

## **Sovereign Risk Ceilings: Rethinking Credit Assessment Through Risk Disaggregation**

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**A full technical report with in-depth analysis is forthcoming and will be available at <https://ccsi.columbia.edu/rethinking-sovereign-risk-ceilings/>**

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This briefing paper examines the conditions under which sovereign risk ceilings are applied to non-sovereign debt issuers in emerging markets and developing economies (EMDEs). The analysis proposes a structured framework to disaggregate “sovereign risk” into explicit, identifiable transmission channels, evaluating how contractual, legal, and structural mitigants modify default risk. The findings are intended to inform a more precise, channel-based approach to credit assessment rather than repeating existing macroeconomic critiques of proxy-based rating ceiling's.

In international debt markets, the credit rating of a sovereign typically acts as a ceiling for all borrowers within that country. This practice, known as the sovereign ceiling, limits the extent to which companies can access affordable financing, regardless of their individual risk profiles. While originally developed as a safeguard against systemic risks observed during past sovereign crises, this approach now raises important methodological and practical questions - particularly in EMDE contexts where elevated sovereign risk premia translate into a binding cost-of-capital constraint on climate-aligned investment.

This paper argues that the sovereign ceiling functions as a simplifying shortcut that can obscure meaningful differences in risk across borrowers. By treating sovereign distress as uniformly transmissible across all domestic entities, the methodology compresses risk differentiation and may misrepresent actual default probabilities.

The proposed alternative is an approach based on disaggregating sovereign risk into specific transmission channels. Once these channels are identified and assessed individually, many can be mitigated through contractual design, financial structuring, and institutional arrangements. In such cases, the sovereign ceiling adds limited analytical value and may distort investment decisions. The objective is not to dismiss sovereign risk, but to reposition it as one input among others in a more granular and evidence-based framework for credit assessment.

The paper focuses on non-sovereign debt issuers in EMDEs, particularly domestic-revenue, capital-intensive sectors such as power, digital infrastructure, and transport. Export-oriented projects are included only as a contrast case. The paper does not attempt to re-rate sovereigns or design a new ratings model; nor does it dismiss macro financial risk. Its scope is whether a proxy-based ceiling adds analytical value once specific interference channels and their mitigants are assessed directly at the instrument level.

Thus, the central question this paper addresses is not whether sovereign stress can affect domestic infrastructure borrowers. It can. The question is whether the pathways through which it does so can be sufficiently contained to warrant credit differentiation above the sovereign. Where the answer is yes, a rigorous methodology should be able to recognize it.

This paper is an executive summary of a longer analytical paper grounded in extensive empirical evidence; all quantitative analysis, data, and supporting references are contained in that forthcoming report, available at <https://ccsi.columbia.edu/>. Readers seeking the underlying evidence base—including analysis of rating agency methodologies, default and recovery data, and the full transmission channel assessment—are directed to that paper.

# 1. Role, Origins, and Limits of the Sovereign Ceiling

Sovereign credit ratings strongly influence access to international capital markets in emerging and developing economies. Under prevailing methodologies, the rating assigned to a government effectively sets an upper bound for the ratings of domestic borrowers. This constraint shapes the availability, cost, and tenor of external financing.

The sovereign ceiling emerged during a period marked by repeated sovereign crises in emerging markets. In the 1980s and 1990s, defaults were often accompanied by broad economic dislocation, including currency collapse, capital controls, and disruptions to domestic financial systems. In this context, it was reasonable to assume that corporate and project-level borrowers would be unable to meet external obligations if the sovereign itself was in distress. The rationale is straightforward: governments facing financial pressure may impose capital controls, restrict access to foreign exchange, intervene in contracts, or disrupt payment systems.

Over time, however, the application of the ceiling has become more formalized and embedded in rating methodologies. While rating agencies have introduced limited flexibility, allowing for above-sovereign ratings under specific conditions, these exceptions remain narrow. Typically, they apply only to entities with substantial foreign currency earnings, offshore structures, or geographically diversified operations.

