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# Optimal Policies for Regulating Credit Rating Agencies

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Over 150 international jurisdictions have sovereign ratings from at least one of the Big Three international credit rating agencies – S&P Global, Moody's, and Fitch. In terms of the global debt scene, the private creditor is becoming ever-more important, now holding the majority of developing country debt. This shift in ownership is happening faster in Africa than in any other developing region. As the opinions of the leading credit rating agencies are critically important to the decisions of private creditors, the rise of private creditors as the dominant form of financing for the developing world has now brought the developing world into increasing contact with the world of the credit rating agencies. As these two worlds collide, the result is an impasse that is preventing modern debt treatment programmes from having the desired effect. Because of the new fear of being downgraded by the credit rating agencies based upon holding more private debt, no rated country has applied to participate in the Common Framework despite the obvious need. Today, according to UNCTAD data, 3.3 billion people live in countries that spend more on interest payment than they do education of healthcare. 54 developing countries spend more than 10% of their revenues on net interest repayments. In Africa, the past decade has seen interest payments increase by 132%, and nearly half of the Continent live in countries that spend more on interest payment than on health. This shift in debt ownership and the subsequent inability to restructure that debt is having a real-world impact on the most vulnerable.

I have been asked to talk to you today about the optimal choices that are available with regards to regulating credit rating agencies. Recent history is an ideal guide here. Up until the mid-2000s, the credit rating agencies were entirely unregulated. Controlled loosely by common law within a few jurisdictions, the credit rating agencies operated as a critical component of the ever-increasing technical world with few constraints. That relative freedom came to an abrupt end with the onset of the Global Financial Crisis. Because of the conduct of the leading credit rating agencies, the United States and the European Union enacted sweeping legislative and regulatory reforms in the wake of the Crisis, resulting in two full-scale regulatory frameworks that continue to exist today. Those regulatory frameworks, initiated by calls from IOSCO – the International Organisation of Securities Commissions – focused on increasing competition, increasing transparency, reducing conflicts of interests, and promoting the concept of liability, amongst other elements.

The reason why history is an ideal guide here for us today is because there are many lessons to be learned from the experience of the US and the EU. Competition only marginally increased, despite the massive amounts of political and regulatory capital deployed. Major conflicts of interests, like the issuer-pays model, continue to this day with regulators in the UK only this month instructing credit rating CEOs to do much better after identifying continued failures. Requests continue unabated for more transparency from the credit rating agencies, despite progress in that area. The formalising of liability in the space led to investigations which were concluded with record settlements. However, there were more abstract lessons learned about the challenges of regulating credit rating agencies.

Controlling the behaviour of credit rating agencies is very jurisdiction-specific. Only the US and the EU, and to an extent the UK, are impactful regulators. By that I mean that the traditionally important markets for the credit rating agencies have the most regulatory capital. There is no global authority; the IOSCO Committee that initiates regulatory movement in this space has no authority. Each jurisdiction legislates and regulates the credit rating space according to its own needs, a fact made clear by the particular manner in which the EU has regulated the credit rating space to protect the composition of the multi-State Bloc. We also learned since the Crisis that whenever the regulatory authority is deemed by the credit rating agencies to go too far, they deploy their 'joker cards', which usually entails the agency prospectively removing themselves from the environment – at the prospect of having liability applied in the US, the agencies refused to have their ratings included in financial prospectuses. In a similar move in a related field, changes to the Indian regulations on ESG rating agencies saw S&P Global leave the country entirely.

A large proportion of regulatory capital has been mistakenly deployed over the past 25 years. The mistake has been to misunderstand how much of the credit rating game a regulator can affect. Credit rating agencies, despite their flaws, have been for a very long-time critical components of the global economy. Today, given the changing nature of debt ownership on the sovereign bond market, this is truer now than ever before. The credit rating agencies provide private creditors with something that nobody else can – theoretically impartial third-party signals of creditworthiness that can be used by various components of the Capital Markets, ranging from the non-bank institutional investor that is starting to dominate the sovereign debt space, to the regulators mandated with overseeing this gargantuan financial system. Developing regulations, or even initiatives, that will have a large effect on such an important system, has been proven to be short-sighted.

Because of that, there is another way which could be more fruitful but which requires a particular change in understanding from those on the global scene. Incremental but targeted changes are the way forward. For example, calls for more transparency often conclude with the need for credit rating agencies to provide essentially open-source methodologies. This is not possible. Rather, as I discussed in my recent paper for UNU-CPR, credit rating agencies should publish the precise public information they have used for each and every sovereign credit rating. This would increase transparency and allow countries to better understand how they were rated. Currently, only passive reference to the types of public information that may be useful are included within publicly-available sovereign rating methodologies. Second, representation in the global regulatory process for credit ratings is now critical. Because of the lack of a global authority, the role of IOSCO and its credit rating committee is all important. Despite having more than 20 members, not one is from the African Continent. I have called for this to change and repeat that call now – there must be African representation on that Committee. Finally, the countries in question for us all today – those seeking to develop and those who are vulnerable – mostly share two characteristics; a lot of the sovereigns are relatively young countries (often gaining independence relatively recently) and often do not have a wealth of experience when it comes to the Capital Markets. There is a long-term but appropriate way to fix this – that is, capacity building.

Capacity Building in the credit rating arena at least, is now of critical importance. Being able to understand the processes, the nuance of interactions with agents, the critical nature of data preparation, the roles and responsibilities within the interaction, how to organise a governmental approach effectively, and the larger system at play, is not a universally-understood game. I suggest to you today that it needs to be. Not only for the countries, but for the credit rating agencies too. The credit rating agencies' critical role will only be enhanced by a more knowledgeable sovereign borrower base. Initiatives like the Africa Peer Review Mechanism, UNDP's Credit Rating Initiative, and the Africa Legal Support Facility are all actively working on this mission as we speak, but the time has come to have a discussion about what this objective could look like for the whole world.

Could Bangladesh prosper with more knowledge, support, and guidance for the credit rating system as much as Jamaica could, or Ghana could, or the Philippines? Absolutely. The modern world is being defined by the retreating of traditional aid and investment, and the growing domination of the private creditor. That trajectory leaves us with a simple conclusion – the credit rating agencies will become more important than they already are, not less. To make that growth in importance a progressive one, countries need more support with this very particular relationship and whilst improving regulatory strategies to be more granular and incremental would be a welcome addition, focusing international efforts on levelling the playing field in terms of knowledge and capacity is the ultimate gamechanger.