CREDIT RATING AGENCIES' LIABILITY IN THE LIGHT OF THE GLOBAL FINANCIAL CRISES OF 2007-2008

By Olena Chemrat

MA SHORT THESIS
COURSE: Capital Markets and Securities Regulations
PROFESSORS: Andrzej Baniak, Tibor Tajti
Central European University
1051 Budapest, Nador utca 9.
Hungary

Table of Contents

Abstract

The research paper examines both economic and regulatory aspects of the credit rating agencies (CRA) and their leading role in global financial crises, as well as gives detailed analyses of the ratings services provided by the Big Three CRA. The primary focus of this paper is on the comparison of the credit rating agencies services' regulations before the subprime mortgage crises, during the global financial crises and after it both in USA and in Europe. It provides the examples of some major issues brought against the Big three rating agencies for their failures to meet the certain requirements in the light of the Global financial crises.

The paper proceeds with the regulatory framework examination and analyses of the changes in the USA and European regulations regarding the supervision of the rating agencies, stipulating the Dodd–Frank Wall Street Reform and Consumer Protection Act and the 2006 Credit Rating Agency Reform Act's provisions. It concludes with the proposal for the future reforms in the regulatory framework of the market of rating services.

Introduction

> "Whether you're earning $7 an hour or $700,000 a year, it's very important to protect your credit rating". [1]
>
> Frank Abagnale

The recent events that took place in 2007-2009 on the global financial markets arena, have witnessed an urgent need in the optimal credit rating agencies' regulatory framework and sustainable reforms.

Through the process of globalization and capital markets expansion, where the financial innovation products appear to be dominating the industry, the role of credit rating agencies as the core mechanisms for independent evaluation of the safety of the particular types of securities and borrowers have drastically increased.

Nowadays, rating agencies are considered one of the primary sources of the capital market movements and interest rates fluctuations. Their ratings keep various financial institutions, businesses and entire countries in total awe, which entails erratic consequences resulting in most of the cases in the long-lasting economic recessions and crises. The CRAs represent the powerful influential tool that can easily influence various financial markets.

One of the New York Times financial news reporter once mentioned that at the end of the Cold War, there were two main superpowers: USA and Moody's, meaning that if the USA is able to eradicate any enemy, the Moody's can easily shatter the financial markets by downgrading the ratings.[2]

[1] Frank, Abagnale. "Frank Abagnale Quotes." *You-e-HUT Ideas*. N.p., 13 Aug. 2012. Web. 04 June 2014. http://www.kluwerarbitration.com/CommonUI/document.aspx?id=KLI-KA-1232570&query=
[2] Chua, Jean. "Moody's Downgrade of Banks 'Absurd,' Says Dick Bove."*CNBC.com*. N.p., n.d. Web. 05 June 2014. http://www.cnbc.com/id/47912905.

Over the past few decades, the Big Three CRAs that dominated the market have been in the heart of the attention of many financial market players. [3] Starting from the 1973 oil crises, then the Black Monday financial market collapse, Enron, dotcom bubble and ending up with the recent global financial subprime mortgage crises, CRAs were at the epicenter of the events. Their services were loosely regulated, empowering the agencies to dominate the financial markets and controlling all the operations with the securitized products.

The credit crunch in USA entailed the Eurozone bond market crises, which resulted in various countries' defaults and losses. It's very important to see how the collapse of one system affects the functioning of the other one. Although the regulatory frameworks of financial markets' independent rating agencies in USA and Europe were disparate, both major economies were on the verge of collapse when the crises struck.

This paper provides the overview of the credit rating agencies, focusing on their functions and regulations. It compares three historically significant periods in the US and European financial markets: pre-crises, the collapse of the system and the post-crises. The final part of the thesis addresses the problems of the CRAs' liabilities and main regulatory frameworks, changes made over the time and suggests the proposal for the future reforms.

[3] White, Lawrence J. "Credit Rating Agencies: An Overview." *Annual Review of Financial Economics* 5.1 (2013): 93-122. *Credit Rating Agencies: An Overview*. Web. http://web-docs.stern.nyu.edu/old_web/economics/docs/workingpapers/2013/White_CRAsARFE_Jun2013.pdf

Chapter 1. The evolution of the Credit Rating Agencies: pre-crisis existence

1.1 CRAs in USA: industry structure and regulatory aspects

During the recent global financial crises, the most trusted and reliable independent rating institutions have showed their incompetence, misusing the assigned powers and providing higher ratings to the issuers of the securities and the "junk" default level securitized products. Various scholars and economists still argue of what was the primary role of the CRAs in the global financial crises and what were the main reasons of the entire financial system's collapse.

The process of the capital markets globalization and diversification of various financial products, together with broader spectrum of the presented opportunities brings the challenge to the investors of where to insert their money in order to obtain higher yields.

Historical references and overview of the CRAs' changes over the time present a better understanding of the rating process and justify the challenges the financial markets face nowadays.

The assigned ratings have a direct effect on the interest rates paid on the security, its price and the yields that the given security brings. The higher the rating, the lower the risk of the issuer's default.[4]

Wikipedia explains: "the credit rating represents the credit rating agency's evaluation of qualitative and quantitative information for a company or government; including non-public information obtained by the credit rating agencies' analysts". [5]

The establishment of the transparent market system, characterized by high liquidity of the securities, is closely correlates with the formation of the unified process of credit risks assessment. The offer of the rating services is considered to be one of the substantial ways of risk assessment. As the time goes by, ratings and grades assigned to various types of securities become an essential part of the investment process and fundamental procedure for entering international global financial markets.

[4] "Credit Rating Definition | Investopedia." *Investopedia*. N.p., n.d. Web. 05 June 2014. http://www.investopedia.com/terms/c/creditrating.asp.
[5] "Credit Rating." *Wikipedia*. Wikimedia Foundation, 06 Mar. 2014. Web. 05 June 2014. http://en.wikipedia.org/wiki/Credit_rating

Ratings assist to prove the liquidity of the certain types of financial instrument, as well as improve the image of the issuers, lowering the interest rates for their loans and offering the opportunity to borrow money upon request at any reasonable time.

The main task for the CRAs is to identify and calculate the future creditworthiness of certain borrowers and securities regarding the specific date. The rating can affect the issuer's access to the capital, the structure of financial operations and the relevancy of the investment type. Some regulatory bodies such as Securities and Exchange Commission in USA use ratings to regulate the capital markets.

Depending on the location and the functions performed, the CRAs can be divided into two main categories: national and global. National rating agencies are capable of providing more efficient assessment of the creditworthiness of their clients, as they are able to collect more transparent data regarding particular types of securities or the issuers, while global rating agencies face the problem of underperformance of the capital market participants in terms of providing the valid and most up-to-dated information for estimation, which plays a great role in assessing of the solvency of various entities. The price paid by the issuers of the securities on the national level is much lower and usually varies between $3000 and $30000 USD, whereas global agencies ask for the higher remunerations in the range between $50000 and $100000 USD.

The CRAs in USA are regulated by the Credit Rating Agency Reform Act of 2006, Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), Section 15E and Rules 17g-1 through 17g-7of the Securities Exchange Act of 1934.[6]

As the capital markets are developing at the exorbitantly high speed and the financial innovations pervade the markets in various forms, the role of the special purpose institutions capable of providing the risk assessment for the capital markets transactions has been rapidly increasing. So how were these independent institutions created and what was their primary role?

Together with the expansion of the trade between the distant regions of the country in the middle of 19th century in the US, the uncertainty about the exchange of money and goods made

[6] "Nationally Recognized Statistical Rating Organizations ("NRSROs") Subtitle C of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") Title IX, Subtitle C: Improvements to the Regulation of Credit Rating Agencies Section 15E of the Securities Exchange Act of 1934, as Amended by the Dodd-Frank Act Section 15E: Registration of Nationally Recognized Statistical Rating Organizations Securities Exchange Act of 1934 Rules 17g-1 through 17g-7." *Spotlight On: Nationally Recognized Statistical Rating Organizations ("NRSROs")*. N.p., n.d. Web. 05 June 2014. https://www.sec.gov/divisions/marketreg/ratingagency.htm.

over the large distance became a crucial problem for many merchants. They could not rely on their business partners any longer, nor could they offer the extension of a credit, as there was no way to evaluate the creditworthiness of the customer and receive a guarantee that the borrowers will have enough sufficient costs to cover their obligations. Before trade expansion, merchants used to know all their customers personally, later on it became impossible to acquire all the information about the customers, which led to the uncertainty on the capital markets. This is the time when some credit reporting institutions (agencies) came into place.

Historically, the first rating agencies were established by Louis Tappan and John Bradstreet back in 1841 in the state of New York.[7] They were independent institutions, which collected information about the customers, rated their ability to pay back the obligations and published the obtained results in brochures or guides.[8]

Later on in early 1900, together with the development of the railroad industry in USA, credit rating agencies were fulfilling the role of the agents, who would provide the bond market securities' ratings. In early 1907, in the light of the financial crises, the demand for the independent analyses of the information regarding the railroad bonds and other securities increased drastically. In a couple of years, John Moody, a famous financial analyst, published the ratings that he assigned to the railroad bonds after their evaluation. That publication became the first ever publicly accessible information on the riskiness of the securities.[9] Later on, the "Big Three" CRAs appeared on the market offering same types of services with the Fitch entering in 1913, Standard and Poor's Publishing Company (S&P) in 1916, and Standard Statistics Company in 1922.

With the separation of the investment and commercial banking followed by the passage of the Glass-Steagall Act of 1933, the rating industry started to gain its popularity on the US markets. There was an urgent need for the new regulations to supervise the investment banking operations, making transactions more transparent and providing the disclosure of the information regarding the securities issuance. The Securities and Exchange Commission (SEC) was created, introducing

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[7] Richard Sylla (1–2 March 2000) "A Historical Primer on the Business of Credit Ratings". The Role of Credit Reporting Systems in the International Economy. Washington, D.C.: The World Bank. Retrieved 21 September 2013.

[8] "Buy Now Pay Later Sites: The History of Personal Credit | Buy Now Pay Later Sites." *Buy Now Pay Later Sites: The History of Personal Credit | Buy Now Pay Later Sites*. N.p., n.d. Web. 05 June 2014. http://www.buynowpaylatersites.net/buy-now-pay-later-sites-the-history-of-personal-credit/

[9] "Credit Rating Agency." *Wikipedia*. Wikimedia Foundation, 06 May 2014. Web. 05 June 2014. <http://en.wikipedia.org/wiki/Credit_rating_agency>.

the new regulation that imposed the interdiction on investment banks to invest in "speculative investment securities", which were assigned the lowest grades by recognized rating agencies. Basically, the US institutions were allowed to invest only in the investment grade securities, evauated by the leading rating agencies in USA.[10]

In between 1930s and 1980s, the market for credit rating services was expanding rapidly, various American companies, industrial firms and even world countries were undergoing the rating process. Commercial papers, deposits in the banks also were included in the scope of rating agencies' operations. It was after 1960s, when credit rating agencies started to charge the issuers of the securities and the investors for their services in order to avoid the problem of free riding when the demand for analytical and statistical services was increasing drastically. [11]

With the collapse of the Bretton Woods system in early 70s, the rating agencies industry undergone restrictive financial regulatory oversight. The SEC started taking a closer look at the credit rating agencies, relying on their ratings and grades under the federal securities laws. In 1975 SEC set up the minimum capital requirements for the market intermediaries specified in the Rule 15c3-1, stating that the higher the rated securities were, the less reserves could they hold.[12] Only ratings from "nationally recognized statistical ratings organizations" (NRSROs) - the "Big Three" agencies - were legally accepted.[13] Over time, the SEC imposed some more rules and regulations on the NRSROs under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940.[14]

Later on, in 1980s, there was a rapid change in the world of financial markets, which was caused by the moves from more expansive and short-term "intermediated" financing to much

[10] White, Lawrence J. (Spring 2010). "The Credit Rating Agencies". *Journal of Economic Perspectives* (American Economic Association) **24** (2): 211–226. doi:10.1257/jep.24.2.211. Retrieved 22 September 2013.
[11] White, Lawrence J. (24 January 2009). "Agency Problems—And Their Solution". *The American*. American Enterprise Institute. Retrieved 21 September 2013.
[12] "Testimony: The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets." *Testimony: The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets (Chairman Christopher Cox, Sep. 26, 2007)*. N.p., n.d. Web. 05 June 2014. http://www.sec.gov/news/testimony/2007/ts092607cc.htm.
[13] "A Brief History Of Credit Rating Agencies." *Investopedia*. N.p., n.d. Web. 05 June 2014. http://www.investopedia.com/articles/bonds/09/history-credit-rating-agencies.asp
[14] Federal Securities Laws." *SEC.gov*. N.p., n.d. Web. 02 June 2014. https://www.sec.gov/about/laws.shtml

cheaper "disintermediated" one, together with the liberalization of the financial markets' from the government intervention.[15]

The number of institutions dependent on the rating services had been increasing with the expansion of the debt securities market. It was the time when CRAs started providing various rating services other than for the bond securities.[16] The ratings were extended to the performance risk of some areas of structured finance, represented by the asset-backed securities (ABS) and collateralized debt obligations (CDOs), which are characterized as a risk transfer instruments.[17]

It was estimated, that by the beginning of the global financial crises, US bond market had more than $11 trillion structured finance debt securities. The Big Three CRAs were obtaining large revenues providing their services. The diagram below represents the important figures of the CRAs activities at that time. [18]

From the diagram we can see, that the revenues and profits these nationally recognized independent agencies were making in 2010, were enormous. The Big Three altogether were having around $4,5 billion of revenues, making $1,74 billion of profits.

