COMMITTEE ON CAPITAL MARKETS REGULATION

The Role of Credit Ratings Agencies During COVID-19

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COMMITTEE ON CAPITAL MARKETS REGULATION

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Staff Report:

The Role of Credit Ratings Agencies During COVID-19

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Introduction

Credit rating agencies are third party organizations that issue independent, forward looking opinions about the relative creditworthiness of an issuer of debt, such as a corporation or government.[1] The credit ratings issued by the agencies help market participants make informed investment and financial decisions.[2] These agencies were criticized for their performance in providing this information during past economic and financial crises, and similar concerns during the COVID-19 crisis resurfaced.[3] This staff report evaluates the performance of the credit rating agencies during the COVID-19 crisis, and concludes that the agencies responded to evolving market and economic conditions promptly and performed their role well as independent providers of forward-looking information.

The report proceeds as follows. Section 1 provides a brief overview of credit rating agencies and the actions that they have taken during COVID-19. Section 2 reviews the timeline of the credit rating agencies' actions, finding that the agencies issued prompt revisions once the severity of the COVID-19 crisis became apparent. Section 3 examines the agencies' debt ratings and finds that pre-COVID ratings appear to have been accurate insofar as the riskiest levels of debt have received the majority of downgrades and accounted for nearly all defaults. Section 4 then examines agencies' actions by sector and finds that they accurately revised their forward-looking ratings based on evolving market conditions. Section 5 sets forth conclusions.

1. Background on Credit Rating Agencies and Overview of their Actions

Credit rating agencies present their forward-looking information by assigning a rating to an issuer's debt based on its risk. The higher the level of risk that the issuer will not pay back the debt the lower the rating – with the riskiest debt assigned "non-investment grade", and safer debt assigned "investment-grade." Investment-grade and non-investment grade debt is further broken out into tiered sub-categories. **Figure 1** below presents the three largest rating agencies' (S&P Global, Moody's, and Fitch) rating tiers. The agencies continuously monitor the entities that they rate, and they issue an upgrade (downgrade) when there are material positive (negative) impacts on an issuer's ability to pay back debt.

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[1] "Updated Investor Bulletin: The ABCs of Credit Ratings," *SEC* (October 12, 2017): https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_creditratings

[2] *Id.*

[3] "Markers marked: Credit-rating agencies are back under the spotlight," *The Economist* (May 9, 2020): https://www.economist.com/finance-and-economics/2020/05/07/credit-rating-agencies-are-back-under-the-spotlight

Figure 1: Major Credit Rating Agency Rating Scales		
S&P Global	*Moody's*	*Fitch*
AAA	Aaa	AAA
AA	Aa	AA
A	A	A
BBB	Baa	BBB
BB	Ba	BB
B	B	B
CCC	Caa	CCC
CC	Ca	CC
C	C	C

Note: Shaded area represents "non-investment" grade ratings.
Source: U.S. SEC[4]

In order to provide timely and accurate forward-looking information to market participants during the COVID-19 crisis, credit ratings agencies reevaluated their market and economic forecasts used in their credit rating methodologies. For example, Fitch estimated that the public health and economic crisis was likely to lead to revenue destruction of approximately $8.5 trillion between 2020-2021 for the global corporates it rates.[5] Based on their systematic reassessment of issuers' credit profiles, the agencies then adjusted ratings and ratings outlooks. Moody's downgraded 1,134 of the global entities it rates between March 1, 2020 and February 28, 2021.[6] Similarly, Fitch downgraded 1,260 of the global entities that it rates between March 6, 2020 and February 19, 2021.[7] And from February 3, 2020 to February 22, 2021, S&P downgraded a total of 1,115 of its global issuers.[8]

The next sections explore these downgrades in more detail. Section 2 considers the timeline of COVID-19 ratings downgrades. Section 3 examines the categories of debt (based on their rating) that were downgraded by the rating agencies during COVID-19. And Section 4 examines downgrades by rating agencies on an industry-specific basis.

