



The Daily Dish

The Debt Limit, Ratings, and Rating Agencies

DOUGLAS HOLTZ-EAKIN | DECEMBER 7, 2021

With a government shutdown in the rearview mirror, the primary policy issue shifts to the debt limit. Recall that Congress provided Treasury with a short-lived cash infusion that kicked the date by which the debt limit will need to be raised (or suspended) to roughly December 15. That time is fast approaching, but thus far there is no publicly disclosed plan to address the limit.

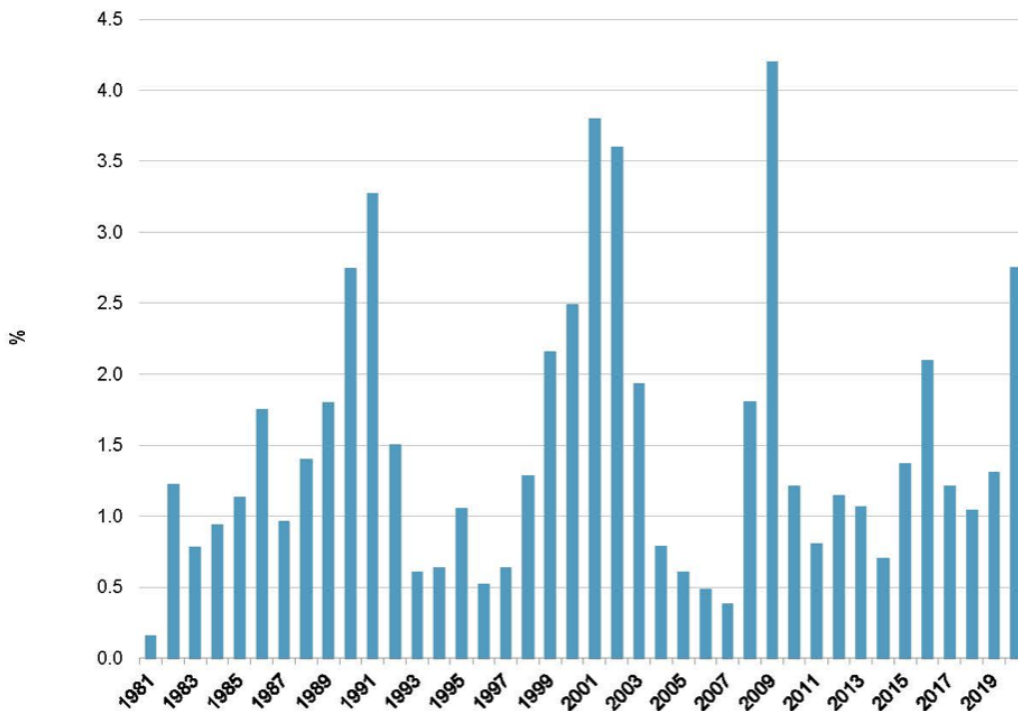
This is a concern, at least for me, because even if the limit is ultimately dealt with, a very messy process that threatens default may lead [rating agencies](#) to [downgrade](#) the United States – something that happened a decade ago. This possibility raises the question: Should we care what the rating agencies think?

This is not a rhetorical question. In the aftermath of the financial crisis the rating agencies received considerable criticism of their ratings of the exotic securities structured around mortgages. The Financial Crisis Inquiry Commission (FCIC) opined: “Financial institutions and credit rating agencies embraced mathematical models as reliable predictors of risks, replacing judgment in too many instances. Too often, risk management became risk justification.” Even the dissent by myself, Bill Thomas, and Keith Hennessey took a dim view: “Failures in credit rating and securitization transformed bad mortgages into toxic financial assets. Securitizers lowered the credit quality of the mortgages they securitized. Credit rating agencies erroneously rated mortgage-backed securities and their derivatives as safe investments.”

Still, that was a decade ago, and the rating agencies have undergone enormous management changes and investments in their approach to rating securities. Has it worked?

As it turns out, there is a great opportunity to look into this. Nobody saw the COVID-19 pandemic coming, so it is a genuinely independent shock to the financial system. This produced lots of financial distress, notably a sharp rise around the globe in corporate defaults. The graph (below) documents this fact for corporate securities rated by S&P Global; it is reproduced from its [review](#) of rating performance in 2020.

Annual Global Corporate Default Rate

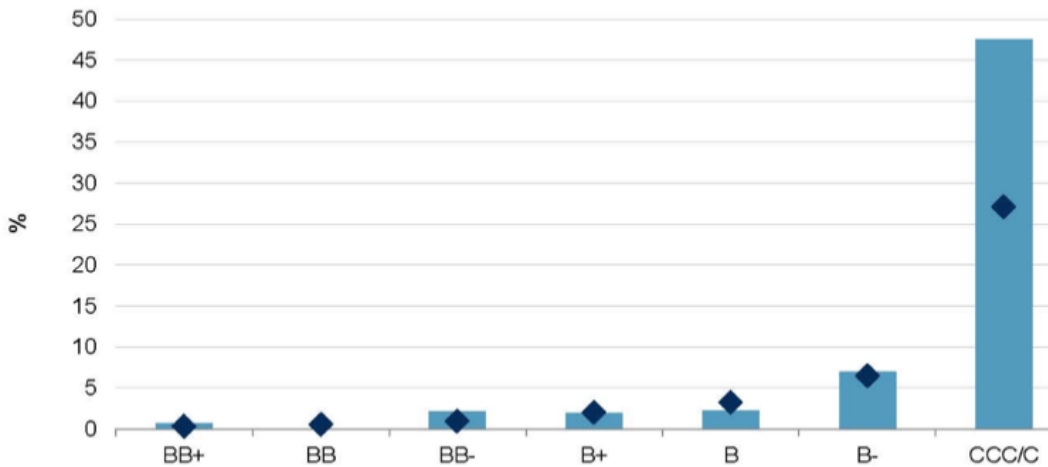


Sources: S&P Global Market Intelligence's CreditPro® and S&P Global Ratings Research.
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Clearly, the rate of corporate default jumped north in 2020, although it remains below the spike evident in the financial crisis. And, importantly, this is a global phenomenon (as was the pandemic) so it is not the artifact of the specific policy responses in any single nation.

If rating agencies did their job right, those defaults should be concentrated in the lower-rated bonds. As the next graph (also reproduced from that report) shows, default rates for bonds rated B- or above tracked close to their historical average in 2020. But poor-quality bonds defaulted at a rate far above what history would have projected.

Global Corporate Default Rates



Sources: S&P Global Market Intelligence's CreditPro® and S&P Global Ratings Research.
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In short, the rating agencies (S&P in this case) did their job. The ratings provided information on credit risk, and when the environment became stressed, that information predicted defaults.

That is a far cry from the perception of 10 years ago. It suggests that the due diligence in the interim has proved fruitful. It also suggests that Congress and the administration should not play footsie with the debt limit to the point that the United States risks a downgrade.