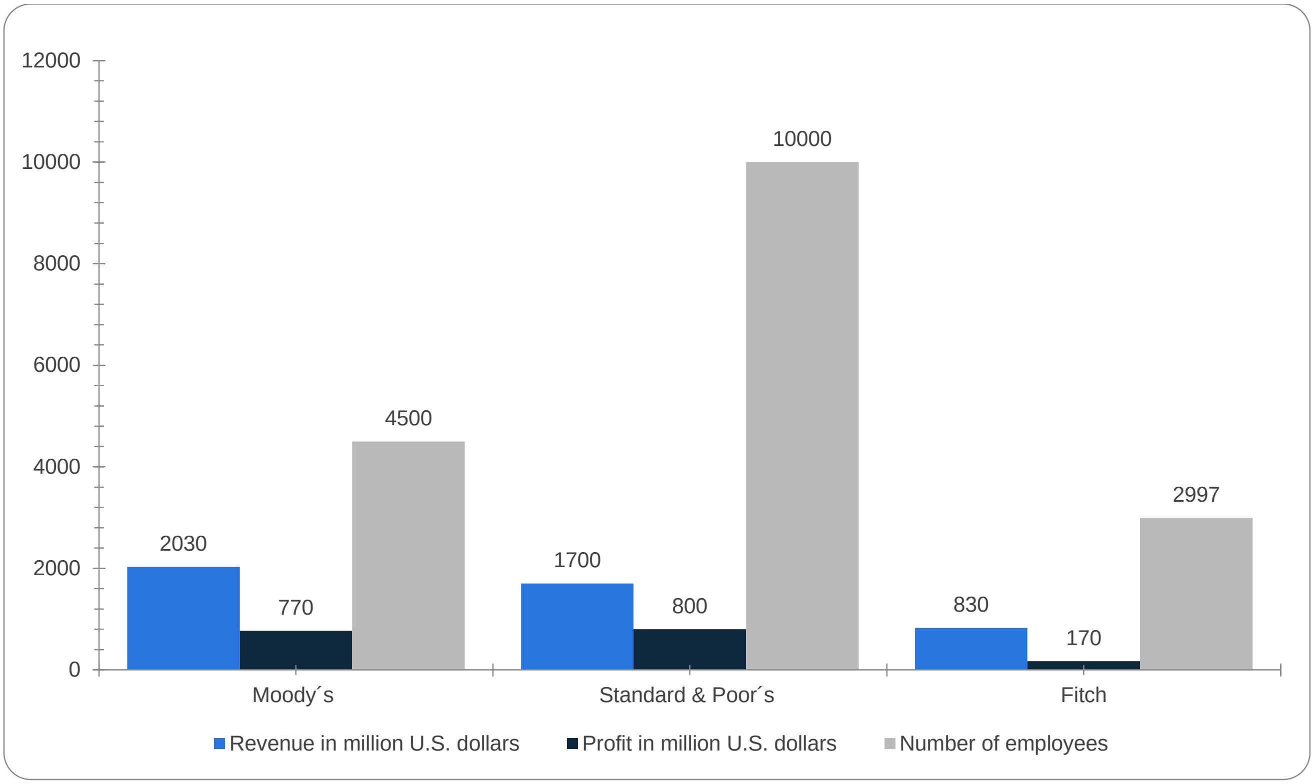
Diagram 1.1 - Comparison of selected key figures of the rating agencies Moody's, Standard & Poor's and Fitch in 2010

[15] Sinclair, Timothy J. (2005). *The New Masters of Capital: American Bond Rating Agencies and the Politics of Creditworthiness*. Ithaca, New York: Cornell University Press. pp. 57–59. ISBN 978-0801474910. Retrieved 21 September 2013.

[16] "Structured finance is a broad term used to describe a sector of finance that was created to help transfer risk using complex legal and corporate entities. This transfer of risk, as applied to the securitization of various financial assets (mortgages, credit card receivables, auto loans, etc.), has helped provide increased liquidity or funding sources to markets like housing and to transfer risk to buyers of structured products." (http://en.wikipedia.org/wiki/Structured_finance)

[17] Jobst, Andreas A. "WHAT IS STRUCTURED FINANCE?" (n.d.): n. pag.*Working Paper*. 01 Sept. 2005. Web. http://www.securitization.net/pdf/publications/structuredfinance_20oct05.pdf

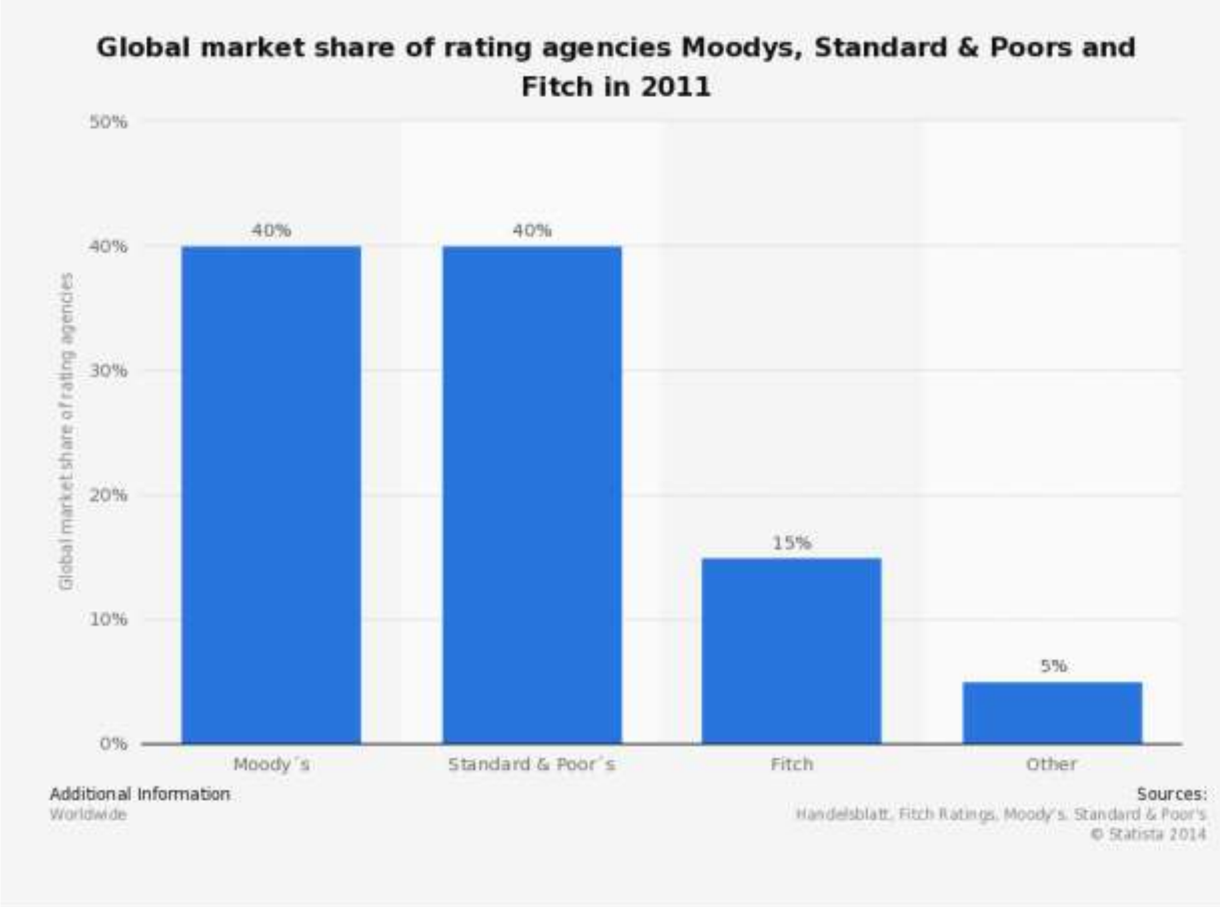
[18] "Rating Agencies - Comparison of Selected Key Figures | 2010." *Statista*. N.p., n.d. Web. 05 June 2014. http://www.statista.com/statistics/275505/selected-key-figures-of-rating-agencies/



In 2011 these agencies had the largest market share and controlled almost 95% of the credit rating services market, influencing the current world prices: Moody's Investor Service and S&P holding 40% each and Fitch 15%.[19]

Diagram 2 - Global market share of the rating agencies: Moody's, S& P's and Fitch in 2011

[19] Handelsblatt, Fitch Ratings, Moody's, Standard & Poor's, Handelsblatt, No. 127, July 5, 2011, page 7



Nowadays among other rating agencies in the capital markets, Morningstar, Dominion Bond Rating Service Ltd., and A.M. Best Company Inc., Kroll Bond Rating Agency, Egan-Jones Rating Company, R&I Inc and Japan Credit Rating Agency are gaining popularity, however their role on the market is very insignificant, accounting for around 8% in total.[20] So the main attention is always drawn to the Big Three.

S&P, being for almost 150 years in the market, is a McGraw-Hill subsidiary founded by Henry Varnum Poor and Luther Lee Blake, which conducts the financial markets research analyses. The company is famous for its American S&P 500 and Australin S&P 200 indexes. The agency has representatives in 23 countries worldwide and investors continuously show their trust in the company’s services, at least it was the case before the global financial crises. Nowadays,

[20] "List of Credit Rating Agencies." *Wikirating* -. N.p., n.d. Web. 05 June 2014. http://www.wikirating.org/wiki/List_of_credit_rating_agencies

S&P also serves the investors with various risk aversion indexes, who manage to maximize their profits by making the right decisions based on the S&P's investment research.[21]

Another large rating agency - Moody's Investors Services - has offices in 26 countries. Before 1970s, it was assigning ratings solely for the government bonds. Nowadays, the agency's financial analysts interact with the issuers on constant bases, making the process of rating assignment open and transparent.[22]

The Fitch Publishing Company, founded in 1913 by John Knowles Fitch, whose primary target was to publish financial statistics on stocks and bonds, was the first rating agency to introduce the rating scale (from AAA to D ratings) for various debt instruments.[23]

Even with the passage of the CRA Reform Act in 2006, which opened up the competition in the rating industry, the Big Three CRAs are still dominating the market, issuing 97% of all credit ratings in US and almost 95% of the world.[24] The percentage of outstanding credit ratings reported to the SEC by rating agencies in 2007-2011 presented in the Figure 1 below.[25]

Figure 1 – Moody's annual report on the number of outstanding credit ratings assessed in 2007-2011.

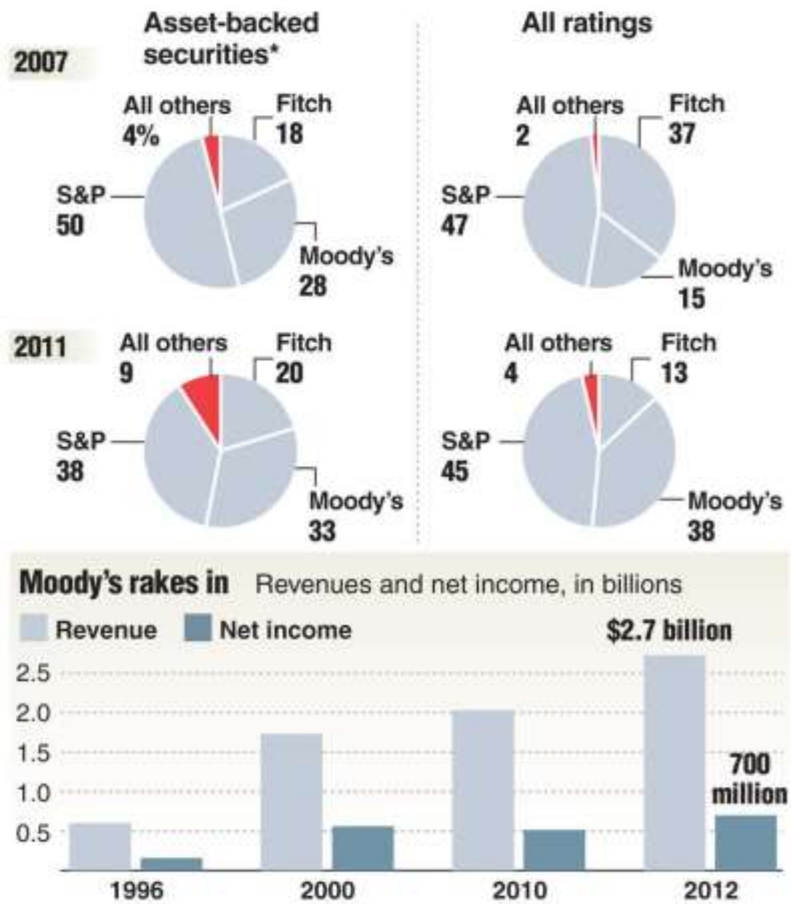
[21] "Standard & Poor's | Americas." *Standard & Poor's | Americas*. N.p., n.d. Web. 04 June 2014. http://www.standardandpoors.com/en_US/web/guest/home

[22] "History of Credit Rating Agencies and How They Work." *Money Crashers*. N.p., n.d. Web. 05 June 2014. http://www.moneycrashers.com/credit-rating-agencies-history

[23] A Brief History Of Credit Rating Agencies." *Investopedia*. N.p., n.d. Web. 05 June 2014. http://www.investopedia.com/articles/bonds/09/history-credit-rating-agencies.asp

[24] Alessi, Christopher. "The Credit Rating Controversy. Campaign 2012". Council on Foreign Relations. "`The three major rating agencies hold a collective market share of roughly 95%. Their special status has been cemented by law -- at first only in the United States, but then in Europe as well,` explains an analysis by DeutscheWelle."