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[4] "Report to Congress: Credit Rating Standardization Study," *SEC* (September 2012): https://www.sec.gov/files/939h_credit_rating_standardization.pdf

[5] Rocha, Martha, Carla Taylor, and Michael Simonton, "Pandemic Progress Check: U.S. Corporates," *Fitch Ratings Special Report* (September 25, 2020): https://www.fitchratings.com/research/corporate-finance/pandemic-progress-check-us-corporates-recent-trends-unlikely-to-drive-broad-upward-revisions-of-recovery-assumptions-25-09-2020

[6] "COVID-19 one year on: Opportunities and hazards will drive differences in recoveries across sectors," *Moody's Investor Service* (March 10, 2021): https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1266499

[7] "Rating Snapshot," *Fitch* Ratings (accessed May 24, 2021): https://www.fitchratings.com/topics/coronavirus-ratings-snapshot

[8] *Serino, Nicole and Sudeep K Kesh, "Covid-19 and Oil Price-Related Public Ratings Actions on Corporations, Sovereigns, and Project Finance to Date," S&P Global Ratings (February 23, 2021): https://www.spglobal.com/ratings/en/research/articles/200318-covid-19-coronavirus-related-public-rating-actions-on-non-financial-corporations-to-date-11393186#ContactInfo*

2. Timeline of Ratings Actions during COVID-19

A popular criticism of credit rating agencies, and one that has been considered by the U.S. Securities and Exchange Commission ("**SEC**"), is that they may be incentivized to initiate downgrades too slowly – delaying important information to markets.[9] However, a review of the timeline of the credit rating agencies' actions during COVID-19 shows that such a delay did not occur during the COVID-19 crisis.

The economic and financial impact of the COVID-19 crisis was fast as the severity of the virus became apparent. The virus began to spread across the globe through the month of February, and in response, global markets experienced their largest weekly drop since the Global Financial Crisis ("**GFC**") during the last week of February.[10] The outbreak was then recognized as a pandemic by the World Health Organization ("**WHO**") on March 11. In response to the turmoil, the U.S. Federal Reserve announced a number of facilities and programs intended to support markets between March 17 and March 23, such as the Primary and Secondary Market Corporate Credit Facilities focused on supporting corporate debt.[11] The events of February through March led the ratings agencies to quickly adjust their outlooks in their efforts to provide "information and metrics to help investors make informed decisions."[12]

A review of the weekly distribution of ratings actions shows that the bulk of rating actions occurred promptly at the beginning of the crisis. Ratings actions can include changes in numerical ratings, changes in outlooks, or placing ratings on credit watch. As **Figure 2** below demonstrates, S&P issued the vast majority of its ratings actions between March and May. Every week from March 20 to May 8 S&P registered a total of 100 or more global negative ratings actions, with the week beginning March 27 recording a pandemic high of more than 260 actions (**Figure 2**). The weekly totals have since dropped considerably after the initial wave of ratings actions, with only the week beginning June 12 recording more than 50 actions.[13] The slowdown in credit actions coincided with the ratings agencies' expectation of a slow recovery.[14]

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[9] Mandel, Michael, "Credit Rating Agencies: Sending a Clear Signal," *Progressive Policy Institute* (July 23, 2020): https://www.progressivepolicy.org/publication/credit-rating-agencies-sending-a-clear-signal/

[10] "Timeline of Events Related to the COVID-19 Pandemic," *Federal Reserve of St. Louis* (accessed January 28, 2020): https://fraser.stlouisfed.org/timeline/covid-19-pandemic