As a result, most domestically focused borrowers remain constrained by the sovereign rating, regardless of their individual financial strength or structural protections. Critically, the eligibility conditions for piercing the ceiling—offshore cash-flow capture, hard-currency earnings, and geographic diversity providing insulation from the sovereign jurisdiction—were calibrated for foreign-currency export transactions in the 1990s and continue to reflect that heritage. They are not simply difficult to satisfy for domestic revenue infrastructure projects denominated and paid in local currency: they are logically inapplicable. A project cannot achieve structural separation from the economy it was built to serve.

## 2. What the Evidence Shows

Empirical data challenge the assumption that sovereign distress leads to widespread default among domestic borrowers. Historical evidence shows that, even during severe sovereign crises, a significant proportion of companies and financial institutions continue to service their debt. Moody's own data on EM corporate defaults during sovereign crises show that the majority of rated entities — over three-quarters of all EM corporates and sub-sovereigns, and over 83% of utilities and 94% of banks — did not default during the four-year crisis windows reviewed.

Default rates do increase during periods of sovereign stress, but the impact is uneven. Many firms remain resilient due to differences in business models, contractual arrangements, and financial structures. This suggests that sovereign risk does not transmit uniformly across all entities.

Further evidence from infrastructure financing in emerging markets reinforces this point. Projects supported by development finance institutions and structured with robust contractual and financial safeguards have exhibited low default rates and high recovery rates over extended periods (see the Global Emerging Markets Risk Database (GEMs), a consortium database of development finance institutions coordinated by the IFC). In some cases, their performance is consistent with high investment-grade risk, despite being rated significantly lower due to sovereign constraints.

This divergence between observed performance and rating outcomes suggests that the current methodology may overstate risk for certain borrower classes. For the period 2016–2026, only five verified above-sovereign rating precedents were identified globally across all asset classes. All five relied on structural isolation: offshore SPVs, future-flow securitizations, or international diversity. Zero above-sovereign precedents exist for domestic revenue infrastructure.

This reflects methodological foreclosure at least as much as it reflects underlying credit weakness. Treating it as evidence that the ceiling is necessary conflates the methodology's effect with evidence about the risk itself.

In effect, the methodology leads to three related failures:

- **Loss of differentiation:** Borrowers with very different risk profiles receive similar ratings.
- **Mispricing of risk:** Credit spreads may not accurately reflect underlying default probabilities, artificially reducing the realm of investable opportunities
- **Structural bias:** Domestically focused projects are disadvantaged relative to internationally diversified entities.

Many EMDE banks and corporates—some with credit profiles stronger than their sovereigns—are not rated by the Big Three. As a result, evidence on above-sovereign outcomes is inherently partial, reflecting only the rated subset of the economy. This creates a structural blind spot: entities that could qualify are never tested because they lack international ratings or do not maintain them. For them, being unrated is effectively equivalent to being capped by the sovereign ceiling—just expressed through non-coverage rather than explicit constraint.

# 3. Disaggregating Sovereign Risk Transmission

A central contribution of this report is the decomposition of sovereign risk for the country's issuers into eight distinct transmission channels. Rather than treating sovereign distress as a single, undifferentiated risk, this approach identifies the specific mechanisms through which it can affect a borrower's ability to service debt.

These channels include:

- Restrictions on foreign exchange conversion and transfers
- Government-imposed payment moratoria
- Regulatory and contractual intervention
- Default or delayed payment by state-controlled counterparties (ie: the off-taker risk, considering the most frequent counterparty of infrastructure in EMDEs).
- Currency depreciation and inflation
- Banking system disruption
- Expropriation or asset seizure
- Broader macroeconomic downturns

The practical effect of the sovereign ceiling is that all eight channels bind simultaneously and with similar force, irrespective of currency regime or project structure. That single assumption is the methodology's core weakness.

A disaggregated approach yields a sharply different result. For a well-structured domestic revenue infrastructure project operating in a floating local-currency regime, typically only two channels dominate in the operational phase: regulatory and contract interference, and offtaker payment risk. The remaining six are either structurally limited by the local-currency denomination of debt and revenues or mitigable under international project finance arrangements (where foreign-currency debt is involved).