[25] Status quo for rating agencies (chart of percentage of outstanding credit ratings reported to the SEC 2007 and 2011; and Moody's revenue and income 1996, 2000, 2010, 2012)| mcclatchydc.com



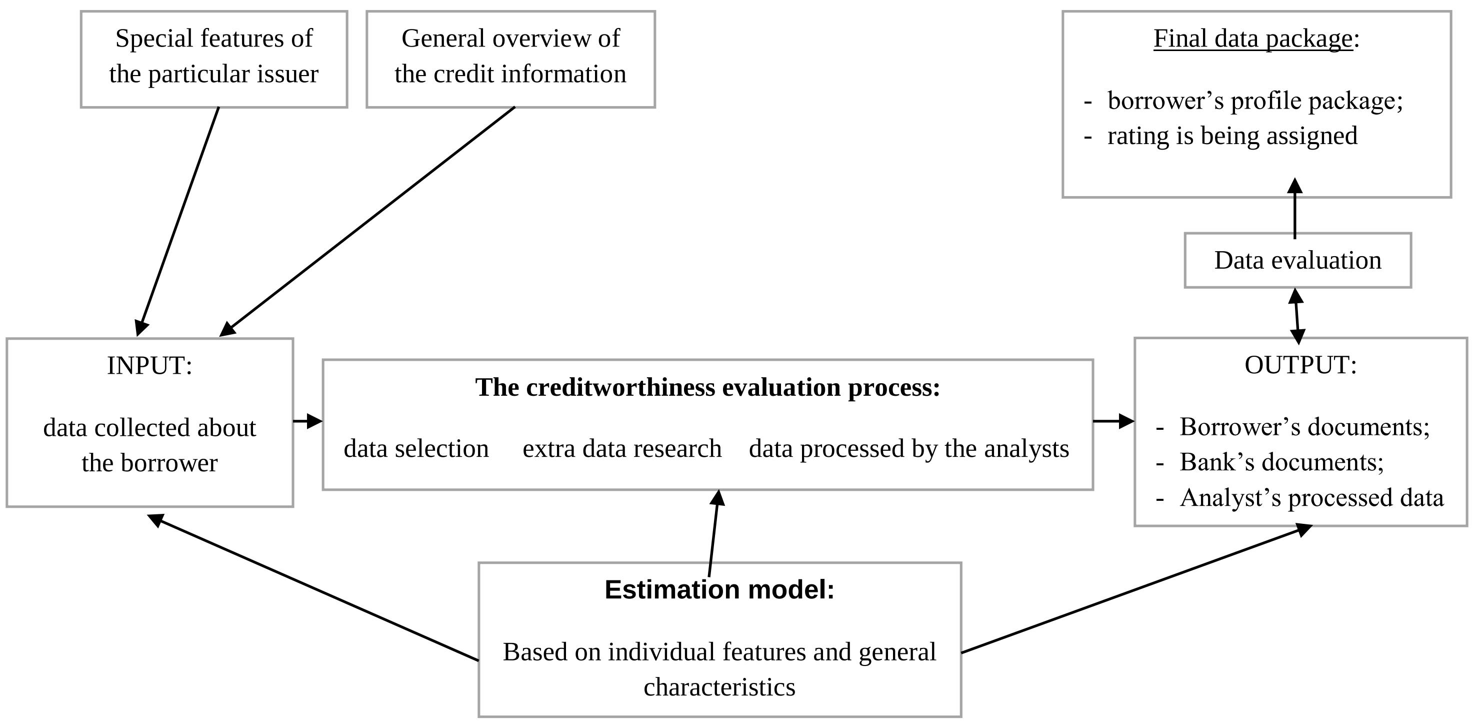
NOTE: Figures don't total 100 percent due to rounding
*Asset-backed securities are backed by a range of debt, including commercial and residential mortgages, car loans and student loans
Source: U.S. Securities and Exchange Commission, Moody's annual reports

The combination of various professional techniques used by the Big Three rating agencies to provide the professional assessment level of the risk that investors face, sterns from the main function that these agencies perform nowadays : estimation and evaluation of the securitized products and the issuers.[26] The main accent is stressed on the probability of the borrower's bankruptcy statement. The problem faced nowadays, is the that some of the other important indicators of the issuer's creditworthiness, such as macroeconomic changes in the economic conjuncture of the market, current ratio problems, etc. are not taken into account by the rating agencies, but which can have a substantial influence on the future of the issued securities. Among these "omitted" factors are the macroeconomic changes in the economic conjuncture of the market, current ratio problems, etc.

[26]"History of Credit Rating Agencies and How They Work." *Money Crashers*. N.p., n.d. Web. 05 June 2014. http://www.moneycrashers.com/credit-rating-agencies-history

The issuers of the securities (the governmental sector, multiple companies and businesses, as well as the financial sectors of the economy) pay rating agencies to be graded and evaluated. The main interest in obtaining the ratings sterns from the benefits that the borrowers gain by having been rated. These benefits cover the broader set of opportunities for the borrowers to be able to attract the investors, as well as get access to the lower interest rates and obtain good reputation. Rating agencies usually follow the traditional approach while estimating the creditworthiness of their clients[27]. The model they use is presented in the figure 2.

Figure 2 – The CRAs' ratings evaluation process.



Issuers of the securities provide CRAs with the confidential information, which is not accessible to the public. In case the information is not adequate, rating agencies may suspend the rating assessment and request for some more details. Rating agencies do not guarantee that the ratings will be accurate nor do they disclose the detailed methodology they use for assigning the

[27] "Международные рейтинговые агентства (International Rating Agencies), N.p., n.d. Web. 05 June 2014. http://forexaw.com/TERMs/Services/Rating_agencies/l1412

ratings. Usually only small pieces of this information are available on the CRAs' websites. When the data evaluation is completed, collected information is packed into the single profile and the rating is being assigned.

Investors implicitly rely on the independent opinion of the rating agencies, taking into a consideration the underlying grade that was assigned to the particular type of the security or to the issuer. The ratings that Big Three companies provide as a part of their services, vary from agency to agency. Ratings do not represent the information regarding the price of the security, they just measure the level of risk the investors will face.The ratings scale is divided into two primary categories: investment grade and speculative grade ratings. At the same time, the ratings could be short term and the long term, which represent the ability of the issuer to fulfil its financial obligations. These ratings are based on the international scale of credit ratings. The comparison table of ratings used by the Big Three CRA's is shown in the Appendix A.

Short term credit ratings are based on the issuer's liquidity ratios and estimate its ability to pay back all the debt obligations within a relatively short period of time, usually less than 12 months, while the long term ratings imply much longer time base – over the life of the issued securities. It's considered that the long term ratings are the indicators of the issuer's default level.

According to the scale, the stronger the issuer's financial position, the higher the company's rating. The highest rating is AAA, which is considered to be a gold standard, as it represents the least risky securities or the companies that are less likely to become insolvent. Rating like triple A represent the benchmark for safety and considered to be a guarantee for the investors that the given securitized product will contain the minimal level of risk.

As one goes down the credit rating scale, the risk level of the security or the issuer reneging on the obligation to pay the back the bond principal and the interest on it, as it was specified in the debenture agreement, increases. So the lowest rating D is the junk bond rating, representing the high probability of the issuer's default. Usually these default level debt instruments have previously demonstrated the failure to pay back the obligation, so in order to attract investors, they offer higher interest rates and expected return, to cover the risk. The assigned rating falls under any of these categories:

- High grade;
- Upper medium grade;

- Lower medium grade;
- Non-investment grade speculative;
- Highly speculative;
- Substantial risks or near default;
- In default.[28]

The investment risk is not fixed; it fluctuates with the time, being affected by various economic and global factors. The same can be stated about the expected return, meaning that it's relatively impossible to predict and calculate the guaranteed return on the investment. In order to be able to estimate the future yields on the invested capital, one should rely on the historic data over the certain period of time regarding that particular type of securities, which will provide the approximate estimation of the future return.

Most of the time it is much easier to estimate the expected returns on the common investment classes of securities, such as stocks and bonds, by simply evaluating their performance for the past several decades, whereas it's much more difficult to estimate the return on derivatives, which are relatively new to the market and, by their definition, bear much higher risk.

The following pyramid presented in Appendix B shows the level of the risk the given securities bear, starting from almost risk-free assets at the bottom of the pyramid and ending up with the highly default risk securities, which bring the most return on the investment. [29]

Apart from the rating assignment process, various rating agencies are involved in the forecasting. They make predictions regarding the financial state of the issuer for the future base period up to half a year. They conclude one of the following possibility of the rating's behavior:

- positive forecast: states that the positive changes are more likely to occur and that the rating will be upgraded in the future;
- stable forecast: there is a relatively little chance of the financial stability changes, meaning that the rating is less likely to be changed;

[28] History of Credit Rating Agencies and How They Work." *Money Crashers*. N.p., n.d. Web. 05 June 2014. http://www.moneycrashers.com/credit-rating-agencies-history

[29] "Risk and Returns | Markets & Trading | TradeStation University." *Risk and Returns | Markets & Trading | TradeStation University*. N.p., n.d. Web. 05 June 2014. http://www.tradestation.com/en/education/university/markets-and-trading-resource-center/articles/direct-investing/risk-and-return.

- negative forecast: there is a high possibility of the default in the future, which will affect the issuer's rating by way of downgrading it.

On account of the credit rating agencies, many creditors can obtain a relevant independent opinion regarding the investment opportunities and portfolio diversification possibilities, not only mitigate, but also lessen the risks, conduct a comparative analyses on the risk-to-expected return ratio, etc. At the same time, the agencies are keeping the track of the rated securities througout the whole life period of the issued security, so the investors can get an access to it at any point in the future and estimate the riskiness of their investments.

Issuers of the securities have the following advantages of obtainign the rating from the CRAs:

- broader access to the larger pool of investors;
- costs minimization for the capital attraction from various investors;
- lower interest rates;
- opportunity to forecast the future borrowing costs and plan the systematic expances;
- provide incentives to improve the borrower's financial state.

Creditors and investors are better off with relying on the rating system by gaining the following benefits:

- evaluation of the credit default risk;
- ability to adjust the investment strategy based on the information regarding the issued securities;
- estimation of the risk premium (the difference between the expected rate of return on the investment and the risk free rate to evaluate the yield on the investment);
- optimal reward in a form of compensation for the risk, based on the current risk-return ratio;
- opportunity to monitor the investment portfolio system and make corrections according to the rating fluctuations.

As for the other capital markets' participants, such as financial intermediaries, the credit rating assessment provides the following:

- simplification of the underwriting process;
- constant supervision of the riskiness levels.

Among the main disadvantages could be considered the following factors:

- dilatory reaction on the capital market fluctuations and the securities trading process itself;
- incapability to keep up with the financial innovations that pervade the financial markets nowadays;
- lax methodological approach used in rating the securities;
- loopholes in the regulatory frameworks;
- competition among top CRAs;
- conflict of interests, especially when the assignment of the ratings is paid by the governmental authorities, some institution or the company which is interested in high grades. [30]

The problems listed above were among main reasons of why CRAs were at the origins of the credit crunch earlier in 2007.The 2008 Global financial crises was not a surprise, nor was it the first one in the history. Over the past 50 years, there were two global financial crises (oil crises of 1973-1974 and Black Monday of 1987) and around 3 local ones: Mexican crises of 1994-1995, Asian crises of 1997 and the latest Russian crises in 1998.

The main cause of the oil crises was the rapid and the unexpected (unstoppable) oil price increase till almost 400% (starting from $3 per barrel and reaching its highest at $12 per barrel). Part of the reason of the price increase comes from the decrease of the crude oil extraction volumes in most of the Arabic countries, partly it was caused by the war between Israel and Syria together with Egypt. Most of the Israel’s alliances, including the USA, stopped exporting the oil from Arabic countries. Various developed countries’ economies became dependent on the fluctuations of global energy prices.

Black Monday, which happened to be one of the toughest days in US financial market, when it basically collapsed on October 19, 1987, as the Dow Jones Industrial index fell down by 22,6%. Capital markets of Canada, Australia, Southern Korea and Hong Kong collapsed right after the US one.