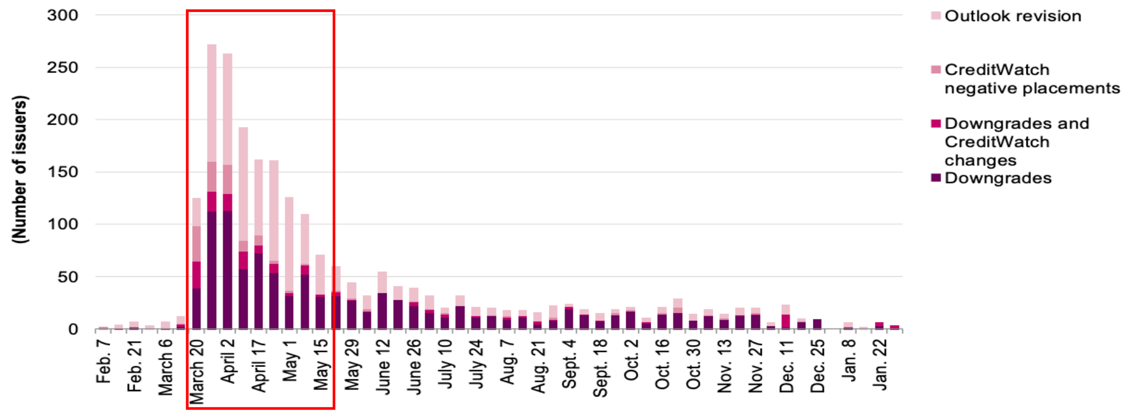
[11] *Id.*

[12] "Intro to Credit Ratings: A Credit Rating is an Informed Opinion," *S&P Global*: https://www.spglobal.com/ratings/en/about/intro-to-credit-ratings

[13] Serino, Nicole and Sudeep K Kesh, "Covid-19 and Oil Price-Related Public Ratings Actions on Corporations, Sovereigns, and Project Finance to Date," *S&P Global Ratings* (December 15, 2020): https://www.spglobal.com/ratings/en/research/articles/200318-covid-19-coronavirus-related-public-rating-actions-on-non-financial-corporations-to-date-11393186#ContactInfo

[14] Kilgore, Tomi, "Credit Downgrades reached a high in the second quarter, with 'junk' rated companies hurt the most – S&P Global Ratings," MarketWatch (July 15, 2020): https://www.marketwatch.com/story/credit-downgrades-reached-a-high-in-the-second-quarter-with-junk-rated-companies-hurt-the-most--sp-global-ratings-2020-07-15

Figure 2: Weekly S&P Global Ratings Actions Caused by COVID-19 and Oil Prices, February 7, 2020 to January 25, 2021.



Rating actions are tracked at an issuer level. If an issuer has had multiple rating actions since Feb. 3, 2020, the last rating action date is reflected in the chart. Data as of Jan. 25, 2021. Source: S&P Global Ratings Research.

While the natures of the two crises are different, a direct comparison of the credit rating agencies' actions during COVID-19 to those of the GFC contextualizes the promptness of the actions taken during the pandemic. As shown above, rating agencies issued downgrades within weeks of the start of the pandemic. The response during the GFC was more delayed in comparison. According to SEC review of rating agency downgrades, wide-ranging action during the GFC was not taken until early 2009, months after the onset of the crisis.[15] The timeline of actions shows that credit rating agencies acted promptly at the start of the pandemic, contrasting with the criticism that rating agencies may be hesitant to downgrade the entities they cover.

3. Categories of Debt Impacted by the COVID-19 Crisis

Another criticism of credit rating agencies is that the agencies may potentially inflate their ratings in order to attract or maintain relationships with customers.[16] One potential sign of inflated ratings would be increased levels of downgrades or defaults of highly rated debt during a crisis. However, analysis of actions taken by the agencies during the COVID-19 crisis shows the opposite, with the vast majority of credit downgrades and defaults focused on the riskiest types of debt. This observation suggests that the rating agencies' pre-pandemic debt ratings appear to have been well calibrated as the most vulnerable debt, determined by rating, was the most negatively impacted during the downturn, and sweeping actions against investment-grade debt were not necessary.[17]

[15] Kothari, S.P., "DERA Economic and Risk Outlook," *SEC Division of Economic and Risk Analysis* (April 23, 2020): https://www.sec.gov/files/DERA_Economic-and-Risk-Outlook-Report_Apr2020.pdf

