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New research reveals credit rating agencies responded too slowly to COVID-19

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The first study into the effect of COVID-19 on sovereign credit ratings found that rating agencies were slow to react to the pandemic's unprecedented economic and fiscal reverberations. The research raises questions about the timeliness and reliability of prominent creditworthiness measures, with potentially significant consequences for investors and for public debt and global financial stability.

Researchers from the University of East Anglia, University of Cambridge, University of Aberdeen and affiliated institutions investigated how credit ratings responded to the pandemic. The results show that, rather than responding as the crisis unfolded from March 2020, the big three rating agencies (S&P, Moody's and Fitch) maintained a broadly business-as-usual course. Typically they postponed rating actions until the dates of credit committee meetings that had been scheduled prior to the pandemic.

Sovereign ratings are relied upon as leading sources of credit risk information and the ratings agencies act as gatekeepers to global debt markets. They affect the cost of public borrowing and the security of people's pensions. When they get it wrong, the consequences can be severe.

"Ratings agencies were perceived to have not foreseen the 2007 financial crisis and were criticized then for being too slow to react. The pandemic provided another opportunity for agencies to act more swiftly but, by and large, this opportunity was missed again," says Yen Tran, lead author and Ph.D. candidate at the University of Aberdeen.

The research shows that compared to previous crises, ratings agencies reacted with considerable hesitation. For example, S&P, which rates a total of 121 sovereigns, issued 20 downgrades on 19 countries in the six months from February 2020, amounting to 16% of its sovereign portfolio. In comparison, in the six months following the collapse of Lehman Brothers in September 2008, S&P downgraded 31 sovereigns, or 25% of its (then smaller) sovereign portfolio.

But whilst the 2008 crisis saw just a 0.1% contraction in global GDP, the pandemic caused a 3.5% reduction in 2020 alone. Why should the pandemic's more severe contraction induce such a muted reaction?

"Rating agencies face the difficult balance between stability and accuracy. They need to provide accurate, up-to-date information on credit risk, but they don't want to spook markets in a time of turmoil and exacerbate the crisis," says co-author Dr. Patrycja Klusak, lecturer at UEA and affiliated researcher at Cambridge's Bennett Institute for Public Policy.

"Regulations permit rating agencies to conduct reviews ahead of schedule whenever changing circumstances require. The pandemic sweeping the planet, triggering unprecedented waves of economic recessions surely was a qualifying example. However, rating agencies have displayed no sense of urgency. Instead they mostly kept their prescheduled dates set before the pandemic," says co-author Dr. Moritz Kraemer.

"The leisurely pace in the fast-evolving risk landscape may be a result of the fact that there is so little competition in their field of business," he added.

"Also, unlike banks or fund managers, they have no financial 'skin in the game," and did not stand to lose money from late decisions. The unrushed approach may also be due to more mundane reasons, such as insufficient analytical resource to conduct a much larger number of credit committees than what would be required in a normal environment."

"None of these reasons are necessarily reassuring for the seamless functioning such critical cogs in the global capital market machine where investors rely on timely and accurate information," says co-author Dr. Huong Vu, University of Aberdeen.

The report shows that as global debt balloons, rating agencies have been slow to respond leaving misinformed markets and warns us about the possible consequences. The study is forthcoming in the *International Review of Financial Analysis*.

More information: Sovereign credit ratings during the COVID-19 pandemic. www.bennettinstitute.cam.ac.uk … eign-credit-ratings/

Provided by University of East Anglia