CRAs could not foresee the oil and gas crises back in 1973, as the credit ratings did not exist at that time, however, the upcoming of the 1987 crises in USA should have been fetched out

[30] "History of Credit Rating Agencies and How They Work." *Money Crashers*. N.p., n.d. Web. 05 June 2014. http://www.moneycrashers.com/credit-rating-agencies-history

by rating agencies. The following table represents the timeframe of the ratings fluctuations of the pre-crises, the collapse and the post crises periods for four countries: USA, Canada, Australia and Hong Kong.[31]

Table 1 – The S&P ratings for the US, Canada and Australia

	S&P
USA	
1.01.1981	AAA
25.09.1991	AAA
Canada	
23.11.1981	AAA
26.06.1989	AAA
14.10.1992	AA+
Australia	
23.11.1981	AAA
26.06.1989	AAA
27.07.1992	AAA
Hong Kong	
23.10.1988	+
26.06.1989	+
12.02.1990	A

The S&P ratings show that there was no significant reaction on the crises of 1897, it even looks like no evaluations have been properly conducted.

The same situation can be overseen during the Mexican crises of 1994-1995. In late 1980s Mexican government introduced new policies to increase the amount of foreign direct investments (FDI) flows in the county. Multiple state-owned enterprises appeared on the recently created Stock Exchange, which partly reach the stated goal and the amount of foreign investments in Mexico

[31] "History of Credit Rating Agencies and How They Work." *Money Crashers*. N.p., n.d. Web. 05 June 2014. http://www.moneycrashers.com/credit-rating-agencies-history

increased. The initial signs of the crises were the capital outflow, as most of the investors were expecting the economic crises to initiate in the country. The S&P's ratings seemed to ignore the current situation again.[32]

Table 2 – the S&P credit ratings

	S&P
3.11.1992	BB+
18.11.1993	BB+
23.12.1994	BB+
10.02.1995	BB
23.03.1995	BB

According to S&P ratings, the downgrade from BB+ to BB that occurred in 1995, was the most precise estimation of the situation on the financial markets. However, the history shows that the crises was at it's peak already in 1994, a year before the rating agencies tracked some changes, even though around $10 billion was withdrawn from the country back then and the banking system started to collapse.

With the strike of the Asian crises back in 1997, which appeared to be very abrupt and extremely painful, Asian financial markets, which had demonstrated an exceedingly rapid economic growth rates in the past, were on the verge of collapse. For South Korea and Thailand there existed a problem with the local banks' liabilities towards western investors. The official starting date for the beginning of the Asian crises was July 2, 1997, when the National Bank of Thailand, who had previously already spent over $33 billion out of the country's reserves to maintain the local currency at the acceptable level and protect it from speculations, had to ask for the loan from IMF, which was obtained in the amount of $17.2 billion. Together with the collapse of the Thai local currency, the crises spread around the Asian countries, affecting India, Philippines, South Korea, etc. FDI flow was dramatically decreasing, and many foreign investors

[32] "History of Credit Rating Agencies and How They Work." *Money Crashers*. N.p., n.d. Web. 05 June 2014. http://www.moneycrashers.com/credit-rating-agencies-history

were taking their money out of these countries in search for the better investment opportunities. Nevertheless, the rating agencies were providing the following information:

Table 3 - Country's credit rating assigned by S&P's

	Country's credit rating assigned by S&P's
Thailand	
May 2, 1996	A
August 1, 1997	A
September 3, 1997	A-
October 24, 1997	BBB
January 8, 1998	BBB-
South Korea	
May 3, 1995 год	AA-
August 6, 1997 год	AA-
October 24, 1997 год	+
November 25, 1997 год	A-
December 11, 1997 год	BBB-
December 22, 1997 год	B+
January 16, 1998 год	B+

The CRAs were also at the heart of the notorious accounting frauds - the ENRON story. The shareholders of the company suffered losses in the amount of $60 billion, while the company's investors were holding around $13 billion of outstanding debt when the ENRON scandal occurred.[33] There was an urgent need for the regulations, so the Sarbanes-Oxley Act was passed to diminish the previous mistakes, introducing the strict regulatory frameworks for company's information disclosures and the auditing policies.[34]

[33] See William W. Bratton, Enron and the Dark Side of Shareholder Value, 76 TUL. L. REV. 1275, 1341–51 (2002)
[34] See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.);

The failure of CRAs to foresee the large bankruptcy cases, such as Enron (December 2, 2001), Worldcom (July 21, 2002), California Utilities, etc. substantially affected the rating agencies reputation.[35]

From the American financial system's collapses, it's important to take a look at the European side of the story of the rating agencies evolution.

1.2 European CRAs and their role in the pre-crisis period

1.2.1 EU rating agencies regulations and industry outlook

> "... rating agencies may spark off a virtuous circle: the more accurate the announced ratings are, the higher is investors' incentive to increase the precision of their private information as well, which raises the efficiency of the market outcome."
> Bannier and Tyrell, Goethe University, Frankfurt

For the past 35 years, credit rating services have been gaining the popularity and became one of the most important elements of the financial markets system. If by the end of 80s, credit rating agencies were operating solely in USA accounting for no more than 30 independent institutions, nowadays the market of the rating services is represented by more than 100 various rating agencies all over the world.

Credit rating services considered to be exotic in Europe for quite a long period of time, being accessible only for international companies, that were doing business on the global level.[36]

[35] Professor Nagpurnanand R. Prabhala. "ESSAYS ON FORCES UNDERLYING 2008 FINANCIAL CRISIS: CREDIT RATING AGENCIES AND INVESTOR SENTIMENT." *Columbia Law Review* 113.8 (2013): n. pag. Web. http://drum.lib.umd.edu/bitstream/1903/10887/1/Alp_umd_0117E_11545.pdf

[36] Cantor, Richard; Packer, Frank (Summer–Fall 1994). "The credit rating industry". *Federal Reserve Bank of New York Quarterly Review* (Federal Reserve Bank of New York). pp. 1–26. ISSN 0147-6580 http://ftp.ny.frb.org/research/quarterly_review/1994v19/v19n2article1.pdf

Rating services today are offered to almost every borrower, who is willing to obtain the rating grade.

The EU CRAs' services are regulated by the EU Regulation 1060/09 on Credit Rating Agencies that was accepted on December 7, 2009 as a response to the global financial crises.[37] The regulation created the special purpose supervisory body European Securities and Markets Authority (ESMA). [38] The EU Regulation 1060/09 was revised in 2011 to empower the ESMA with more responsibilities regarding the CRAs registration process supervision and their main activities on the market.

Among the most crucial problems that CRAs industry was facing in EU before the crises of 2008-2009, were the following:

- the largest amount of rating services was provided by the Big Three agencies, which were headquartered outside of EU, making it more difficult to maintain control and supervision of their operations;
- lax regulation of the CRAs rating systems in most of the EU Member States, for example, it was common for some MS not to implement any regulatory frameworks on the credit rating industry, and even if CRAs were regulated, still there was no separate legislation for their specific services. All the agencies were subject to Community law under 2003/6/EC Directive implemented in January 2003.[39]

It also stipulates that CRAs should follow the Code of Conduct Fundamentals for credit rating agencies, issued by the International Organization of Securities Commissions (IOSCO Code), but only on voluntary bases, meaning that they will not be liable for any of the actions on the capital markets. Moreover, they should be able to reveal the methodological aspects of their rating system and make it available to the public.[40]

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[37] Official Journal of the European Union. "REGULATION (EC) No 1060/2009 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 16 September 2009 on Credit Rating Agencies." *Ado* (n.d.): n. pag. Web. http://www.esma.europa.eu/system/files/L_302_1.pdf

[38] "Credit Rating Agencies | Esma." *Credit Rating Agencies | Esma*. N.p., n.d. Web. 05 June 2014. http://www.esma.europa.eu/page/Credit-Rating-Agencies.

[39] Official Journal of the European Union. *REGULATION (EC) No 1060/2009 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 16 September 2009 on Credit Rating Agencie* (n.d.): n. pag. Web. http://www.esma.europa.eu/system/files/L_302_1.pdf

[40] Ibid.

According to these facts, it is clear now, that the CRAs in EU were the same entities as they were in the states, as the Big Three services prevailed on the financial markets, but the regulatory frameworks varied, making EU regulations more severe and giving the American rating system more freedom and opportunities to generate profits. Further in this paper there is an analyses of these two regulatory systems that were created to supervise and regulate the capital markets. If the financial markets of developed countries were having troubles with their rating systems, then what was happening with the developing countries before the crises reached its top and what is the current situation on the capital markets of various in eastern European countries?

1.2.2 Eastern European Countries CRAs evolution

In contrast to the developed countries, financial markets of the Russian Federation and Ukraine have relatively short history. The rating services' industry is only at the beginning of its formation and the regulatory framework is still not developed well enough to keep up with the standards set up by western countries. [41]

Russia and Ukraine, historically appear to be in a constant dependence on the treasury bonds and notes with longer maturities, as the financial system in most post-soviet countries is still based on the obtaining the international loans to finance all the expenditures. These two countries should relentlessly keep the higher ratings in order to maintain the access to the international loans, as well as be able to obtain lower interest rates. The role that rating agencies play in developing countries' capital markets is just tremendous.

The rating process is usually more intense and inadequate compared to most of the developed countries. These problems usually reflect the cultural differences, language barriers and regulatory systems variations. There comes the question of whether it makes sense for these countries to get the rated, as according to the current situation with Ukraine, it's better for the country not to have any rating than have the negative one, which basically entails the consequences

[41] "International Practice of the CRAs Development." *Factoru mejdynarodnogo razvitiya reitingovuh agenstv* (n.d.): n. pag. Web. http://www.lib.csu.ru/vch/8/2004_01/029.pdf

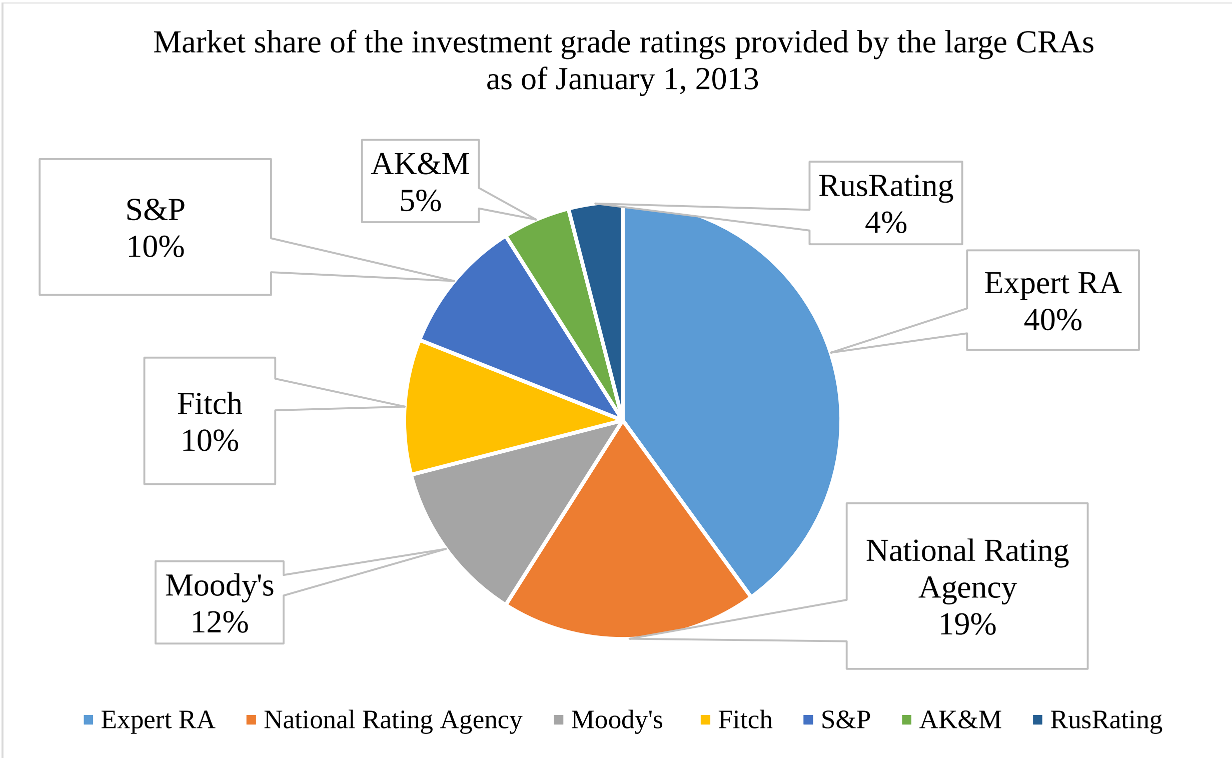
of the flow of the investments outside of the country, extremely high interest rates on the international loans, which even worsen the economic situation.

Currently there are more than 20 independent institutions in Russian industry that offer rating services, however only 8 of them are officially registered as the credit rating agencies. Together with the Big Three rating agencies that dominate the Russian financial market, there are four national rating agencies that share the market with them. These agencies are “Expert RA”, National Rating Agency, Rus-Rating and AK&M rating agency.

