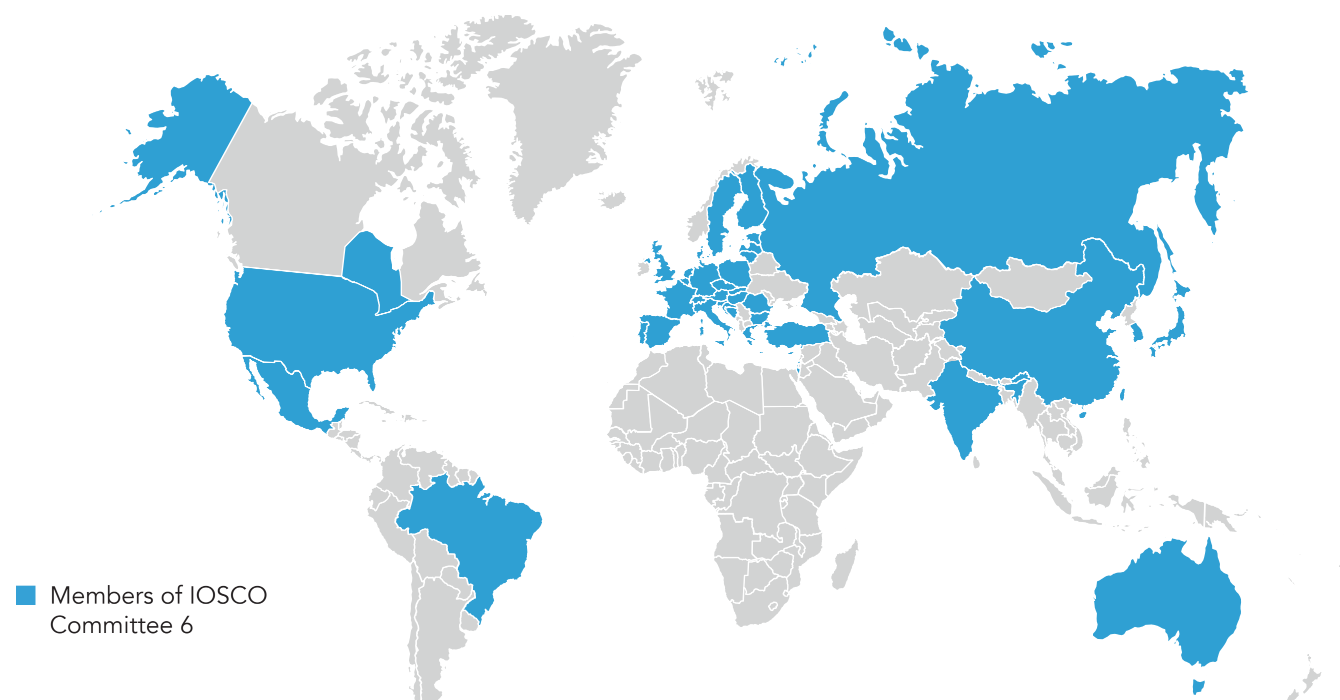
The implementation of capacity-building initiatives is crucial and it would be prudent for policymakers to actively support them. Many African countries are in the early stages of their engagement with capital markets, making specialized capacity-building efforts more important. Understanding and navigating credit rating processes and methodologies adds another layer of complexity that these initiatives can help address. It is important to heed the ACBF's advice that capacity-building efforts must be continuous to be effective. To achieve this, prioritizing collaboration across the continent in credit rating capacity-building is essential to meet the pressing needs.

Policy recommendations

This section offers three actionable recommendations to policymakers and the international community to respond to calls to reform CRA practices. The first two recommendations can be implemented quickly, and the third recommendation requires a strategic, long-term approach, focusing on the African continent.

Recommendation I – Ensure African representation on IOSCO Committee 6

Figure 4: National representation within the IOSCO Committee on Credit Rating Agencies (Committee 6)



Source: IOSCO. See: https://www.iosco.org/v2/about/?subsection=display_committee&cmtid=17

IOSCO plays an important role in the global ratings regulatory framework. Its guidance is influential and often triggers major reforms. For instance, IOSCO's recent calls for action on ESG Rating Agencies led the European Union to embark on a major legislative intervention in the field, akin to that seen in the credit rating sector 15 years ago.

Given IOSCO's standard setting role, the composition of its committees is important. IOSCO Committee 6 focuses on CRAs and is currently chaired by Elisabeth Van Laere, who also heads the CRA Unit within ESMA in the European Union. There are currently 20 members, with two observers from the European Union. The image above shows the nationalities of Committee 6 members. The European Union holds the Chair, has two observer roles and includes individual representation from European Union Member States such as France, Germany, the Netherlands and Spain. Other significant markets for CRAs are also represented, including the UK, US, China and India. However, there is no African representation on the committee.

