Research Report

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Forum:	*General Assembly Second Committee: Economic and Financial*
Issue:	*The influence of rating agencies on the global financial market*
Position:	*Deputy Chair*

Introduction

Credit rating agencies have been around since the 20th century. Their task is to give an independent opinion about entities' ability to pay back debt. Therefore, the credit rating process is one of the most powerful analysis instruments in the economy. The value of credit ratings for securities has been widely questioned. Hundreds of billions of securities that were given the agencies' highest ratings were downgraded to junk during the financial crisis of 2007–2008. Episodes like this happened even earlier, dating back to the Asia financial crisis in 1997-1999. Although there are some doubts regarding credit rating agencies, they have played a key role in the financial community during the last one hundred years. For that reason, to improve productivity and reliability of the rating system some additional measures must be taken.

Definition of Key Terms

Rating agency (or credit rating agency- **CRA**)
A company which evaluates the creditworthiness of organizations (including governments and enterprises) that issue debt in public market. The three largest credit rating agencies are Moody's, Standard & Poor's, and Fitch Ratings which control about 95% of the ratings business.

Credit rating
An analysis of the credit risks. It is based on the financial history of borrowing or lending and credit worthiness of the entity. Ratings are made on a descending scale: AAA is the highest, then AA, A, BBB, BB, B, CCC, etc.

General Overview

History
The history of rating agencies began when United States started to expand to other parts of the country. Before that, merchants had been able to extend credit to customers because they knew their clients personally and could judge whether borrowers could or could not pay it back. However, when trading distances

increased, merchants needed help to elaborate credit worthiness which led up to beginning of the credit reporting industry.

The precursors of present rating agencies were mercantile credit agencies, established due to financial crisis of 1837. The first one was set up in 1841 by Lewis Tappan.

In the early 1900s, when ratings began to be applied to securities, credit rating agencies originated in the United States. That is when the biggest three CRAs were founded.

Issues associated with rating agencies

Since the outbreak of the international economic crisis, there have been several concerns about credit rating agencies. The first big problem that rating agencies had was related with Asia's financial crisis. Thailand had good rating, even though Asia's financial crisis had started five months earlier. The second big scandal was connected with the energy company- Enron in 2001. When this firm had one of the biggest credit ratings, it declared bankruptcy which led to a tightening of the rules regarding independence of audit firms. In their defence, CRAs said that their ratings should only be considered as an opinion not as a financial counselling. Situation like this also happened in 2009 when the largest credit rating agencies evaluated the company's (Lehman Brothers) debt and gave it a good rating. Several days after this, the firm had to sign bankruptcy petition. Another huge scandal was caused by Standard & Poor's when, in November 2011, they lowered France's credit rating by mistake. Because of this, the European Parliament thought about creating a public European rating agency which would be independent from American agencies.

Conflicts of interests

One of the problems of the rating agencies is caused by the fact that borrowers are paying agencies the fee ("issuer pays"). As a result, they have the privilege to choose the CRA which proposes the most favourable ratings because of the fact that fees depend on how the kind of rating that issuers will get. Over 90% of rating agencies' incomes are fees from borrowers, so it is natural that they want as many clients as possible. Unfortunately, this is the main reason for inflated rating. A phenomenon called "rating shopping" means that agencies are offering clients overstated ratings in order to encourage them to use their services.

Competition

When there are only three credit rating agencies which are taken into consideration by issuers and investors, new agencies do not count and have no chance in the market. Therefore, ratings are higher than they should be and "issuer fees" are bigger.

Inadequacy of ratings
Another huge issue related with credit ratings is that they are often inadequate to actual economic and financial standing. Sometimes agencies react too late when it comes to deteriorating borrowers' financial situations. Regrettably, these wrong ratings are not always made by mistake but sometimes they are intentionally made in order to manipulate the market by using ratings.

"Rating trigger"
When a rating agency lowers a rating, all of the sudden this company or country has to pay back all debts earlier than planned. Its situation is only getting worse as it no longer has an accounting liquidity. On the other hand, when ratings do not change properly, the agencies cannot be trusted anymore as their ratings will not be current.

Reliability
There have been many situations which show that rating agencies cannot be trusted every time. Yet, there is still too much faith put in their ratings. Almost all investment strategies have to be changed after ratings are changing. Due to that fact, the investments are risky because rating agencies continue to make many mistakes but the only thing that rating agencies lose is their reputation.

Major Parties Involved

International Organization of Securities Commissions (IOSCO)
In September 2003, IOSCO's Technical Committee published a Statement of Principles Regarding the Activities of Credit Rating Agencies and also a Report on the Activities of Credit Rating Agencies that outlined the activities of CRAs. This report found that, in some cases, CRAs activities are not always well understood by investors and issuers alike. In May 2008 this organization changed code of conduct fundamentals for CRAs.