Russian rating agencies can fall under the two broaden categories – the universal and the specialized one. Universal agencies, such as Moody’s Interfax or Expert RA, provide independent credit rating services to various companies as well as offer a wide range of data analyses products. Specialized agencies provide more narrowed down services only for a particular sectors of the financial market, such as banking sector. Among these agencies are AK&M, Rus-Rating, etc., who conduct the analyses of the issuer’s creditworthiness based on the publicly available information only.

As of January 1, 2013, the CRAs market share of rating agencies that assigned the investment grade ratings to the issuers and the securities on the Russian financial markets is represented by the following diagram:

Diagram 3 - Market share of the investment grade ratings provided by the large CRAs



The diagram shows that the largest number of rating services was provided by the Russian CRA Expert RA, which is one of the leading national agencies on the Russian markets nowadays, the runner up is the National Rating Agency, accounting for almost 20% of the rated issuers and securities. The market share of the Big Three global CRAs is not that large, but still very significant.[42]

The regulations of the Russian CRA services are provided by the Federal Law number 39 from April 22, 1996 “On the Securities Markets”. The law stipulates the definition of the rating agency and explains its main functions on the capital markets.[43]

Russian credit rating scale is the adjusted version of the Top Three CRAs’ scale, where the ratings adjusted by the “ru” sign for Russia, stipulating the fact that these ratings are used solely for the Russian financial markets, however, there is no significant difference in between the

[42] Russian rating agencies – the evolution of the financial markets, N.p., n.d. Web. 05 June 2014. http://www.raexpert.ru/editions/article12.

[43] Federal Law number 39, April 22, 1996, *N 39-Ф3*. N.p., n.d. Web. 05 June 2014. http://base.garant.ru/10106464

international scale and the Russian one.[44] As a result of the single unified standard that is being used by the CRAs, there are many loopholes in the credit rating system. The ratings provided by the 'Big Three" rating agencies are adjusted to the international financial markets and do not take into consideration the national, regional and municipal level specifications. National agencies are more oriented towards the local financial markets in Russia and Ukraine.

In the most Eastern European countries, the system of rating agencies is not perfectly well developed and regulated in comparison to the rating agencies in USA and European markets. The following figure depicts the step by step process of the assignmnet of the credit rating to the particular type of security or the issuer of the security. It uses a very straight forward methodology, which gives the borrower the opportunity to not disclose the final result in case of the unsatisfying grade.

Basically, the way the rating agencies work in most of the developing countries is by evaluation of the various financial ratios or indexes that show the financial status of the particular issuer of the security.

[44] Russian Rating Agencies - Financial Markets." *Banki.ru*. N.p., n.d. Web. 05 June 2014. http://www.banki.ru/wikibank/rossiyskie_reytingovyie_agentstva

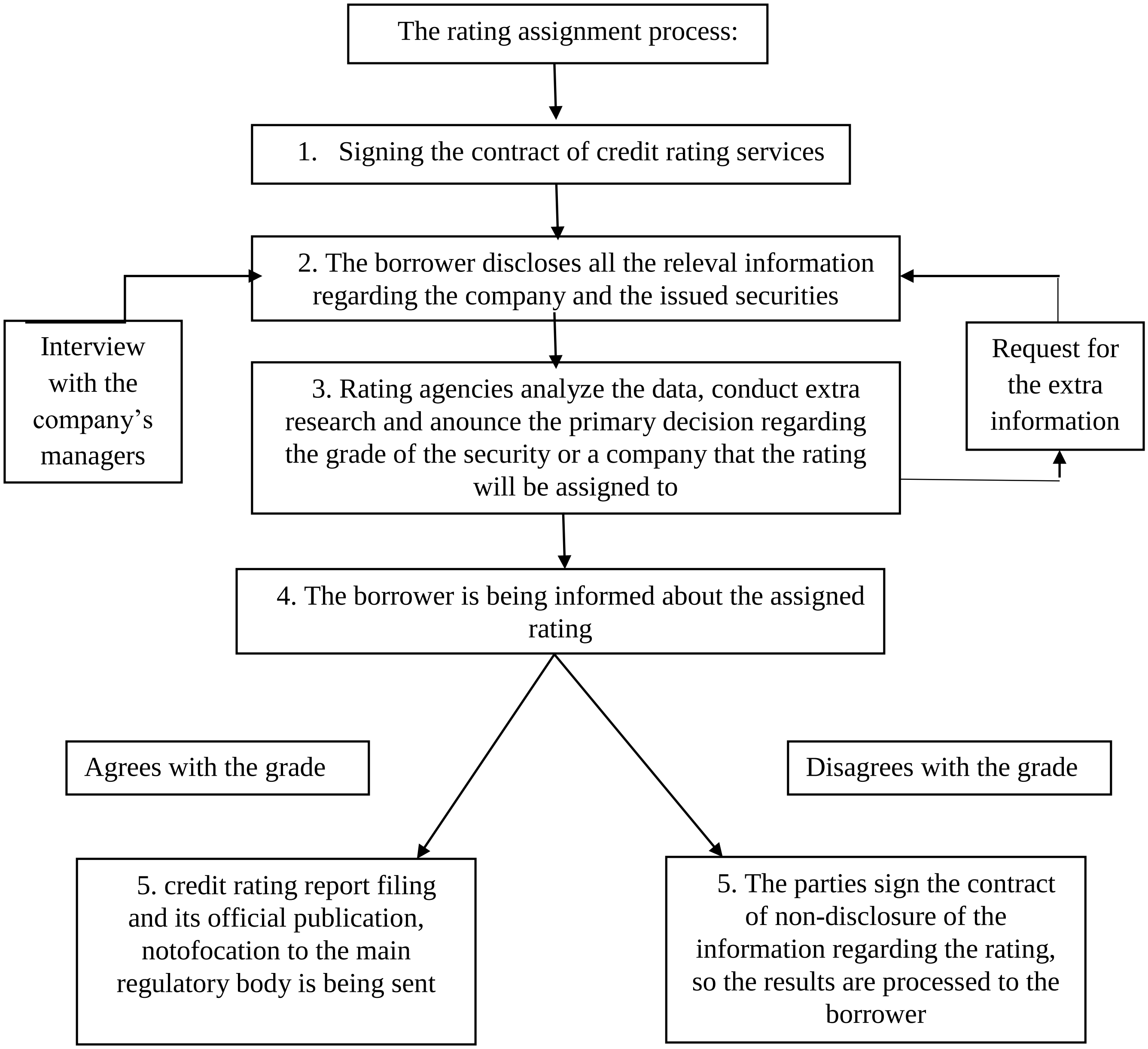


Figure 2 – The credit rating assignment process.[45]

In October 2008, the Supervisory Committee of International Economic Relations passed the Regulatory Act of the Federal Law number 173-FZ regarding the "Additional measures for the Russian Federation financial markets support system" that empowered commercial and universal banks, that obtained the investment rating grade of BBB- , to seek the financial aid and opportunity

[45] "Rating Process and It's Regulatory Ramework." *Рейтинговые процедуры Агентства*. N.p., n.d. Web. 05 June 2014. http://www.credo-line.com/ru/rating/Reytingovye-procedury-Agentstva.htm

to get the international loans. The Regulatory Act was based on the International Organization of Securities Commissions' (IOSCO) and the Basel II Accord standards, which was passed to create the high standards for the Russian CRA services and the establishment of the transparency on the financial market and the economy in general.[46]

The economic and financial globalization that is slowly invading the Russian markets controls the process of their regulation on the global scale. The ratings assigned by the globally recognized CRAs play an important role on the rating arena, being trusted by various investors and financial institutions.

Russian markets still face the problems of under regulation and inefficiency, which prevents the capital markets from expanding and attracting more foreign investors.

[46] "IOSCO." *IOSCO*. N.p., n.d. Web. 03 June 2014. http://www.iosco.org/

Chapter 2. The subprime mortgage crisis in the USA: the Big Three CRAs saga

2.1 The prominent role of CRAs in a collapse of the major investment institutions

CRAs have been widely criticized by their actions over the crises in 2007-2009, which severely damaged their reputation of an independent default risk assessment.

In January 2012, when the Guardia di Finanza, the Italian financial market supervisor, decided to initiate the investigation process on one of the offices of S&P's Milano, right after S&P downgraded the Italian ratings back in fall of 2011, he received a response stating that the rating agencies were did nothing wrong and cannot be held liable for the italian economy's recession and the entailed long lasting depression.

It becomes unclear of who is actually responsible for the recent crises, which was primarily caused by the inability of the CRAs to professionally fulfill their duties and live up the investor's expectations.

The collapse was inevitable and it entailed severe financial and economic consequence, many of which still dominate on the financial markets of various countries.

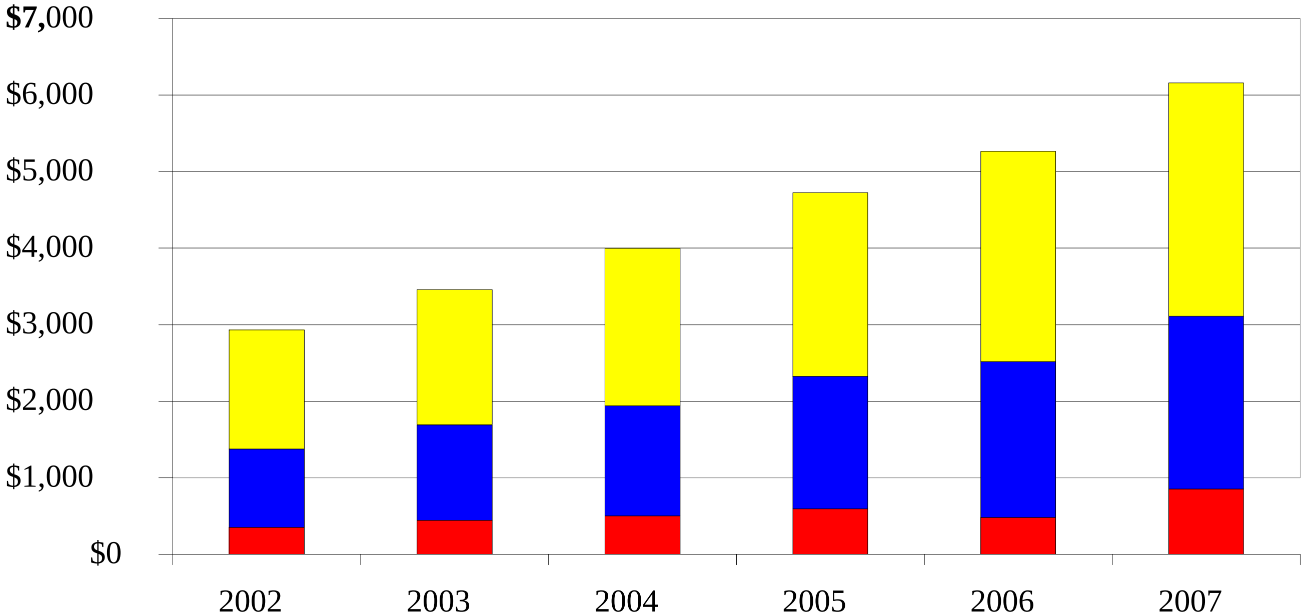
Basically the system collapsed, when the banks were paying CRAs for creating new financial securitized products, beneficial for the agencies, as they were able to make large profits on these operations, being duly paid.

Moody's senior managing director, who left the office on 2004 left a comment regarding that situation, explaining that the "[a]gencies had to dance to the tune of the banks if they wanted business. … [T]he investment bank putting together the bond could easily go to the various agencies and say 'how would you rate this pool?' They could just do it in preliminary way" and if the banks were not satisfied with the results, they simply turned to another agency with the same requests for the higher rating.

Moody's senior analyst, William J Harrington, explained that the rating process of CDOs before the crises stroke, was absolutely out of control, meaning that the agency was just chasing the cash flows coming from the multiple orders.

On the diagram below, it is well shown how the profits of the Big Three CRAs were exorbitantly growing throughout the entire five year period of time.

Diagram 4 – The Revenues of Big Three Credit Rating Agencies: 2002-2007 in millions of USD



The top segments represents the revenues of S&P's CRA, the middle one is Moody's volume and the bottom part represents Fitch agency's money flows. Thus, it can be clearly seen here that by the beginning of the global financial crises these three rating agencies were making the millions of billions of USD of profits. Reportedly, the S&P's alone was able to be responsible for over $2 trillion dollars' worth of securities over the crises.