Analyzing these channels individually allows for a more precise assessment of risk. In many cases, only a subset of these channels is relevant to a given project or issuer.

## 4. The Role of Mitigation Mechanisms

A central implication of the disaggregated approach is that sovereign-related risks are not fixed; they can often be reduced through design. Modern project finance structures include a range of contractual, financial, and institutional tools that influence how — and whether — risk is transmitted to creditors, while the issuer's own cash flow remains the primary source of debt service, a different mechanism from a third-party guarantee that legally replaces the issuer's credit risk altogether

As mentioned, regulatory risk and offtaker payment risk are typically the most important channels for domestic infrastructure. Both can be mitigated, though not eliminated, through specific mechanisms. The current rating methodologies do analyze these risks, but the mitigating effect of project-level protections is not fully reflected in the final rating outcome once the offtaker credit quality constraint and the sovereign ceiling are applied.

For regulatory risk, mitigation operates through a combination of clearly defined tariff-setting rules and indexation mechanisms, contractual protections such as change-in-law provisions, institutional arrangements that limit discretionary intervention, and participation by multilateral development institutions, which can alter government incentives.

For offtaker risk, commonly used tools - in the context of a single state-controlled offtaker model — include sovereign guarantees backing payment obligations, liquidity buffers such as reserve accounts, structured payment waterfalls that prioritize debt service, and credit enhancement from development finance institutions.

Financial structuring tools also play an important role. Fixed-rate debt, hedging instruments, and conservative liquidity planning can reduce exposure to interest rate and currency volatility.

These features do not remove underlying risk, but they can deter opportunistic government interference or materially change its timing and impact.

## 5. Two Illustrations

Two cases illustrate the limits of using sovereign ratings as a proxy for regulatory risk.

### **Spain and South Africa: Regulatory Risk Cannot Be Inferred from Sovereign Ratings**

Despite holding investment-grade status, Spain implemented retroactive changes to its renewable energy tariff regime between 2010 and 2014. These measures significantly reduced revenues for existing projects and, in many cases, impaired their ability to service debt.

South Africa, by contrast, suspended new procurement rounds under its renewable energy program (REIPP) between 2015 and 2019 amid fiscal and political stress. Yet existing power purchase agreements were honored, and project cash flows remained intact, even as the state-owned utility faced severe financial distress.

Regulatory stress occurred in both cases. Only one resulted in payment impairment. Sovereign rating did not predict this difference. The ceiling does not distinguish between different forms of regulatory intervention, nor does it assess whether contractual protections are effective in preserving cash flows. As a result, it can both understate risk in higher-rated jurisdictions and overstate it in lower-rated ones.

### **Eskom and REIPPP: Offtaker Stress Without Binding Default Risk**

The South African REIPPP program provides a concrete illustration of how far observed performance can diverge from ceiling-based inference. As of early 2026, Eskom — the state-owned offtaker for REIPPP projects — is rated B2/B/B by the three major agencies, several notches below investment grade, with over R100 billion in outstanding municipal arrears. South Africa's sovereign debt stands at approximately 78% of GDP, and Eskom itself carries roughly R360 billion in total debt securities and borrowings — having received over R230 billion in government debt relief since 2023. The sovereign ceiling approach treats REIPPP independent power producers as exposed to the sovereign's level of credit risk.

Yet REIPPP producers have continued to receive payments without interruption throughout the period of Eskom's financial distress. Three structural features explain this divergence: a sovereign guarantee backstopping Eskom's payment obligations under the PPAs; payment waterfall provisions that prioritize IPP settlements; and the South African government's sustained political commitment to the renewable energy transition.

Offtaker stress is present, but it is not binding for project debt service. The ceiling cannot make this distinction. A transmission-based methodology must.

## 6. Toward a More Granular and Modular Approach

A more effective framework would assess credit risk at the level of the individual transaction or issuer, taking into account both exposure to sovereign-related risks and the effectiveness of mitigation measures. The paper proposes a four-step architecture:

**Step 1** — Standalone credit assessment: evaluate intrinsic creditworthiness based on issuer fundamentals, financial structure, and counterparty quality, without reference to the sovereign ceiling.

