Press Points for Chapter Three:
The Uses and Abuses of Sovereign Credit Ratings

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Key Points

- Sovereign credit ratings have inadvertently contributed to financial instability. This is because ratings are embedded in various rules, regulations and triggers, so that downgrades can lead to destabilizing knock-on and spillover effects in financial markets.
- The reliance on ratings in financial rules and regulations should be reduced, while being wary of unintended consequences.
- Rating agencies should also be discouraged from delaying rating changes, which create potential procyclical cliff effects.
- Rating agencies should pay more attention to sovereign debt composition and contingent liabilities, and sovereigns could do more to provide such information.

Credit ratings play a significant "certification" role in fixed-income markets, and are embedded in various rules, regulations and triggers, so that downgrades can lead to destabilizing knock-on and spillover effects as investors rush to buy or sell securities as credit ratings change. This was seen in the wake of the sharp downgrades of structured finance products during the recent financial crisis.

More recently, the downgrades accompanying weakened sovereign balance sheets have again drawn attention to the credit rating agencies and their rating methodologies. The problem lies not entirely with the ratings themselves. In general, ratings are fairly accurate in foretelling when a sovereign is likely to default, though more attention to sovereign debt composition and contingent liabilities could help improve their rating decisions.

Concerns have been expressed about the conflicts of interest inherent in the issuer-pay business models of the major rating agencies that allow issuers to shop for high ratings. However, an investor-pay model can also give rise to conflicts of interest. For example, investors might pressure rating agencies to put-off downgrades to delay forced sales of securities.

Policy proposals:

A number of policy proposals arise from the chapter, including the following:

- Policymakers should work towards the elimination of rules and regulations that hardwire buy or sell decisions to ratings. They should continue their efforts to reduce their own reliance on credit ratings, and wherever possible remove or replace references to ratings in laws and regulations, and in central bank collateral policies. They should discourage the mechanistic use of ratings in private contracts, including investment manager internal limits and investment policies. However, they should recognize that smaller and less sophisticated investors and institutions will continue to use ratings.

- It is important that the authorities continue efforts to push rating agencies to improve their procedures, including transparency, governance, and the mitigation of conflict of interest. In particular, those agencies whose ratings are used in the Basel II standardized approach should have to meet similar validation standards as those required for banks that use their own internal ratings.

- Rating agencies should be discouraged from over-smoothing the downgrades that their analysis would imply since that merely delays what is likely to be inevitable, and create potential cliff effects.

- In addition, sovereigns could do more to provide relevant and timely data to enable market participants to conduct their own independent credit analysis. This should include disclosure of contingent liabilities. In that regard, the IMF has been encouraging countries to prepare and make publicly available a fiscal risk statement.