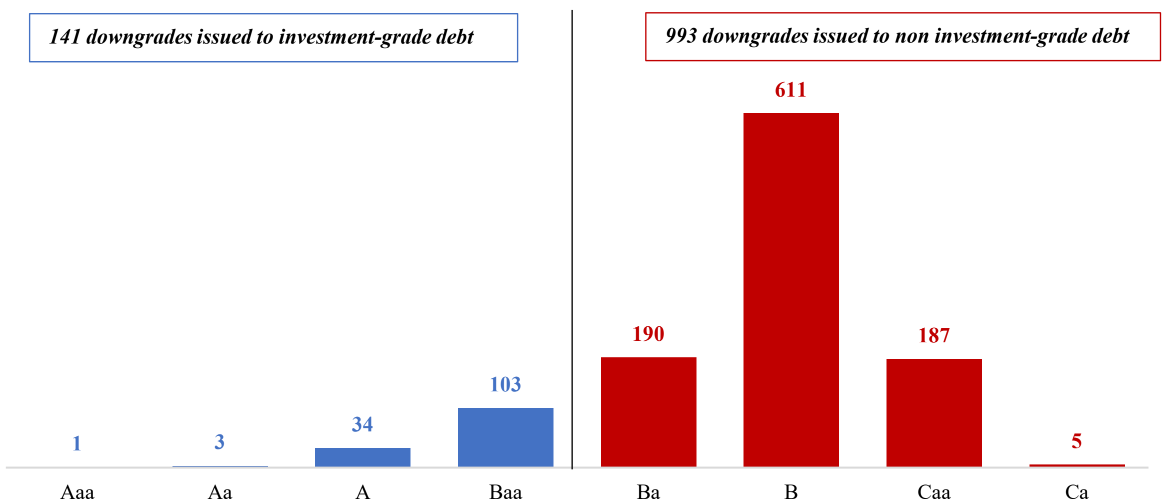
[16] Podkul, Cezary and Gunjan Banjeri, "Inflated Bond Ratings Helped Spur the Financial Crisis. They're Back," *Wall Street Journal* (August 7, 2019): https://www.wsj.com/articles/inflated-bond-ratings-helped-spur-the-financial-crisis-theyre-back-11565194951

[17] *Id.*

A. Downgrades during the COVID Crisis

As **Figure 3** shows, Moody's downgrades to global non-financial corporates from March 1 to February 28, 2021 have largely focused on non-investment grade debt. As of February 28, 993 of the 1,134 downgrades issued to global non-financial corporates were made to non-investment grade debt, 611 of which were made to highly speculative B-rated debt.[18] Overall, the 993 non-investment level downgrades represent 41% of non-investment grade debt rated by Moody's. In contrast, investment-grade debt received 141 downgrades over the same period – representing only 13% of the investment-grade debt rated by Moody's. Further demonstrated in **Figure 3**, 103 of the investment-grade downgrades impacted Baa-rated bonds, the riskiest level of investment-grade debt.[19]

Figure 3: Moody's Downgrades , March 1, 2020 to Februray 28, 2021



Source: Moody's data, March 1, 2020 to February 28, 2021.

Comparing the categories of debt downgraded during COVID-19 to past crises further demonstrates that the level of investment-grade debt downgrades has been muted during the current downturn. Moody's data on downgrades indicates that quarterly net downgrades (measured as credit downgrades minus credit upgrades during a quarter) to investment-grade debt reached their highest point of 26 during the pandemic in the second quarter of 2020, and then dropped to 7 by the third quarter of 2020.[20] In contrast, net-downgrades to investment-grade debt during the

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[18] "COVID-19 one year on: Opportunities and hazards will drive differences in recoveries across sectors," *Moody's Investor Service* (March 10, 2021): https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1266499