Appendix 2 shows the information regarding the number of trade transactions in fixed income securities on the global bond market over the 4 years' time change.[47]

Right in the middle of the sub-prime mortgage crises, the SEC began an investigation process within the Big Three agencies. The CEOs of Moody's, S&P's and Fitch were asked to report before the House Oversight Committee, which brought up the recently found messages and e-mails between some of the S&P's officials, discussing the recent services that the rating agency

[47] "Global Bond Market - Transactions with Fixed-income Securities, 2012 | Statistic." *Statista*. N.p., n.d. Web. 05 June 2014. http://www.statista.com/statistics/247245/fixed-income-security-transactions-on-the-bond-market-worldwide

was providing and mentioning in their conversation that basically any security can be assigned a high rating, specifying that: “We rate every deal. It could be structured by cows and we would rate it.”[48]

The CNBC news report described the CRAs as “being portrayed as profit-hungry institutions that would give any deal their blessing for the right price.”[49]

While S&P’s was trying to provide investment level ratings to basically every type of security they were dealing with, Moody’s were not backing up from the market. The former managing director Jerome Fons confessed that the agency was pursuing the goal of “maximizing its revenues”, trying to look “issuer friendly” while competing with the other Big Three agencies on the market.[50]

Over the crises and shortly after it, the CRAs were globally criticized for their ratings and blamed for the collapse of various financial institutions, such as Lehman Brothers, that eventually filled for Chapter 11 bankruptcy, etc. and never was bailed out by the government.[51]

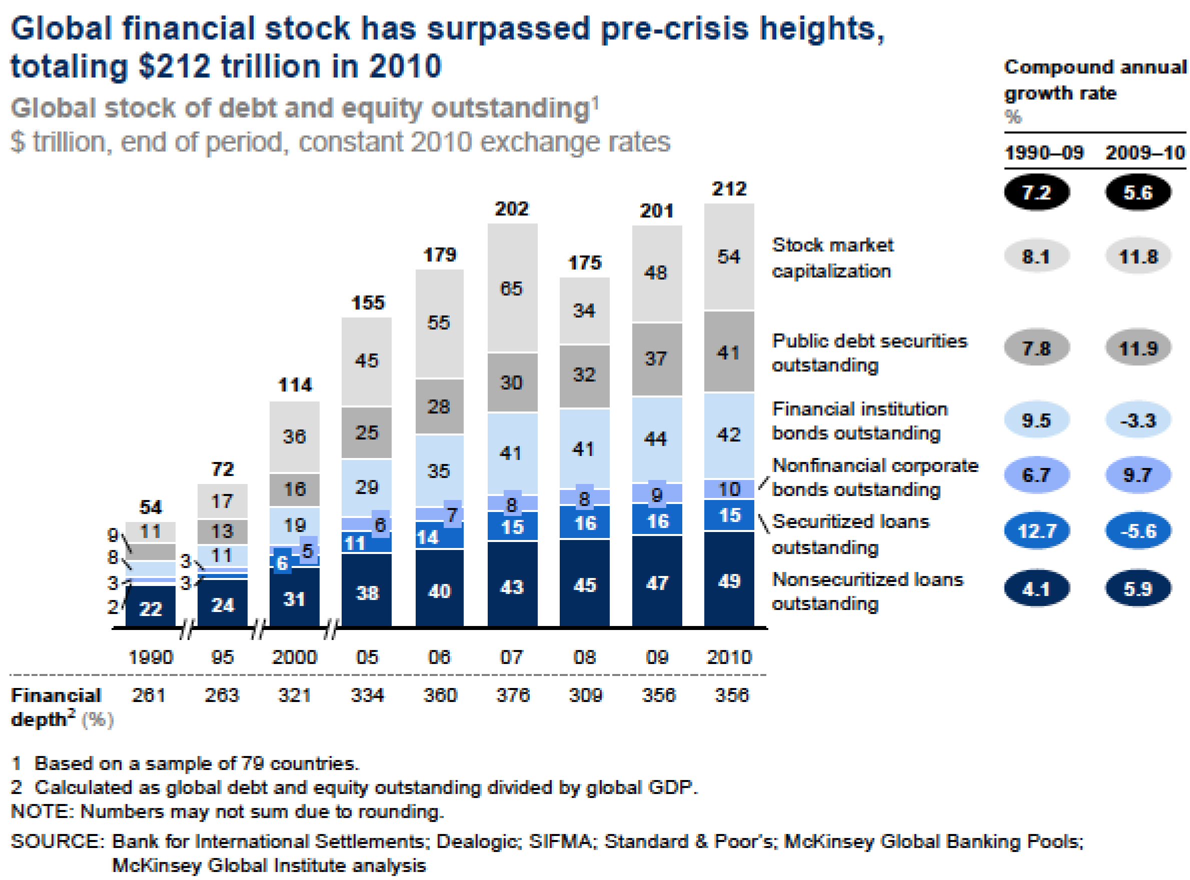
Later on, starting from 2010, the agencies in US and Europe were more concentrated among the sovereign debt, actively assigning the ratings to various countries.[52] The most important rating was done by the S&P’s was the downgrade of the US AAA-rating in the beginning of the second half of 2011, which resulted in huge price volatility of market securities. A year earlier, Greece, Ireland and Portugal were downgraded to the default level rating, entailing the Eurozone financial market crises in 2010. The downgrading process was expanding to nine other European countries back in 2012, especially hitting hard France and Austria.[53]

[48] Zamansky, Jake. "The Chickens Come Home to Roost for Standard & Poor's."*Forbes*. Forbes Magazine, 05 Feb. 2013. Web. 05 June 2014. http://www.forbes.com/sites/jakezamansky/2013/02/05/the-chickens-come-home-to-roost-for-standard-poors-2
[49] "S&P Officials: We'd Do a Deal 'Structured by Cows'" *CNBC.com*. N.p., n.d. Web. 05 June 2014. http://www.cnbc.com/id/27321998
[50] "Finance Clippings." *: October 2008*. N.p., n.d. Web. 05 June 2014. http://financeclippings.blogspot.hu/2008_10_01_archive.html
[51] Pranvera Latifi. "Lehman Brothers’ Rise and Fall: From Hero to Dust." (n.d.): n. pag. Web. http://www.lcbr-archives.com/media/files/12sym13.pdf
Hristopher Alessi, Roya Wolverson, and Mohammed Aly Sergie, Online Writer/Editor. "The Credit Rating Controversy." N.p., 22 Oct. 2012. Web. http://www.cfr.org/financial-crises/credit-rating-controversy/p22328
[52] Hristopher Alessi, Roya Wolverson, and Mohammed Aly Sergie, Online Writer/Editor. "The Credit Rating Controversy." N.p., 22 Oct. 2012. Web. http://www.cfr.org/financial-crises/credit-rating-controversy/p2232
[53] "Eurozone Crisis." *Wikipedia*. Wikimedia Foundation, 06 Feb. 2014. Web. 02 June 2014. http://en.wikipedia.org/wiki/Eurozone_crisis

In 2008 CRAs were widely criticized for the incompetence of assessing the financially innovative products that were represented by various mortgage-backed securities, collateral debt obligations, etc. The agencies failed to estimate the real level of risk behind these packages of securitized products. Basically, the Big Three CRAs started worrying about the real ratings only after the bubble bursted. It was estimated, that Moody's alone downgraded around 84% of all rated mortgaged securities accounted for $869 billion USD.[54]

The Global financial stock of debt and equity outstanding in 2010 was growing at the increasing rates, it reached and even overpassed the crises level heights. The picture is shown on the Figure 5 below. [55]

Figure 5 – Global financial stock of debt and equity outstanding in 2010.



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[54] Efraim Benmelech Jennifer Dlugosz. "THE CREDIT RATING CRISIS." (n.d.): n. pag. Web. http://cid.bcrp.gob.pe/biblio/Papers/NBER/2009/Junio/w15045.pdf

[55] "Debt Securities Statistics." *Debt Securities Statistics*. N.p., n.d. Web. 05 June 2014. http://www.bis.org/statistics/secstats.htm

The sub-prime mortgage crises in US turned into the global financial crises. Companies began to experience hardships in obtaining the loans, issuing various securities. However, according to the credit ratings of S&P the situation looks totally different, as there was no re-consideration and the supervision involved in the rating process. So the crucial question arises here is that how was it possible that the rating agencies were not able to foresee the collapse of the system back in 2005-2006, but still assigning the highest ratings to the junk bonds?

2.2 The keystones of the problems in the market of credit rating services

It was evaluated, that the key problem on the financial markets back in 2007 was the informational problem between buyers and sellers of the securities. These problems can be described by:

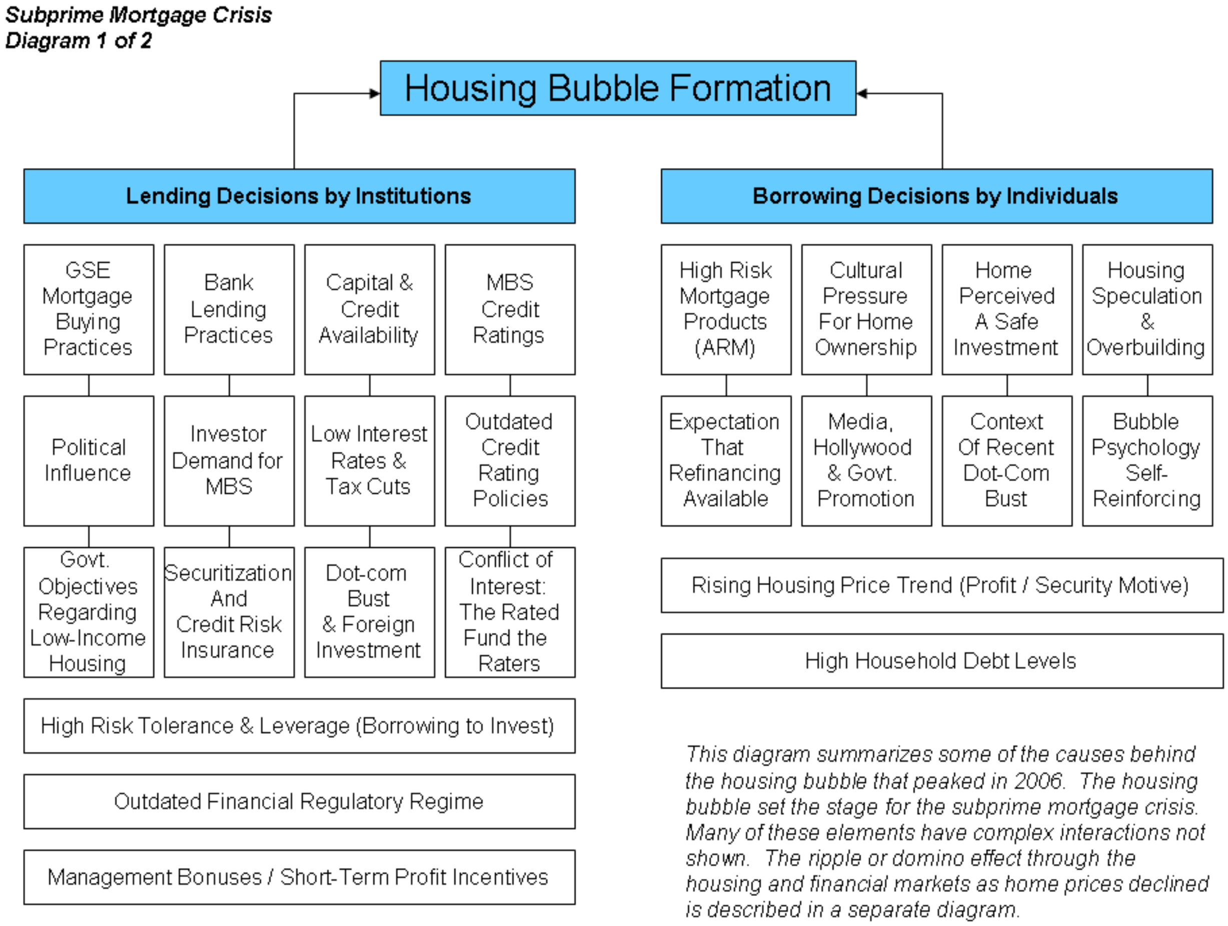
- the shits from the direct financing through obtaining the bank loans, which were regarding relatively expensive and unattractive for many borrowers;
- the expansion of the CRAs industry on the global scale , especially in Europe and Asia in anticipation of profit maximization;
- constant development of the financial innovational products and the inability of the regulatory framework to follow the market trends.

Professor Timothy Sinclair from the University of Warwick studied the CRAs problems in the middle of 2000s and in his research paper he came up with the conclusions that the problems of the CRAs were not unexpected and not new. Rating agencies were at the heart of the financial problems but never were actually found liable for their incompetency and unprofessional approaches. [56] Traditionally Moody's and S&P's have stood behind a defense of 50th amendment right in US of Free speech. These are not finance institutions nor are investment advisors, they just provide their independent opinions.

