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1. Supervisor: Prof. Dr. Konegen
2. Supervisor: Martin Stienstra MSc

Bachelor thesis:

The role of rating agencies within the European debt crisis

Stephanie Düker
Kanonierstr. 6-7
D-48149 Münster
Phone: 0049 171 8532488
E-Mail: Stephanie.Dueker@gmx.net

Matrikelnummer: 363660
Student number: s1245503

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List of acronyms

CDS	Credit Default Swap
CRA	Credit Rating Agency
ECB	European Central Bank
EDC	European Debt Crisis
ERA	European Rating Agency
ERF	European Rating Fund
INCRA	International Non-Profit Credit Rating Agency
IOSCO	International Organisation of Securities Commissions
S&P	Standard and Poor's
ESMA	European Securities and Markets Authority

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“It is well enough that people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning”.

Henry Ford (1863-1947)

1. Introduction

These days there is hardly any broadcast or print news presented that does not regularly report on Credit Rating Agencies (CRA). CRAs can be defined as “(…) commercial firms that assess the ability of companies, institutions and governments to service their debts” (Ryan, 2012, p.6). However, “it is important to note that CRAs are note an absolute predictor whether a particular debtor will default on a particular obligation, rather it is a subjective view indicating the creditworthiness of a company, as well as its security or obligation” (Ryan, 2012, p.6). The reports on CRAs either focus on the activities of the CRAs or on claims to change the method of operation of CRAs or the rating market. This can be lead back to the circumstance, that performance and skills of the CRAs as well as the quality and topicality of their ratings attract permanent criticism during the enduring European Debt Crisis (EDC). However, critique of CRAs is not new. Already at the beginning of this millennium, when some large firms experienced insolvency, the expertise of the CRAs was doubted. Hence, during the financial crisis and the insolvency of Lehman Brothers in 2008, especially the incorrect ratings of structured financial products have been the focus of criticism. In the current EDC the criticism mainly refers to the downgrading of Greece and other states with financial problems, which now undergo struggle of high interest (Theurl & Schätzle, 2011). Against this background “(…) many are asking whether the credit rating agencies play a useful role in the market and whether their credits risk assessments are accurate (IMF, 2010, p.86)”. It is questioned in public and academic context how much influence private institutions like CRAs should have. However, the public dialogue regarding the improvement of the rating quality is controversial and mostly a differentiated consideration is absent (Theurl & Schätzle, 2011). The Commissioner for Internal Market and Services Michel Barnier wants to reduce the financial markets’ dependency on CRAs, as ratings would have direct influence on markets and the economy, as well as on the prosperity of the European citizens. Furthermore, José Manuel Barroso, president of the European Commission, voiced the suspicion that due to the US-American origin of the most important CRAs, ratings regarding Europe are not conducted objectively (Schäder & Brämser & Hammerschmidt, 2011). To date, there is no political or economical theory that can explain the rating business and its impact by taking into account all actors and influencing factors. Due to this reason, the above mentioned discussions, regarding an improvement of the rating market are multifarious. It seems as if nobody has the perfect answer to the occurring problems due to the lack of an appropriate theory.

Against this background, this bachelor thesis aims to focus on the following research question:

"In what way could the organisation of the rating market be responsible for the reaction of the rating agencies in the European debt crisis and which possibilities for change are thinkable?"

As there is no other topic politicians and markets, Europeans and Anglo-Saxons, as well as the audience and actors talk as much past each other, it is necessary to firstly deal with the fundamental principles regarding the rating market (Dohms, 2012). Therefore, to answer the main research question, the first of three subquestions will focus on the general organisation of the rating market:

"How is the market of ratings organised and which problems can be deduced from this?"

Thus, the second part of the analysis will concentrate on the situation of the rating and financial markets during the EDC. Thereby, the development of ratings and in relationship to this, the development of the yields of government bonds, will be considered. The focus will be especially on Greece, as it was the first state experiencing financial difficulties in terms of the current EDC. Furthermore, it is the state with the most serious problems until July 2012. Also a lot of other states have been affected by the EDC. However, the detailed consideration of all of them would exceed the scope of this bachelor thesis.

The second subquestion that will be answered to explicate the current situation is:

"How did the rating agencies react during the European debt crisis?"

After having examined the principals of the rating market and having considered the current reactions of the CRAs, the focus will be on the future. Based on the previous perceptions, as the third part of the analysis, the following final subquestion shall be explored:

"Which possibilities for change are thinkable to improve the method of operation of the rating agencies?"

After having examined the three subquestions, an answer to the main research question will be given in the conclusion. Furthermore, the final part of the bachelor thesis will present the limitations of the work in hand and reveal possibilities for further research.

2. Methodology

In the introduction of this thesis the background and aim of the research has been exposed. On this basis a short description of the methodical approach will now be given.