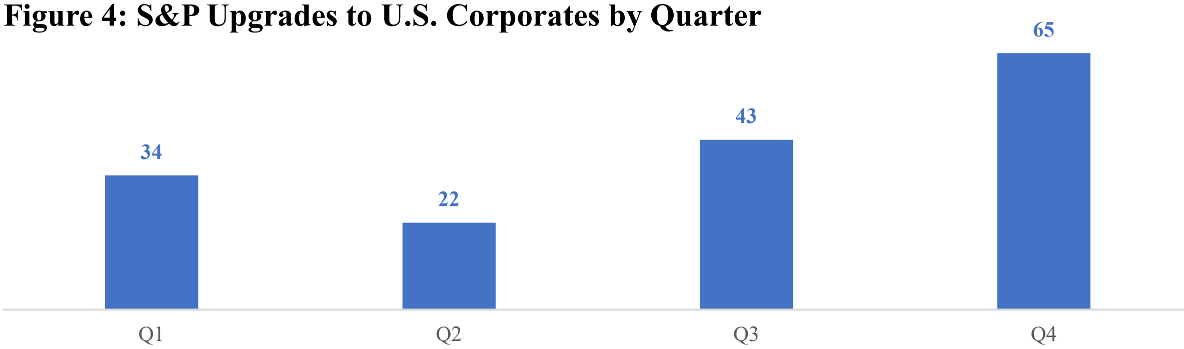
[19] *Id.*

[20] Lonski, John, "Credit Markets Review and Outlook," *Moody's Capital Markets Research* (November 12, 2020): *https://www.moodysanalytics.com/-/media/weekly-market-outlook-resurgent-covid-19-threatens-corporate-credits-improved-trend.pdf*

GFC exceeded the COVID-19 high in all but one quarter, peaking at an all-time high above 80 in the second quarter of 2009.[21]

The low levels of net downgrades during the third quarter of 2020 can also in part be explained by the New York Federal Reserve's announcement on March 23 that it would support corporate debt through the Primary and Secondary Market Corporate Credit Facilities. These and other actions by the government were taken into consideration by the rating agencies through their updated economic and financial forecasts used in the credit rating process. Research from the International Organization of Securities Commissions ("**IOSCO**") found that U.S. government support programs helped relieve downward pressures on credit ratings.[22] Moody's research corroborated these findings, suggesting that the support helped to increase upgrades while simultaneously decreasing downgrades.[23] As displayed in **Figure 4** below, upgrades to U.S. corporates increased to 43 in Q3 2020 (the quarter immediately following the Fed's announcement of supportive actions) from 22 in Q2 2020 according to S&P data.[24] This trend continued into Q4 2020, with upgrades increasing to 65 based on positive vaccine news and the passing of additional fiscal stimulus.[25]

Figure 4: S&P Upgrades to U.S. Corporates by Quarter



Source: S&P data as of December 31, 2020.

The onset of the crisis also raised concerns around the prospect of elevated levels of fallen angels (investment-grade debt that is downgraded to non-investment grade).[26] However, Fed actions to support markets helped to keep the number of fallen angels at relatively muted levels compared to past economic crises. According to Moody's, the global fallen angel rate reached

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[21] *Id.*

[22] "Observed Impact of COVID-19 Government Support Measures on Credit Ratings," *IOSCO* (February 2021): https://www.iosco.org/library/pubdocs/pdf/IOSCOPD671.pdf

[23] *Id.*

[24] Kraemer, Nick, Evan Gunter, and Jon Palmer, "Credit Trends: U.S. Corporate Upgrades Rise As Vaccines and Stimulus Boost Optimism for 2021, *S&P Global* (February 1, 2021): https://www.spglobal.com/ratings/en/research/articles/210201-credit-trends-u-s-corporate-upgrades-rise-as-vaccines-and-stimulus-boost-optimism-for-2021-11820311

[25] *Id.*

[26] Hutman, Susan and Robert Hopper, "Corporate Debt: Defaults, Downgrades and Fallen Angels," *Alliance Bernstein* (April 30, 2020): https://www.alliancebernstein.com/library/Corporate-Debt-Defaults-Downgrades-and-Fallen-Angels.htm

