Debt relief, debt crisis prevention and human rights: the role of credit rating agencies

Credit rating agencies (CRA) have an enormous influence on market expectations and the lending decisions of public and private investors. However, past financial and debt crises, in particular the sub-prime mortgage crisis and the Asia financial crisis have exposed the inherent structural problems of CRA and their failure to perform the role they are supposed to. Even though many reform proposals have been made, not much progress has been made thus far. In this report, the Independent Expert argues that the reform can no longer be postponed, particularly to prevent negative impacts on human rights of the people.

As part of international efforts to respond to the impact of the COVID-19 pandemic, some international initiatives were introduced in 2020 to reduce the mounting debt burden of poor countries. However, the fear of possible credit rating downgrades has deterred the implementation of the Debt Service Suspension Initiative (DSSI) of the G-20. Some sovereign downgrades have also increased financial market volatility and the difficulty of developing countries to gain access to new sources of financing. In addition, downgrades or credit alerts may sometimes make Government’s efforts to contain debt crisis ineffective.

The report discusses the role of the so-called “big three” CRA, which control over 92% of the global market. These agencies suffer from birth defects, notably conflict of interests, biased decision-making, oligopoly, wrong business model and lack of transparency. Often, gradings are procyclical, which carry risks of triggering a self-fulfilling prophecy of debt crisis, affecting the livelihoods of the population.

In turn, this has meant that credit rating assessments have an outsized role in debt crises, with examples in the last decades. Negative impact of downgrades include reducing the fiscal space of countries, limiting investment in much-needed social protection, food, health or education and on measures needed to tackle poverty and inequalities. In addition, mounting levels of debt have led to retrogression in the protection and realization of human rights, especially economic, social and cultural rights.

The report acknowledges that in recent years, with the adoption of environmental, social and governance (ESG) indicators, these CRA might be signalling an opening towards the consideration of human rights. In this regard, the Independent Expert offers indications of human rights instruments, standards, norms and that should provide guidance to CRA.

The Independent Expert concludes that amelioration of credit ratings has been marginal. Despite various proposals made over the years, the structural defects of CRA, the market distortions they create and the errors in their assessments have yet to be amended. The “big three” CRA continue to dominate the market and there is still no meaningful competition within this system. Accountability and transparency have not improved much. Current existing regulations have not fundamentally altered the market structure for CRA; and many good proposals have either remained on paper or have been stalled or shelved. Yet the importance of credit rating has not diminished, as demonstrated by the difficulties encountered in the implementation of the Debt Service Suspension Initiative (DSSI).
Recommendations:

The Independent Expert’s main recommendation is to reform the international financial architecture and promote debt crisis prevention and resolution, including reforming CRA. The gravity of the sovereign debt situation in 2021, exacerbated by the COVID-19 pandemic, and compounded by the health, socio-economic and human rights crises, has once again proven the need for regulation and reform. In this regard, allowing developing countries to have access to financial resources to strengthen economic, social and cultural rights during special circumstances, such as the COVID-19 pandemic, and assisting them in obtaining long-term economic development should be part of the credit rating assessment equation.

In particular, the Independent Expert recommends:

1. Reform CRA with steps taken at the international, regional and national levels. The reform should take into account the fact that large CRA operate on an international scale, hence national regulations, though necessary, may not be sufficient. At the international level, the involvement of the Group of 20, the Financial Stability Board or the Basel Committee on Banking Supervision, and international financial institutions is important but not inclusive enough. The United Nations has actively stepped into the process; it should continue to perform a leading role. At the regional level, institutions should also be put in place. For instance, the African Union and its policy organs have been working on its continental policy framework of mechanisms on rating agencies’ support for countries;

2. Reduce or break the current oligopoly of the “big three”. The lack of competition perpetuates wrongful behaviour and removes the incentive to improve the quality of credit ratings. The removal of the oligopoly could be made possible through the encouragement of the entrance of new players into the market, including publicly owned CRA;

3. Address the issue of conflict of interest. The underlying cause of many of the problems for CRA is conflict of interest, and it is therefore necessary that the issue be addressed urgently. The “issuer pay” business model should be changed;

4. Introduce a system of monitoring and accountability of CRA. A system of accountability would make CRA try harder to do a better and more professional job in the rating process and reduce sloppy performances;

5. Suspend the issuance of ratings during a crisis when there are international efforts to introduce mechanisms to deal with the crisis. In times of crisis, such as COVID-19 pandemic or natural disasters, rating agencies should defer publishing their rating reviews, as markets have their way of discounting risk when fundamentals are conspicuously changing. In addition, rating announcements could hamper the implementation of special crisis containment and resolution measures introduced by the international community. Not suspending credit ratings during this kind of situation would compromise international efforts;

6. Enhance disclosure and transparency. The disclosure of the rating methodology, key criteria and standards should be made so that investors and borrowers could be in a better position to do their own due diligence and assess the accuracy of the ratings.

In relation to specific human rights standards and norms, the Independent Expert discusses the International Covenant on Economic, Social and Cultural Rights, and three sets of guiding principles developed in the last decade: on foreign debt and human rights, on impact assessment of economic reforms and on business and human rights. She also includes two concrete recommendations:

7. Strengthen the incorporation and application of relevant international human rights standards and norms in the context of the activities of CRA, including in the monitoring, supervision and reform of their functioning.

8. Environmental, social and governance criteria should be enhanced with close review of methodologies in line with human rights standards and norms.