The research will be conducted with a normative- empirical analysis of secondary literature. According to Atteslander (2010) empirical means that theoretical phrased assumptions are reviewed on specific realities. The meaning of the word normative derives from the Latin and stands for a principle or rule. A normative analysis therefore addresses how something should be and by this exceeds a projection due to its valuing character (Enzyklo, n.d.).

As mentioned before, the first part of the analysis will focus on the organisation of the rating market and problems that can be derived from this. To find an answer to the first subquestion an analysis of the basic literature on CRAs and the organisation of this specific market will be undertaken. This means that at this point, the analysis aims to give an overview on the current organisation and intentions to the processing of the rating market. However, at the same time it will be examined if the realisation actually happens in this way or if it differs from this in reality. Therefore this part combines both parts of an empirical analysis as it is defined by Atteslander (2010).

The second part of the analysis will concentrate on the ongoing European debt crisis (EDC). Especially the situation of Greece will be examined by a description of how the CRAs reacted and what consequences this could have induced. This description will be based on the evaluation of charts. Some of them illustrate the development of sovereign ratings, whereas others present the impacts on the financial markets. Therefore, this part of the analysis can be named as a review of specific realities by considering the CRAs' work in reality (Atteslander, 2010).

After analysing the current situation of the CRAs and rating markets as well as the proceedings within the crisis, the last part of the analysis will examine possibilities to improve the method of operation of the CRAs. This will be assessed through studying current suggestions and balancing their pros and cons. This point of view will be normative. This means, that the different possibilities of change are evaluated against the background of what the improvement actions should accomplish and what they will cause in reality.

The literature that will be applied is firstly basic literature providing knowledge about CRAs and the rating market in general. Secondly, it will be made use of various journal articles and some newspaper articles in order to gather updated information regarding the current situation on the rating market as well as to detect solutions that are under consideration for an improvement of the current situation. Furthermore, to explore the development on the financial markets, topical graphs will be used.

3. The organisation of the rating market

According to the first subquestion, the aim of the first part of the analysis is to explore the organisation of the rating market, in order to deduce therefrom problems that could occur and those that already did emerge.

At first, a short review of the development of CRAs will be given, as it will be hardly possible to understand the current situation without knowing how and why issues have developed in a certain way and not the other. Furthermore, the intended task and function of CRAs will be studied in order to refer to it later on when examining the suggestions of improvement. Subsequently, the CRA's method of operation will be regarded intently. This will be essential to have a basis for the analysis in the second part which will focus on the behaviour of CRAs in the EDC and especially towards states with serious financial problems, as for example Greece. In a further step the current legal requirements will be analysed. The knowledge of this will be of relevance to understand, how CRAs should work and which role they should play from a normative viewpoint. A detailed consideration of the legal requirements will also be important for the third part of the analysis as possibilities for change cannot be discussed without background knowledge of the current legal requirements. Finally, the factual influence of CRAs will be analysed.

3.1. Development of the rating agencies

The history of CRAs dates back to the 19th century and its origin is in the United States of America (Elschen & Lieven, 2009). During this time markets and simultaneously trade evolved. Therefore, it became obvious that it would be convenient to gather and disseminate credible information about buyers on a systematic and organised basis, as it was common for colonial importers to give a credit for up to one year to retail customers (Partnoy, 1999).

One of the victims of the financial crisis in 1837 was an operator of a substantial silk business. This man was called Lewis Tappan. He and his brother had one big advantage within this crisis; they had kept detailed credit information about current and prospective customers. During the crisis this knowledge was not only helpful for themselves but also for other merchandisers. The need of knowledge about credit users became an inevitable essential in that situation. Due to this reason, Tappan established the first mercantile credit agency, called 'The Mercantile Agency', in 1841. Tappan and some other mercantile credit raters have been successfully in the following time, which made it interesting to copy Tappan's idea and also to use it for different kinds of businesses (Partnoy, 1999).

In 1900 John Moody founded Moody's and in 1909 the first analyses of railroad investments have been undertaken (Buschmeier, 2011). John Moody published the book 'Moody's Manual of Industrial and Miscellaneous Securities' which did not analyse particular companies but bonds and stocks that have been issued by a company. This can be seen as the beginning of what we understand as ratings today. The exception of Moody's rating system was the valuation in letters, which are known until the present day (Everling, 1991).

Moody's was followed by the Standard Statistic Bureau in 1906 and in 1913 the Fitch Publishing Company was founded. Finally, in 1919 the establishment of Poor's Publishing Company began (Buschmeier, 2011).