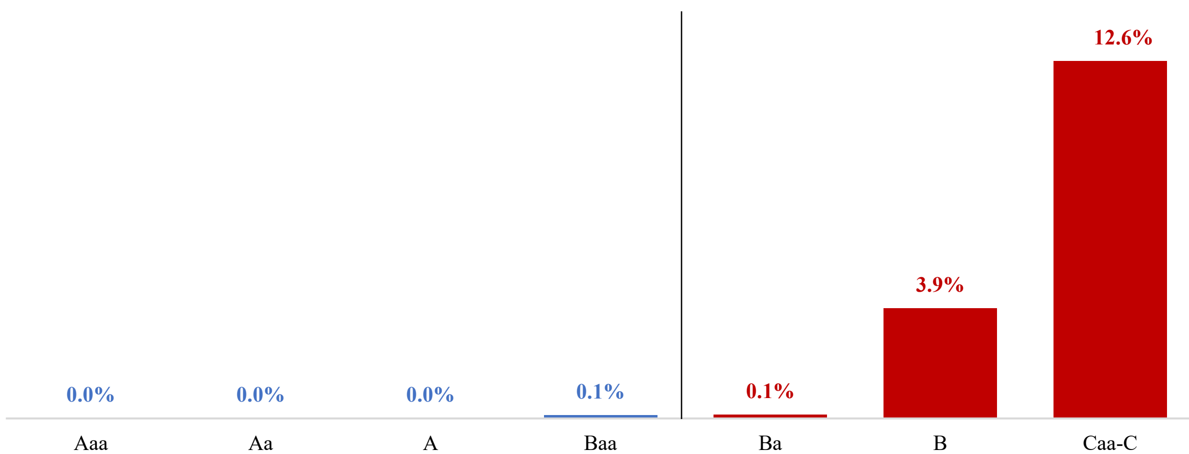
2.1% in 2020, much lower than the high of approximately 5% recorded after the dotcom bubble of the early 2000s.[27]

B. Defaults during the COVID Crisis

Additionally, defaults increased down the rating scale, indicating that rating agencies had accurately rank-ordered credit risk entering the crisis. Every corporate default reported by S&P between January 1 and December 9, 2020 was on non-investment grade debt, and 197 of the defaults (88% of defaults reported by S&P) over the same period were by entities rated CCC or lower – which are considered highly risky with a higher probability of default during a crisis.[28]

As displayed in **Figure 5,** 2020 default rates among global financial and non-financial corporates rated by Moody's increased down the rating scale. Baa-rated debt was the only investment grade debt reporting any defaults in 2020, with a 0.1% rate of default. Ba-rated debt also reported a 0.1% default rate. Lower-rated (riskier) debt was subject to higher rates of default. B-rated debt experienced a 3.9% default rate and the highly risky Caa- to C-rated debt reported a 12.6% default rate.[29] This finding combined with the high level of non-investment grade debt downgrades relative to investment-grade debt downgrades during COVID-19 suggests that the agencies' pre-COVID ratings appear to have been accurate, and that the actions occurring during the crisis were an expected part of an economic downturn – as commentators have suggested.[30]

Figure 5: Moody's 2020 Default Rates by Rating Category



Source: Moody's data, January 1, 2020 to December 31, 2020.

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[27] "Annual default study: Following a sharp rise in 2020, corporate defaults will drop in 2021," *Moody's* (January 28, 2020): https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1258722

[28] Serino, Nicole, Sudeep Kesh, and Shripati Pranshu, "Default, Transition, and Recovery: Four U.S. Defualts Push the 2020 Corporate Tally to 223," *S&P Global* (December 10, 2020): https://www.spglobal.com/ratings/en/research/articles/201210-default-transition-and-recovery-four-u-s-defaults-push-the-2020-corporate-tally-to-223-11775386

[29] "Annual default study: Following a sharp rise in 2020, corporate defaults will drop in 2021," *Moody's Investor Service* (January 28, 2021): https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1258722