**Step 2** — Transmission channel mapping: for each of the eight channels, assess (a) whether it is structurally active for the instrument; (b) the probability it becomes binding under stress; and (c) the credibility and enforceability of available mitigants.

**Step 3** — Reposition the sovereign as a contextual factor: where channels are identifiable, and mitigants credibly address them, the sovereign's influence is captured within the channel analysis — as a factor informing channel activation, binding probability, and mitigant strength — rather than overriding it as a ceiling. The resulting assessment yields a graduated uplift calibrated to the cumulative decoupling observed across channels. Current methodologies reach this gradient only for issuers passing a structural-template gate that domestic-revenue infrastructure cannot pass; the framework proposed here reaches it through channel-level assessment.

**Step 4** — Retain a conservative bound where warranted: where channels cannot be observed, regulatory discretion is opaque, or mitigants are untested, a sovereign-level proxy retains a prudential purpose. It is applied selectively, not universally.

This approach would allow for greater differentiation across borrowers and more accurate alignment between ratings and observed performance.

A further consequence follows from this. To the extent that ratings systematically misprice the risk of well-structured EMDE infrastructure exposures, banks under the standardized approach, insurers under risk-based capital regimes, and pension funds under fiduciary mandates carry portfolio risks that diverge from what their internal models and external ratings imply; methodological accuracy in this asset class is therefore not only a development or cost-of-capital question, but a prudential one, with a natural constituency among regulators and financial-stability authorities.

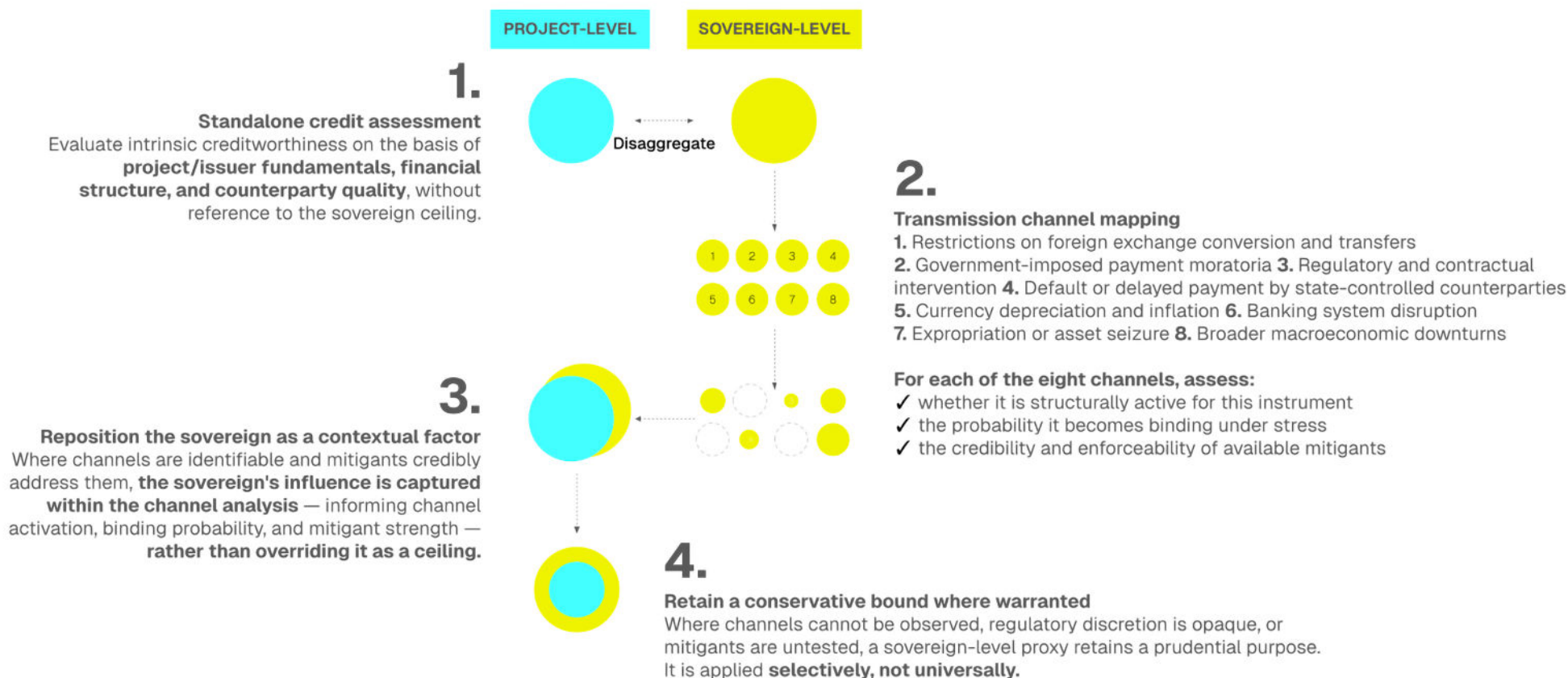
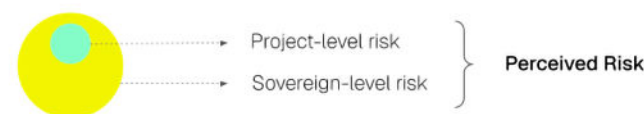
# Assessing Credit Risk