Given the global impact and reach of the CRAs, IOSCO could expand its membership to include an African representative. This would provide African leaders an opportunity to participate in the global ratings regulatory infrastructure. It could also lead to more formal regulatory endeavours pursued in the future if IOSCO was to consider avenues of reform.

Several approaches could be taken to the selection of the African member. One could follow the path of the G20 and appoint an African Union representative. Alternatively, an African country with a mature credit ratings market could be approached. One example here is South Africa. Its regulatory framework is relatively mature compared to other markets on the continent, and it is the only African country where any of the Big Three are located – S&P has two offices there and Moody's has one.

Recommendation II – Mandate full disclosure of CRAs' data sources, including sustainability-related information

Two of the most detailed recommendations to date on improving transparency arise from UNDESA recommendations to (a) separate qualitative and quantitative factors so that the user can see where assessments are more subjective[148] and (b) publish the model-based elements of a rating (quantitative) and then impose a "qualitative overlay" for the benefit of the user.[149] In addition to these recommendations, CRAs could be required to disclose the specific sources of information used in sovereign credit ratings.

While CRAs have made efforts to improve transparency by indicating *potential* data sources, the desk review and analysis of their published methodologies reveals only vague references in their methodology's commentary to organizations like the IMF, World Bank and other multilateral bodies. These references are often mentioned in a general and non-specific way, with CRAs stating what data they are "likely" or "may" use in various situations, rather than providing precise details.

Requiring CRAs to be more precise and defined about all the data sources they use can allow countries to better understand the rating processes used to rate them and allow end users the ability to see *exactly* which data sources were used for *each* credit rating action. This can be particularly helpful for the qualitative components of the credit rating, which are largely unknown for now, besides the use of governance indicators. Additionally, this may be more acceptable to CRAs than full transparency, as it would address liability concerns under European Union and US law.

Publishing data sources would also enhance transparency in how CRAs incorporate climate and sustainability-related data, enabling users to see the type of data used and evaluate whether CRAs meaningfully consider sustainability factors. Additionally, making sustainability-related data public could offer broader benefits. For example, it could facilitate assessments of how CRAs define "materiality" in sustainability, potentially push them towards clearer, shared definitions of ESG components (in response to IMF findings[150]), deconstruct aggregate scores and help shift the focus from policies and financial returns to positive sustainability outcomes.

One limitation of this recommendation is that private information shared by the issuing country could potentially be exposed. To address this concern, CRAs could be required to disclose only the public information used in the rating process for each sovereign credit rating. This proposal may not be applicable to corporate and structured debt ratings. Each of these areas differs significantly from one another in terms of credit rating analysis, history and accuracy, which would affect whether revealing precise data sources for corporate bond ratings, for example, would be useful to end users or even feasible for rating agencies.

Recommendation III – Consider establishing African continental rating regulation

Legislative authority can provide a level of protection and transparency in the credit rating field. There are various benefits to developing an African continental ratings regulation:

- African countries could build a framework tailored to their needs, as the US and European Union have done. This can improve the representation of distinctive issues facing the continent, including climate change considerations.
- Regulation could limit ad hoc rating actions, ensuring African States are provided advance warning of sovereign rating actions (as the European Union has done). This can potentially prevent sovereign debtors (i.e. the country requesting the rating) from a ratings freefall caused by repeated credit rating downgrades.
- International CRAs can be held accountable and ensure CRAs have the necessary regional and local expertise to address issues such as governance and climate risks.
- This framework could foster greater collaboration between African regulators and bolster local capacity-building efforts. The APRM and UNECA's Network of African Regulators are actively seeking to resolve this issue and to effectively raise the "regulatory floor" across the continent by building capacity among regulators.

As highlighted in the "Capacity-Building Measures" section, a challenge to establishing a successful continental credit rating regulatory body is the absence of a unified political infrastructure that can harmonize regulatory standards across Africa. For example, the European Commission managed this process by first setting the regulatory framework and then delegating the implementation of these standards to European Union Member States' designated "competent authorities," under the oversight of the ESMA. The European Union's ability to respond swiftly to the CRAs, mitigating their impact within four years, was largely due to its existing political and legislative union – a foundational element that would be crucial for Africa to replicate in order to build an effective regulatory framework.

The development of AfCRA will likely shape the African Union's future approach to regulation. Securing African representation on IOSCO Committee 6 could also accelerate progress. With IOSCO's backing, the push for African-led regulation would gain momentum, laying the groundwork for a more coordinated and robust regulatory environment across the continent. Ultimately, the need for regulation across the continent will grow if the debt crisis worsens. Legislation, which proceeds regulation and provides a unified foundation, is the single most important mechanism to overcoming the credit rating challenge in much of the Global South.

Endnotes

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