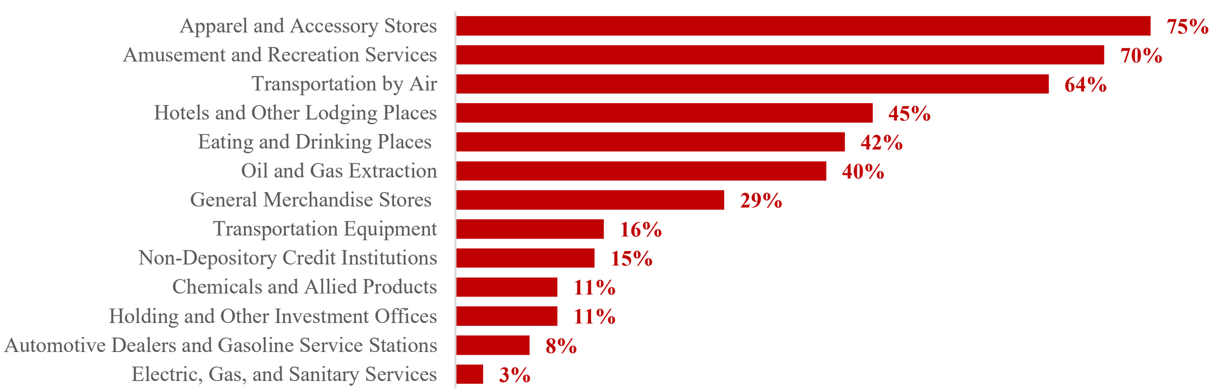
[30] Holtz-Eakin, Douglas, "Credit Rating Agencies and the Lessons of 2008," *Medium* (May 21, 2020): https://medium.com/@djheakin_89462/credit-rating-agencies-and-the-lessons-of-2008-ec986f727ac3

4. Industries Most Impacted by COVID-19

The impact of the COVID-19 crisis has been uneven across industries – with some experiencing record declines in revenue, while others have prospered. A review of the rating agencies' downgrades at the onset of the crisis highlights that the early credit actions taken by agencies concentrated on the industries with potentially extreme exposure to the pandemic, such as brick-and-mortar stores, airlines, and hotels.[31] These industries were ultimately the ones hardest hit by the crisis, suggesting that credit rating agencies accurately revised their ratings at the onset of the pandemic and provided timely, forward-looking information to markets.

As shown in **Figure 6** below, SEC analysis of Refinitiv DataScope data found that apparel and accessory stores were the focus of a swath of downgrades in March – 75% of issuers in the industry received at least one downgrade from either S&P, Fitch, or Moody's.[32] The industry was then and continues to be one of the hardest hit by the pandemic. According to the Commerce Department, total retail sales (which includes apparel and accessory stores) fell by a record -16.4% in April 2020,[33] and sales in strictly apparel and accessory retailers remain down. For instance, year-on-year sales growth for clothing and electronic store each registered approximately -16% as of January 2021.[34] Further, research from S&P reported that retail was the sector with the fourth highest number of defaults from January to December 9, 2020.[35]

Figure 6: Industries recieving at least One Downgrade by S&P, Moody's, or Fitch in March 2020



Source: SEC analysis of Refinitiv DataScope data.

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[31] Kothari, S.P., "DERA Economic and Risk Outlook," *SEC Division of Economic and Risk Analysis (*April 23, 2020): https://www.sec.gov/files/DERA_Economic-and-Risk-Outlook-Report_Apr2020.pdf

[32] *Id.*

[33] Rubel, Matt, "For the Retail Industry, 2020 was a Wild Ride," *Wall Street Journal* (December 15, 2020): https://www.wsj.com/articles/for-the-retail-industry-2020-was-a-wild-ride-11608044400

[34] Irum, Tayyeba and Chris Hudgins, "January retail market: Sales drop an 'absolute disaster'," *S&P Global* (January 19, 2020): https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/january-retail-market-sales-drop-an-absolute-disaster-5-new-bankruptcies-62135046

[35] Serina, Nicole and Sudeep Kesh, "Default, Transition, and Recovery: Four U.S. Defaults Push the Corporate Talley to 223," *S&P Global* (December 10, 2020): https://www.spglobal.com/ratings/en/research/articles/201210-default-transition-and-recovery-four-u-s-defaults-push-the-2020-corporate-tally-to-223-11775386