A **4-step methodology** toward a more granular and modular approach, at the level of the individual transaction or issuer, taking into account both exposure to sovereign-related risks and the effectiveness of mitigation measures.

● Project-level Assessment    ● Sovereign-level Assessment

## Historic Context

In the 1980s and 1990s, defaults were often accompanied by broad economic dislocation, including currency collapse, capital controls, and disruptions to domestic financial systems. In this context, it was reasonable to assume that corporate and project-level borrowers would be unable to meet external obligations if the sovereign itself was in distress.



# Conclusion

Sovereign ceilings were developed as a practical response to a period of high uncertainty and limited analytical tools. While they continue to serve a role in highlighting systemic risks, their application as a uniform cap on ratings is increasingly difficult to justify.

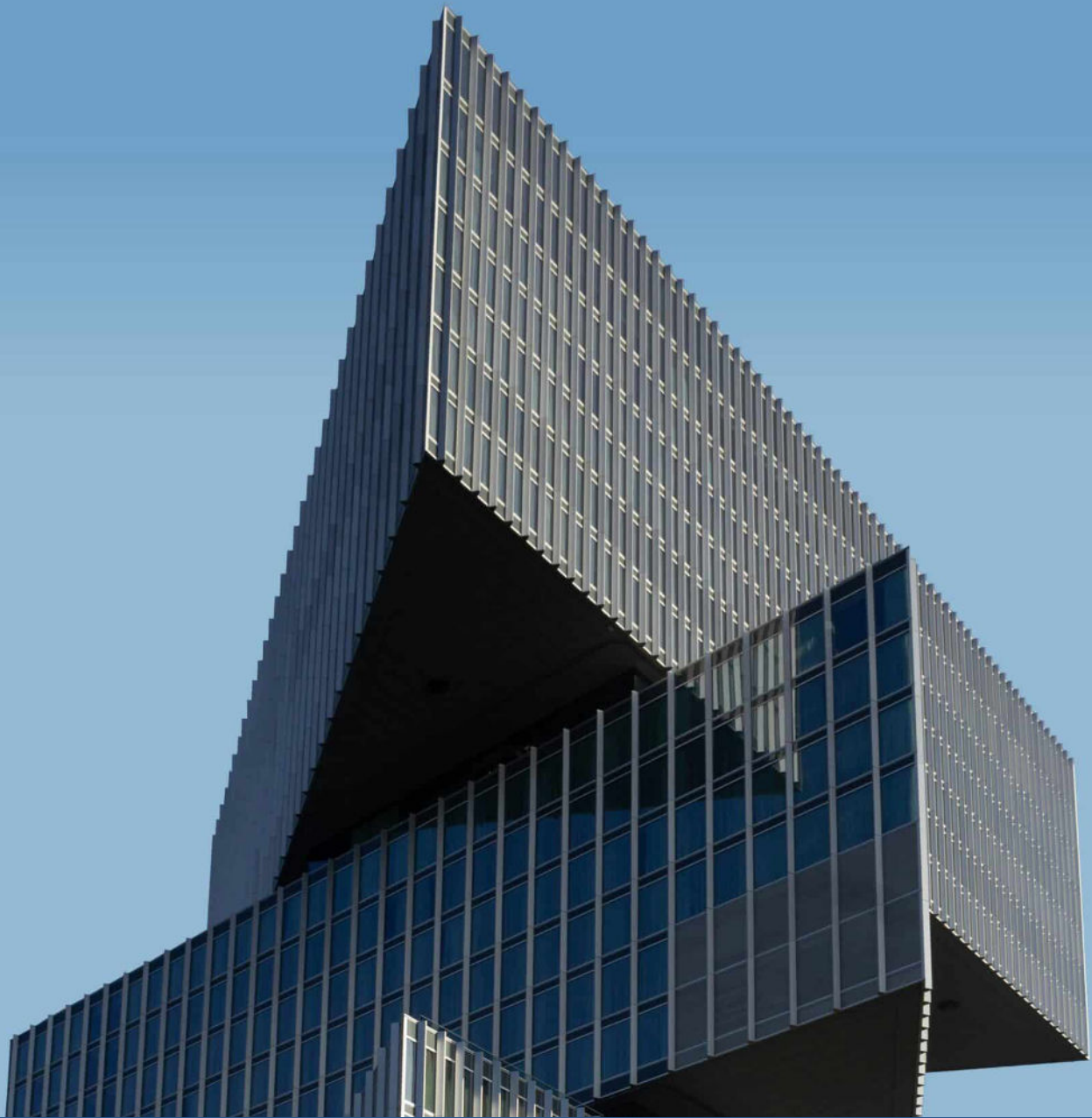
Advances in financial structuring, greater availability of empirical data, and a deeper understanding of risk transmission mechanisms now make it possible to assess credit risk with greater precision. In this context, reliance on a single proxy for sovereign risk may lead to systematic misrepresentation of borrower quality. By the same token, the analytical burden of justifying ceiling application should therefore rest with the agency asserting that the relevant channels are active and unmitigated for the specific issuer, not with the issuer asserting that it has externalized its cash flows from the sovereign environment.

Reframing the methodology to focus on disaggregated risk and mitigation would not eliminate the relevance of sovereign conditions. Instead, it would place them within a broader analytical framework that better reflects how risk operates in practice.

Such a shift would improve risk assessment, whose misperception inflates the cost of capital, support more efficient allocation of capital, and enhance the ability of markets to finance productive investment in emerging and developing economies. The practical stakes are significant. Where a ceiling cannot be pierced regardless of project quality, market participants have less reason to pay for stronger structuring, better counterparties, more credible contractual protections, and more robust mitigation packages. The ceiling may therefore weaken the incentive to build the very features that would improve bankability and resilience.

And where those features are not built, the divergence between observed risk and rated risk is not only a development-finance concern: it leaves banks, insurers, and pension funds carrying portfolio exposures that diverge from what their internal models and external ratings imply, giving regulators and financial-stability authorities a direct interest in the same methodological reform.

More broadly, these methodological improvements carry direct implications for the global climate finance agenda. By correcting the systematic overstatement of risk for domestic revenue infrastructure in EMDEs, a disaggregated approach could meaningfully lower the cost of capital for climate-aligned investment—mobilizing greater private resources for the energy transition in precisely the markets where it is most needed. As explored in CCSI's complementary work on pathways to lower the cost of capital, reducing risk misperception at the instrument level (e.g., guarantees) is one of the most tractable levers available to policymakers and market participants seeking to close the climate finance gap in emerging and developing economies.



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