Among the major factors leading to the mortgage boom was the investment banking operations, that basically were repacking the loans, making them look more attractive for the

[56] Michael R. King & Timothy J. Sinclair. "Grasping At Straws: A Ratings Downgrade For The Emerging International Financial Architecture"."*Portuguese Studies* 30.1 (2014): 112-16. Web. http://wrap.warwick.ac.uk/2036/1/WRAP_King_wp8201.pdf

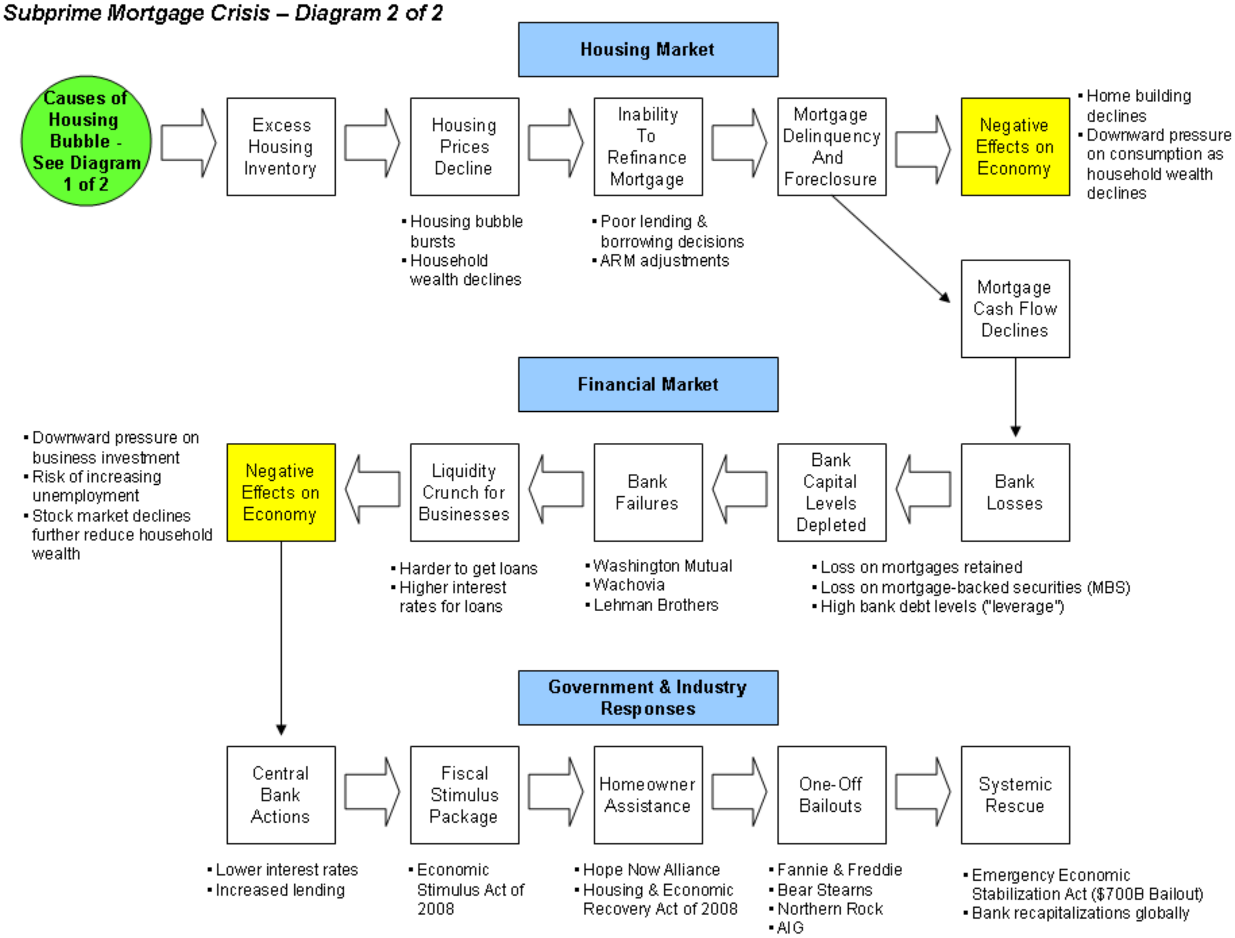
investors. Below are the two Figures that represent the step-by-step process of the formation of the housing bubble in the USA.[57]



Various financial institutions were blamed for the crises on the mortgage markets, but again, it was the rating agencies that actually were the main players and main source of reliability for the investors before the final decision making process on the investment.

[57] "OBAMANOMICS." *OBAMANOMICS*. N.p., n.d. Web. 05 June 2014. http://mcdowellsobamanomics.blogspot.hu

Subprime Mortgage Crisis – Diagram 2 of 2



The financial market problems with the leading roles that CRAs were playing can be categorized in the following ways:

- application of the Issuer – pays Model;
- usage of the complex financial products;
- oligopoly on the rating services markets;
- legal basis;
- fortune-telling of the future price fluctuations on the markets
- procyclicality.[58]

Many investors, while trying to find out the best investment opportunity and estimate the risk, originally paid the services of the CRAs. Meanwhile, in order to be considered by the

[58] Christopher Alessi, Roya Wolverson, and Mohammed Aly Sergie, Online Writer/Editor. "The Credit Rating Controversy." *Council on Foreign Relations*. Council on Foreign Relations, n.d. Web. 05 June 2014. http://www.cfr.org/financial-crises/credit-rating-controversy/p22328

investors, bond issuers pay for the rating agency's assessment. That's where the first conflict of interest arises, stating that the institution in order to be rated pays the evaluator, which affects the objectivity.

A further conflict arises from the fact that the CRAs also assess the complex financial products – packages, consisting of various derivatives and asset backed securities, which are often packaged together to bring high-risk loans to the market. These products were evaluated by the same entities that actually created them, leading to the objectivity problem again. Thus, CRAs tired to please their customers.

The oligopoly problem arises when the analyses of the rating services market reveals that there are only three main institutions that share the larges market of rating services, leaving the rest of the accredited rating institutions way behind.

Moreover, ratings are legally considered opinions, so that rating agencies cannot be sued or made liable for negligent or even false ratings. It entails the consequences of the large downgrades that occurred during the crises, revealing the CRAs errors they were making. When there is no such thing as supranational surveillance, the rating agencies can basically do what they want and affect the investments.

Another problem comes when many investors lend the country huge amount of money, leading to the country's upgrading, but later on the situation returns to normal, when the invested mney dissolve in the economic activities of the country, but the rating is still maintained. As soon as the minor crisis affects the country, its rating abruptly lower, turning into a major crises, with the raise of the interest rates for the new loans.

Independent rating agencies, being the gatekeepers of the credit risk, have failed to perform their duties in the light of the global financial crises.[59] Their deceptive ratings entailed severe consequences for the capital market players, as many of the financial institutions insured their trust in CRAs' services. For instance, mortgage brokers conducted millions of securities operations with the highly risky assets, so did the investment banks, who entrusted their money into the residential mortgage backed securities (RMBS) and collateralized debt obligations (CDOs), which eventually turned out to be of a default level rate.

Problems

[59] Reinier H. Kraakman, Gatekeepers: The Anatomy of a Third-Party Strategy, 2 J.L. ECON. & ORG. 53, 53 (1986)

Thus, rating agencies not only failed to identify the potential market threats and the dangerous risk behind the securitized products back in 2005, but they also abrogated their responsibilities for the services they provided.

2.3 The culpability of the CRAs

In the light of the global financial crises, CRAs lost the trust of many investors by failing to comply with their duties. No restricted regulations existed to regulate and supervise the rating processes, which entailed the consequences that financial markets are still facing nowadays.

It is believed that the First Amendment protection for the rating business should not be possible in the tort liability process with the CRAs.[60]

There were a lot of arguments regarding the question of the civil liability of the rating agencies for their services. However, it was concluded, that these agencies just provide the independent opinion on the investment opportunities and do not make any guarantees nor any obligations for the investors to strictly rely on their ratings. The agencies help to reduce the information asymmetry that exists on the market.[61]

In the USA for a long period of time courts were hesitant as to whether to grant claims against the Big Three rating institutions as the main market players on the global scale. However, the crises of 2007-2008 showed the importance of the creation of the regulatory base and the liability background for regulating the activities of these independent rating institutions.

The civil suit was recently brought to court against the S&P's agency in early 2013, seeking damages of $5 billion for the crutial role that agencies were playing in the light of the global crises, leading to the bankruptcies of the various level investors. This case was an example of the further development of civil actions regarding the Big Three rating agencies.

[60] "First Amendment." *LII / Legal Information Institute*. N.p., n.d. Web. 04 June 2014. http://www.law.cornell.edu/wex/first_amendment

Chapter 3. The regulatory framework of the CRAs: the aftermath of the 2007-2008 crisis

3.1 The regulatory regime models and major provisions in the US and European systems

Global Financial Crises of 2008 has revealed the CRAs' incompetency and unprofessionalism, as they were not able to dismiss the opportunity to make large profits by blindly assigning the rating to various securities and their issuers, without actually checking their default level. As a result, the US and European regulatory bodies initiated the investigation process and started to seriously consider imposing stricter regulations on the rating agencies on both global and local levels. They were pursuing the goal of eliminating the interdependence of investment decisions and the rating grades.

Until recently, CRAs were poorly regulated, as the regulatory bodies were neglect in terms of supervision of the rating services. The main problem that financial markets have been facing since their existence is the inability of the regulatory bodies to keep up with the rapid fluctuations on the capital markets. Regulations usually come after the system's collapse or markets crashes, when it becomes too late to save the system. The case of the recent global financial crises was not an exception.

Right after the crises, lots of discussions were initiated and new regulations and rules appeared to be passed. Both USA and European regulatory bodies were focused on fixing the problems with CRAs services to restrict their activities and provide more transparency for the investors.

It's very important to take a closer look at the regulatory frameworks of these two large markets – the European one and American, in order to understand the reasons for the recent market supervision and control .

As a result, the US regulatory institutions began to change their policies and regulations, to eliminate the dependence of the investment decisions solely on the ratings provided by the agencies. This led to the creation of the alternative rating agency "Muros Ratings", the main idea of which is the rating assignment of the securities upon the requests from the investors only.[62]

[62] "Muros Group." *Muros Group*. N.p., n.d. Web. 05 June 2014. http://murosgroup.com/en

At the same time, right after the crises, the US regulations of financial markets undergone serious changes. In 2010, the US enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act, that had the purpose of the protection of the investors and their businesses by providing the supervision and setting up the regulatory framework for the rating agencies industry.

In EU, a year later, the independent authority – European Securities and Markets Authority (ESMA) was founded, to ensure that the rating agencies meet all the required standards while providing their services.

The main distinguishing feature of the American regulatory system is that it was created prior to the European and is still considered to be more accurate model despite all the disputes arisen over the past few years.

The Credit Rating Agency Reform Act of 2006 was a regulatory response to the rating agency's industry destabilization. It amended section 3(a) of the Security Exchange Act of 1934 and re-written section 15e, which stipulates the registration process for the nationally recognized statistical rating organizations (NRSROs).[63]

In June 2007 SEC established the new regulations: rules 17g (1-6) that stipulate the regulatory framework for the NRSROs services.[64]

Thus, Rule 17g-1 establishes the regulation for the CRA to file an application to the Commission to initiate the registration process:

> credit rating agency also will be required to provide certifications from qualified institutional buyers; a list of its largest customers; audited financial statements; and certain summary financial information. An applicant may request that the Commission keep this information confidential. The Commission will keep this information confidential to the extent permitted by law.[65]

Rule 17g-2 requires an NRSRO "to make and retain certain records relating to its business as a credit rating agency" and stipulates the time range for the maintenance of the records made.

Rule 17g-3 requires NRSROs to annually report to the Commission, submitting all the financial and audit statements.

[63] Congress, U.s. *Section 15E of the Securities Exchange Act of 1934 - REGISTRATION OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS* (n.d.): n. pag. Web.https://www.sec.gov/divisions/marketreg/ratingagency/sea34-15e.pdf

[64] "SEC Votes to Adopt Final Rules to Implement the Credit Rating Agency Reform Act of 2006." *Press Release: ; 2007-104; May 23, 2007*. N.p., n.d. Web. 05 June 2014. http://www.sec.gov/news/press/2007/2007-104.htm

[65] Ibid.

Rule 17g-4 requires an NRSRO to

have written policies and procedures reasonably designed to prevent:

(1) the inappropriate dissemination within and outside the NRSRO of material nonpublic information obtained in connection with the performance of credit rating services;

(2) a person within the NRSRO from purchasing, selling, or otherwise benefiting from any transaction in securities or money market instruments when the person is in possession of material nonpublic information obtained in connection with the performance of credit rating services that affects the securities or money market instruments; and

(3) the inappropriate dissemination within and outside the NRSRO of a pending credit rating action before issuing the credit rating".[66]

Rule 17g-5 requests for he disclose of any important information obtain over the rating process by the CRAs and that is considered to be relevant to the decision making process on the investment.

Rule 17g-6 prohibits the NRSRO from:

"engaging in certain unfair, coercive, or abusive practices and from issuing or threatening to issue a lower credit rating, lowering or threatening to lower an existing credit rating, refusing to issue a credit rating, or withdrawing or threatening to withdraw a credit rating, with respect to securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless all or a portion of the assets within such pool or part of such transaction also are rated by the NRSRO, where such practice is engaged in by the NRSRO for an anticompetitive purpose."[67]

Thus, basically these amendments specify the rating procedure and establish strict rules on the securities and issuers' evaluation process.[68]

EU Regulatory framework of the rating services is represented by the EU directives and regulations.