The airlines industry (transportation by air sector) was also issued a significant number of downgrades at the onset of the crisis. As **Figure 6** above demonstrates, 64% of issuers in the transportation by air industry were downgraded in March by at least one of the three largest rating agencies.[36] As with apparel and accessory stores, the industry was devastated by the pandemic. For instance, total revenue for air transportation plummeted by 78.4% in the second quarter of 2020 from first quarter levels. And while revenues increased over the third quarter, they remained 64.4% lower than those registered at the beginning of 2020.[37] S&P data show that the industry recorded the fifth highest level of defaults amongst all sectors from January 1 to December 9, 2020 at 12, with 10 of the 12 taking place after March.[38] The industry was the focus of government aid that was pivotal in helping infuse airlines with needed cash, however, the extreme impacts of COVID-19 on airlines forced credit rating agencies to downgrade entities across the board and maintain negative outlooks into 2021 despite the aid.[39]

The hotels and other lodging places industry was also the recipient of early actions at the beginning of the crisis, with 45% of issuers experiencing at least one downgrade by one of the three largest agencies (**Figure 6)**.[40] These ratings adjustments preceded extreme distress in the sector. For instance, PwC reported that revenue per available room dropped from $86.67 to $45.70 from 2019 to 2020 and will likely only increase to $54.41 by the end of 2021.[41] S&P reported that the media and entertainment industry (which includes hotels and lodging) registered the third highest level of defaults for all sectors from January 1 to December 9, 2020 with 31, and 29 of the defaults occurred after March.[42]

As the above data show, the COVID-19 crisis has disproportionately impacted some industries more than others; apparel and accessory stores, transportation by air, and hotels and other lodging places have suffered greatly. These are the same sectors that were the focus of a large portion of the credit rating agencies' initial downgrades in March. This observation suggests that the rating agencies were accurate in incorporating the changing environment into their outlooks and in their efforts to provide accurate forward-looking information.

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[36] Kothari, S.P., "DERA Economic and Risk Outlook," *SEC Division of Economic and Risk Analysis* (April 23, 2020): https://www.sec.gov/files/DERA_Economic-and-Risk-Outlook-Report_Apr2020.pdf

[37] Data form through St. Louis FRED (accessed on January 20, 2020).

[38] Serina, Nicole and Sudeep Kesh, "Default, Transition, and Recovery: Four U.S. Defaults Push the Corporate Talley to 223," *S&P Global* (December 10, 2020): https://www.spglobal.com/ratings/en/research/articles/201210-default-transition-and-recovery-four-u-s-defaults-push-the-2020-corporate-tally-to-223-11775386

[39] Baggaley, Philip, Rachel Gerrish, Izabela Listowska, and Betsy Snyder, "Industry Top Trends 2021: Transportation," *S&P Global* (December 10, 2020): https://www.spglobal.com/_assets/documents/ratings/research/100047948.pdf

[40] Kothari, S.P., "DERA Economic and Risk Outlook," *SEC Division of Economic and Risk Analysis* (April 23, 2020): https://www.sec.gov/files/DERA_Economic-and-Risk-Outlook-Report_Apr2020.pdf

[41] Putzier, Konrad, "Hotel Owners Continue to Reel from the Pandemic," *Wall Street Journal* (January 2, 2021): https://www.wsj.com/articles/hotel-owners-continue-to-reel-from-the-pandemic-11609563815

[42] Serina, Nicole and Sudeep Kesh, "Default, Transition, and Recovery: Four U.S. Defaults Push the Corporate Talley to 223," *S&P Global* (December 10, 2020): https://www.spglobal.com/ratings/en/research/articles/201210-default-transition-and-recovery-four-u-s-defaults-push-the-2020-corporate-tally-to-223-11775386

5. Conclusion

A review of the actions taken by the credit rating agencies during the COVID-19 crisis shows that the agencies responded to evolving market and economic conditions promptly and have effectively performed their role as independent providers of forward-looking information. First, rating agencies immediately made credit assessments to identify and rank order the susceptibility of rated issuers to current and future risks arising from the pandemic, providing transparency to market participants. Second, the vast majority of the credit rating agency actions and defaults have focused on the riskiest types of debt, suggesting that the pre-COVID ratings were accurate. Finally, large portions of early downgrades during the COVID-19 crisis concentrated in the sectors that were ultimately the most impacted by the pandemic, suggesting that the rating agencies did well to provide accurate forward-looking assessments with their early actions.

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