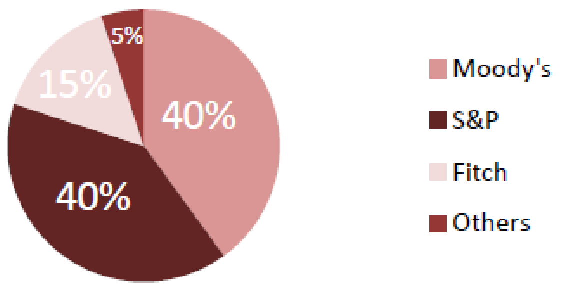
During this time, barriers to enter the rating market were not very high but at the same time the barriers to leave the market were not high either. The costs to generate a rating were not that high, so that they would have prohibited companies to enter the market. However, in case that the ratings of new CRAs were not good and reliable, they consequently could not survive within the market. In case investors thought a rating was not accurate, they reported this to the CRAs. The CRAs thus actually considered this information and can therefore be named information intermediaries. Firstly the issuers refused the ratings. However, they had to provide the CRAs with valuable information, which also included non-public information in order to receive realistic ratings and by this, to be attractive for investors. At the same time, with the help of the non-public information, CRAs could gather reputation by making reliable ratings. During these times, the ratings were paid by investors (Partnoy, 1999). This can be ascribed to the fact, that the investors have been the first interest party in ratings, whereas the issuers had to learn that the ratings could have a positive outcome for themselves.

However, a rapid growth of the CRAs did not start before the end of the Great Depression. In 1941 Poor's Publishing and the Standard Statistics Bureau consolidated and the today well-known name Standard & Poor's (S&P) was established. Since 1966 S&P is in possession of the media group Mc Graw Hill (Buschmeier, 2011).

During the previously described period of time, CRAs have been established in North America whereas there was yet no thinking of something along these lines in Europe (Buschmeier, 2011). Even in the 1960s the topic of ratings was unknown by European issuers. This can be deduced from the fact that issuers and investors only operated on relatively small and manageable national financial markets. However, an internationalisation of business activities and by this, also an internationalisation of financing made it inevitable for multinationals to seek ratings from CRAs, as this was common in North America. American investors have been used to this procedure for decades and would therefore not invest without a rating. Certainly, not only issuers but also investors from Europe were increasingly looking for ratings as the portfolios they wanted to invest in, became more and more international and by this hardly comprehensible and understandable. American CRAs reacted by opening offices in Europe. Nevertheless, at the same time several attempts to establish new CRAs in different European countries failed. Due to their missing reputation, most of them had to close again after a while (Everling, 1999.)

However, as a result of the liberalisation of the financial markets since the 1970s and the creation of new and more sophisticated financial instruments, more and more new actors entered the financial market and the amount of financial products that were traded between them considerably increased (Rosenbaum, 2009). Against this background the need of reliable information and risk assessment about the solvency of the issuers of financial products gained weight. Another reason for an increasing need of ratings was the deflection of demand for bank credits to the financing of businesses with bonds (Rosenbaum, 2009). At present, also states finance themselves with bonds. This, in turn again increases the relevance of CRAs.

Figure 1: Market share of rating agencies (cf. bankenverband.de, 2012)



To date, the three big CRAs, which have been established at the beginning of the rating history, are still the ones that dominate the global rating market (Hiß & Nagel, 2012). In Figure 1 it can be seen that Moody's, S&P and Fitch together have 95% market share. Due to their market-dominating position the further analysis will focus with its explications on these three CRAs.

3.2. The task and function of rating agencies

In the previous part it became obvious that CRAs developed out of the need of information gathering about the persons, companies or states one wants to invest money in. Against this background, a CRA's task is to offer standardised and qualitative information for investors. The aim is to make it possible to compare the reliability of the credit user. However, ratings do not only offer benefits for investors but also for issuers, as they give the possibility to convince the finance providers to invest in them. In case that the rating of the issuer is good, there is a high probability to attain lower costs of financing than by taking a bank loan (Rosenbaum, 2009).

In the following it will be distinguished between three different functions that rating agencies shall accomplish. These are according to Schmidtke (2010) an information function, a weighting function and the function to offer recommendations.

Firstly, the information function will be examined. A rating includes an analysis of the weaknesses and strengths of an enterprise or state, a balance sheet analysis and a review of its strategies and ideas for the future (Hiß & Nagel, 2012). It is common that enterprises which are in need of a rating mandate a CRA and afterwards the results of the rating will be published. Therefore, the results are accessible for most investors, with no costs. In contrast to former times, today the purchaser of the rating (mostly the issuer) has to pay for the rating and not anymore the investor, as it used to be (Schmidtke, 2010). Since the possibility of making copies arose, the issuer-pay model became prevalent (Hiß & Nagel, 2012).The enormous amount of information about the financial market and its actors is compressed in one rating (Schmidtke, 2010). On this account it is a cheap and simple possibility for investors to acquire the sorely needed information. Therefore, CRAs are often defined as information intermediaries (Héritier, 2002). However, although ratings reduce the complexity of information, it can be doubted that the investor will have an extensive knowledge about the target of investment (Schmidtke, 2010).