Fitch Ratings
A rating agency founded by John Knowles Fitch in 1913. In 1924 Fitch Ratings introduced the alphabetic scale from 'AAA' to 'D'.

Moody's Investors Service
At first, John Moody and Company in 1900 published "Moody's Manual" which consisted of basic statistics and general information about stocks and bonds of various industries. In 1909 they started giving analitycal information about the value of securities. In the following ten years their business expand and they were providing ratings for nearly all government bond markets.

Standard & Poor's
A rating agency which was created by merge in 1941 between Standard Statistics and Poor's Publishing. First rating agency was founded by Henry Varnum Poor who published the "History of Railroads and Canals in the United States" in 1860.

Timeline of Events

1841	First mercantile credit agency established by Lewis Tappan.
1860-1941	Process of creating the largest credit rating agencies in the world.
1997-1999	Asia financial crisis- first big doubt in rating agencies work.
2001	Enron's bunkrupcty.
2003	IOSCO's Technical Committee published a Statement of Principles Regarding the Activities of Credit Rating Agencies.
2008	Lehman Brothers' bunkrupcty. New IOSCO code regarding rating agencies.
2009	New European Union rules- national supervisory bodies are controling rating agencies. G-20 "Declaration on Strengthening Financial".
2010	European Sales and Marketing Association is being created in order to control rating agencies.
2011	France credit rating was lower than the actual one. European Parliament idea of creating an own CRA.

Previous Attempts to solve the issue

One of the most important attempts to change the situation about credit rating agencies was in May 2008 when IOSCO wrote a new code of conduct fundamentals. In April 2009, the G-20 created a new document- "Declaration on Strengthening Financial" where they established that IOSCO should be a model in monitoring rating agencies. The same year, the European Union created new rules. Since then, national supervisory bodies should control rating agencies. Additionally, all ratings agencies that are willing to work on the territory of UE are obliged to register in the Committee of European Securities Regulators. In 2010, the European Sales and Marketing Association (ESMA) was created in order to control audit firms. ESMA is able to impose sanctions on rating agencies such as cash penalties or temporary suspension from making credit ratings.

Possible Solutions

The idea of creating an European rating agency might be put into effect as it could have a big influence on global market because of its independence from American rating agencies.

As it has been stated earlier, rating agencies were not scared after making mistakes because the only thing they could lose was their reputation. Unfortunately for them, after the ESMA was created, it has the power to punish agencies, and so the CRAs' ratings have to be more reliable. That is why institutions like ESMA should be supported and created all over the world, not only in the European Union.

Likewise, the situation of the bankruptcy of the firm Enron showed that ratings might be checked more frequently in order to prevent sudden changes in ratings.

Furthermore, a new, public, independent institution might be created to evaluate credit rating agencies. Therefore, people who use these agencies ratings would only choose the one which is the most dependable.

To prevent rating for being inaccurate or inflated, there could be a new rule which would oblige issuers to use different rating agency every few years.

Also the regulation of paying "issuer fees" could be changed to "investor-pays" with the intention to eliminate indirect settlements between issuers and CRAs. The "investor-pays" system was used until 1980s and nowadays it is only used

by three minor rating agencies.

Another solution, which some of rating agencies use, is to pay the employees, who give enterprises ratings, a salary that does not depend on how much money CRAs will get from issuers or how good the rating will be.

Moreover, there are only 3 rating agencies that really count. Competition contest could be encouraged in order to give small rating agencies a chance. Consequently, the ratings would be more accurate and the "issuer fees" would be lower.

Additionally, rules included in IOSCO's code should be adhered to by credit rating agencies all over the world.

Useful documents

UN Thematic Debate- "The Role of Credit Rating Agencies in the International Financial System"
http://www.un.org/en/ga/president/67/letters/pdf/Thematic%20Debate_Role%20of%20Credit%20Rating%20Agencies%20-%2028%20June%202013.pdf

"Code of conduct fundamentals for credit rating agencies"
https://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf

Appendix/Appendices

"Definition of 'credit rating' "
http://www.investopedia.com/terms/c/creditrating.asp

"History of Credit Rating Agencies and How They Work"
http://www.moneycrashers.com/credit-rating-agencies-history/

"The Credit Rating Controversy"
http://www.cfr.org/financial-crises/credit-rating-controversy/p22328

"Credit rating agency"- *Wikipedia*
https://en.wikipedia.org/wiki/Credit_rating_agency

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