The EU Directive 2003/6/CE on insider dealing and market maniulations that rules the financial market deregulations and provides a list of sanctions applied to the wrongdoing behaviors

[66] SEC Votes to Adopt Final Rules to Implement the Credit Rating Agency Reform Act of 2006." *Press Release: ; 2007-104; May 23, 2007*. N.p., n.d. Web. 05 June 2014. http://www.sec.gov/news/press/2007/2007-104.htm
[67] Ibid.
[68] Helwege, Jean. *Comment Letter on File No. S7-04-07* (n.d.): n. pag. Web. http://www.sec.gov/comments/s7-04-07/s70407-60.pdf

of the financial market players. In the Article 6 it stipulates the provisions regarding the violation of the market regulations in sense of manipulation and violation of the insider trading information. The data used by CRAs is considered to be such an information that should be protected against abuses.[69]

The Directive 2003/125/CE was passed to implement Directive 2003/6/EC of the European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest. It refers to the CRAs services industry, stating that:

"recommending or suggesting an investment strategy is either done explicitly (such as "buy', "hold" or "sell" recommendations) or implicitly (by reference to a price target or otherwise)."[70]

The 2006/48/EC Directive on capital requirements for credit institutions stipulates that the risk assessment process must be regulated by the External Credit Assessment Institutions (ECAI), which CRAs are part of. It provides for the monitoring and the supervision of the rating process of the CRAs.[71]

Basel II Accord, as it was previously mentioned, also sets out the rules for the financial market regulations, concentrating on the role of the CRAs. It provides the precision of the rating process regulation and the risk estimation. The Basel II Accord developed two main approaches used by investment banks to measure the risk: the Standardized Approach and the Internal Rating Based Approach. CRAs are the main institutions that are used to apply both of these approaches.[72]

As mentioned above, the regulatory approaches created by US and European Regulatory Institutions as a response to the global financial crises are different from each other, making the US system more investment friendly and the European more strictly regulated.

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[69] SEC Votes to Adopt Final Rules to Implement the Credit Rating Agency Reform Act of 2006." *Press Release: ; 2007-104; May 23, 2007*. N.p., n.d. Web. 05 June 2014. http://www.sec.gov/news/press/2007/2007-104.htm

[70] "COMMISSION DIRECTIVE 2003/125/EC of 22 December 2003 Implementing Directive 2003/6/EC of the European Parliament and of the Council as Regards the Fair Presentation of Investment Recommendations and the Disclosure of Conflicts of Interest (Text with EEA Relevance)." (n.d.): n. pag. Web. http://www.esma.europa.eu/system/files/MADImplDir_2003_125.pdf

[71] http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm

[72] "Liability of Credit Rating Agencies: A European Draft." *Welcome to Eubelius*. N.p., n.d. Web. 05 June 2014. <http://www.eubelius.com/en/spotlight/liability-credit-rating-agencies-european-draft>.

3.2 Proposal for the future reforms

Jeffrey Manns, George Washington University Law School professor, in his article "Rating Risk after the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability" proposes a reform of creating a "SEC-administered user free system that will enlist the purchasers of corporate debt – the primary beneficiaries of credit risk assessments – as self-interested monitors of rating agencies and complements to SEC oversight".[73]

The article argues that the conflict of interests that exists between the CRAs and the issuers of the securities is one of the major causes of the financial crises, that recently hit hard the world economy. In order to conceal the shortcomings of the rating services, the SEC imposed new regulations on the CRAs and raised the standard requirements for the issuers of the securities. [74]

Credit ratings reflect the relatively long-lasting relationship between the creditworthiness of the borrowers and the risk that investors will bear.[75] They don't fluctuate on a daily bases, but at the same time they can be re-evaluated and the changes in the ratings of the particular securities might be made.

Creation of a user fee system proposed by professor Manns, that will provide a set of opportunities for the cooperation between the SEC, SRAs and the investors, will contribute to making the financial markets operations more transparent and well monitored.[76] The contracts that would bound the CRAs to perform their duties with regard to the creditors and be held liable for the breach under the user free system, will be monitored and administered by the SEC. Under this system, CRAs must have the proper certification and follow the mandatory reporting requirements, meeting the standards of the information disclosure process and eliminating the negligence while reducing the involvement in the risky products.

The possible solutions that can be implemented as to the regulation of the rating system are:

[73] Rating Risk after the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability, available at http://scholarship.law.gwu.edu/cgi/viewcontent.cgi?article=1849&context=faculty_publications
[74] John C. Coffee & Hillary A. Sale, Redesigning the SEC: Does the Treasury Have a Better Idea? 30 (Columbia Law and Econ. Working Paper No. 342, 2009), available at http://ssrn.com/abstract=1309776
[75] Gretchen Morgenson, Arcane Market is Next to Face Big Credit Test, N.Y. TIMES, Feb. 17, 2008, at A1.
[76] http://scholarship.law.gwu.edu/cgi/viewcontent.cgi?article=1849&context=faculty_publications

- tax solution, as the governments can attract the capital in a more stable and favourable through the direct financing with taxes and fees, limiting the reliance on the CRAs' risk assessment
- extanded supervision, meaning that the agencies must be monitored and work more transparently;
- competition and alternatives can be reached by restricting the power of the three rating agencies;
- accountability achieved by changes in the range of criteria evaluations;
- immediate reaction and response to the market changes.[77]

The main idea of improving the regulatory framework regarding the credit rating agency's services is based on the creation of the unified liability system, that would prevent the rating institutions from making large profits by assigning false investment level ratings to the default level securities and the issuers of these securities.

[77] "Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies." *UNITED STATES SECURITIES AND EXCHANGE COMMISSION* (n.d.): n. pag. July 2008. Web. http://www.sec.gov/news/studies/2008/craexamination070808.pdf

Conclusion

The process of financial market's globalization together with the growth of the technological development presented broader opportunities for the financial institutions and businesses to accumulate profits and attract various investors. There was a need for financial debt instruments' standardization and creation of the adequate risk rating system, which would regulate the investment portfolios. These needs were satisfied by the creation of the credit rating agencies, which help to solve the problem of the information asymmetry.[78]

Various international organizations acknowledged the danger of ratings' misuse. So nowadays, a multiple standards of rating agencies regulations are being developed to eliminate these problems.

In the light of the subprime mortgage crisis, one crucial question was to be considered: How could so many bright economists, market researches, etc. not predict the financial system collapse ahead of time, when the securitized products were occupying the financial markets boosting the enormous amount of profits for large financial institutions? The answer to that question is still unclear, however, it's true that when the money start coming out of nothing and the regulatory base is being lax and full of loop holes, which provide great opportunities for the institutions to generate large profits.

The credit crunch in USA entailed the Eurozone bond market crises, which resulted in various countries' defaults and losses. It's very important to see how the collapse of one system affects the functioning of the other one. Although the regulatory frameworks of financial markets' independent rating agencies in USA and Europe were disparate, both major economies were on the verge of collapse when the crises struck.

This paper examined the regulatory framework of the CRAs in Europe and USA, it provided the overview of the CRAs evolutionary development process, their regulations before the global financial crises and the response of the regulatory bodies after the credit crunch of 2007.

[78] "Proposed Regulation of Credit Rating Agencies." N.p., n.d. Web. http://www.mas.gov.sg/~/media/resource/publications/consult_papers/2011/consultationpaperbody.ashx

Even though the financial systems of US and Europe are considered to be well developed and have been existing for a quite long period of time on the markets, they are still not perfect.

The thesis paper demonstrated that the implementation of the strict regulations and the supervision of the CRAs' services will not only provide solutions as to how create an efficient financial markets system, but also will give the investors to obtain a better opportunities and to generate more profits, being legally protected from the systematic and idiosyncratic risks that capital markets accumulate.

Supervision of the enforcement of The Dodd-Frank Wall Street Reform and Consumer Protection Act, together with the Sarbanes-Oxley Act of 2002, Securities Act of 1933 and Securities Exchange Act of 1934 in US will contribute to financial markets regulations and promote the financial stability for the investors and the economy in general.

In Europe, the recent Regulations and Directives, enforced by the Member States, will play a great role in the regulatory framework of the European capital market, but as long as the Big Three International CRAs prevail in the rating services industry, the regulations will not be of a decent help. However, the promotion of the small CRAs services would eliminate the risk of financial instability in the countries and create a great opportunities for many investors.

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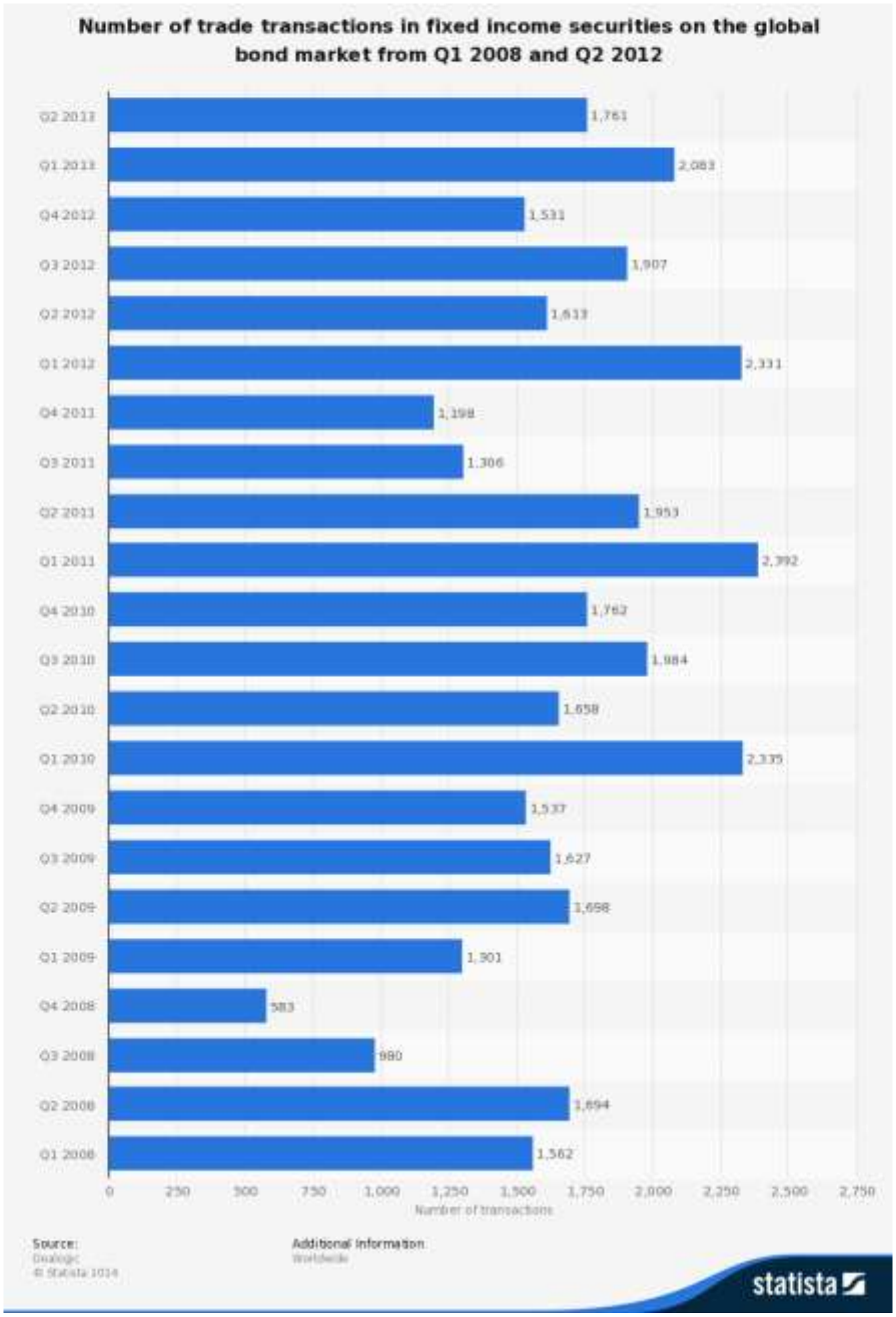
Appendix A – Credit Ratings Comparison table

Moody's		S&P		Fitch		
Long term	**Short term**	**Long term**	**Short terme**	**Long term**	**Short term**	
Aaa	**P-1**	**AAA**	**A-1+**	**AAA**	**A1+**	**Prime**
Aa1		**AA+**		**AA+**		**High Grade**
Aa2		**AA**		**AA**		
Aa3		**AA-**		**AA-**		
A1		**A+**	**A-1**	**A+**	**A1**	**Upper Medium Grade**
A2		**A**		**A**		
A3	**P-2**	**A-**	**A-2**	**A-**	**A2**	
Baa1		**BBB+**		**BBB+**		**Lower Medium Grade**
Baa2	**P-3**	**BBB**	**A-3**	**BBB**	**A3**	
Baa3		**BBB-**		**BBB-**		
Ba1	Not Prime	BB+	B	BB+	B	Non Investment Grade Speculative
Ba2		BB		BB		
Ba3		BB-		BB-		
B1		B+		B+		Highly speculative
B2		B		B		
B3		B-		B-		
Caa		CCC+	C	CCC	C	Substantial risks
Ca		CCC				Extremely speculative
C		CCC-				In default, with little prospect for recovery
/		D	/	DDD	/	In default
/				DD		
/				D		

Appendix B - Appendix 2 shows the information regarding the number of trade transactions in fixed income securities on the global bond market over 2008-2012.



Appendix C – Types of risks according to the CRAs