EUROPEAN ASSOCIATION OF CREDIT RATING AGENCIES

How Ratings Impact Borrowing Cost?

Beyond upgrades, downgrades, and headlines

EACRA Educational Series #20

1. From Credit Risk to Borrowing Cost

The Big Picture

The borrowing cost of an issuer can be broadly decomposed as:

Borrowing Cost = Risk-Free Rate + Credit Spread

Credit ratings primarily influence the **credit spread**, i.e. the compensation investors demand for bearing default risk and uncertainty.

Ratings do **not** set prices directly.

They **shape investor behaviour, constraints, and benchmarks**, which in turn affect pricing.

2. The Direct Channel

Perceived Default Risk

At their core, credit ratings express a **relative probability of default** over a given horizon.

All else equal:

- Higher-rated issuers are perceived as **less likely to default**
- Lower-rated issuers are perceived as **riskier**

This affects:

- Required yield at issuance
- Secondary-market spreads
- Refinancing conditions over time

Empirically, spreads tend to **increase step-wise** as ratings migrate down the scale, especially around key thresholds.

3. The Threshold Effect

Investment Grade vs High Yield

One of the most powerful mechanisms is the **rating threshold effect**. The boundary between:

- **Investment Grade (IG)** and
- **High Yield (HY)**

often triggers **non-linear changes** in borrowing costs because many investors face **mandate constraints**.

Consequences of crossing a threshold may include:

- Forced selling by IG-only investors
- Reduced eligible investor base
- Lower market liquidity
- Higher refinancing risk

This is why rating downgrades around the IG/HY boundary can have **disproportionate market impact**.

4. The Regulatory Channel

Capital and Solvency Frameworks

In regulated financial systems, credit ratings are embedded - directly or indirectly - into prudential frameworks.

Examples include:

- Bank capital requirements
- Insurance solvency charges
- Eligibility rules for certain portfolios

When a rating changes, it can alter:

- The **capital cost** of holding the exposure
- The **economic attractiveness** of lending or investing

These effects can feed back into pricing, especially for large or regulated investors.

5. The Benchmarking Channel

Relative Value, Not Absolutes

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Markets rarely price risk in isolation.

Issuers are often priced **relative to peers**:

- Same sector
- Same rating category
- Same maturity bucket

Credit ratings provide a **common language** that allows investors to:

- Compare spreads
- Identify anomalies
- Allocate capital efficiently

In this sense, ratings contribute to **market discipline and comparability**, even when investors disagree with a specific opinion.

6. Primary vs Secondary Market Effects

Different Dynamics

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The impact of ratings differs across markets:

Primary market

- Influences coupon setting and investor demand
- Affects deal execution and allocation

Secondary market

- Shapes spread volatility
- Amplifies reactions to outlooks, watches, and rating actions

Importantly, **outlooks and watches** often affect borrowing costs *before* any actual rating change.

7. What Ratings Do Not Do

Setting the record straight

To avoid common misconceptions:

- Credit ratings do **not** predict exact default timing
- They do **not** set interest rates mechanically
- They do **not** replace investor credit analysis

They are **one input** - but a structurally important one - in the pricing of credit risk.

Key Takeaway

Indirect channels, real effects

Credit ratings influence borrowing costs through **multiple indirect but powerful channels**:

- Risk perception drives the credit spread
- Investor mandates contrain the eligible universe
- Regulatory frameworks set capital and solvency charges
- Market benchmarks relative value across peers

Their impact is often **non-linear**, **state-dependent**, and **strongest at thresholds**.

Understanding these mechanisms is essential for issuers, investors, policymakers, and supervisors alike.

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