Next, the weighting function will be considered. As the CRAs evaluate the solvency of the respective issuer, they do not only offer information but also give estimation at the same time. They estimate the creditworthy of the rating object. This is not only essential knowledge and of high importance to know for the investors, but at the same time very essential for the issuers. It is more or less inevitable for participation and contribution at the financial markets today, as investors expect a rating. However, ratings are also helpful to find the right price for a new emission. It is clearly recognisable that the issuers take a great interest in receiving a good rating, as this will contribute to a reduction of the cost of capital procurement (Schmidtke, 2010).

Finally, the function to offer recommendations will now be analysed. Although CRAs tend to neglect this function of their business, it is undeniable that private investors use ratings as a decision guidance. But even institutional investors, often decide exclusively on the basis of ratings as they regularly do not have sufficient information for an individual evaluation of the investment. Furthermore, ratings are standardised today. Therefore it is easy to compare ratings and by this the quality of the investment (Schmidtke, 2009). In turn, with high probability, this can be seen as the basis for the individual investment decision. However, it has to be stated that this function is one in question, as the perception of the investors differs from the one of the CRA's. The investors use ratings as recommendations whereas at the same time the CRA's stress that they offer information about the future creditworthiness but do not recommend any investments (Moody's, 2012).

Besides the aforementioned functions of ratings, there is also a regulatory function of the rating which is related to legal obligations. However, at this point it will not be looked at this function, as this will be considered in the part "current legal requirements" of this bachelor thesis.

Finally, it can be stated that according to Schmidtke (2010) CRAs are nowadays one of the most important intermediaries of information within developed financial markets. Without CRAs the financial markets, as they operate today, would not be possible. Approximately 80% of the monetary transactions are influenced by ratings and CRAs (Schmidtke, 2010).

3.3. The method of operation of rating agencies

Understanding the CRA's method of operation and by this the insight of how ratings are created is of elementary relevance for the evaluation of the significance of ratings (Everling, 1991). However, this analysis will not focus on the special rating criteria of different CRAs nor on special forms of rating scales due to different repayment periods. It will rather give an overview over the general rating procedure and focus on the criteria that are important for the creation of sovereign ratings. Furthermore, factors that can put the rating quality at risk will be evaluated.

3.3.1. Solicited rating

The creation of solicited ratings proceeds, in principle, as follows: Firstly, the credit user awards the contract to a CRA of its choice. Hence, introductive conversations take place and a team of analysts meets the emitter's management in order to gain personal information. This non-public information, provided in a presentation and a conversation with the management, is used, in correlation with the information available to the public, for a detailed analysis. All collected information during this process has to be kept in confidence. The team of analysts draws up an internal concept whereby the rating committee thereafter decides upon the matter trough a vote. Subsequently, the issuer gets a notification of the rating and the most important points influencing the decision. After that, there is the possibility for a counter statement by the purchaser. This could include more information in order to try to get an improved rating. In case that a change of the rating is probable, a new analysis is made and the rating committee has to decide again. As a last step, the rating will be published (Everling, 1991). According to Schmidtke (2010) this process is managed by the three big CRAs within 90 days. After the first published rating a regularly review (at least once a year) of the rating takes places.

3.3.2. Unsolicited rating

Besides solicited ratings, there are also ratings that take place without a mandate. Thereby it has to be distinguished between two forms of an unsolicited rating. Firstly, the prospective issuer often also cooperates with the CRAs although the rating is unrequested, as the credit user is certainly interested in a good rating. Therefore, in this case the procedure is similar to the procedure of a solicited rating. Most of these ratings are reviews of prior ratings (Schmidtke, 2010).

Secondly, there is the possibility that the emitter does not cooperate and therefore the rating takes place exclusive on the basis of information accessible to the public. These ratings mostly occur in that case, if a rating seems to be necessary to the CRAs for an improvement of the data basis or for a completion of the market coverage (Schmidtke, 2010).

After having examined the general method of the CRAs operation, thus the most important criteria that are used to generate a rating shall be considered.

Firstly, it should be indicated that there are two different kinds of rating objectives. Either the emission or the emitter itself can be rated (Bauer, 2009). In relation to the emitter, there has to be made a further distinction. Companies, as well as states can both be the target of a rating (Schmidtke, 2010). According to Everling (1991) the rating of a state is also of high importance to companies based in this certain country, as the sovereign rating normally is the upper limit for a company rating. This is called “sovereign ceiling” (Hillebrand, 2001, p. 158). In the basis of this bachelor thesis, that aims to examine the influence of CRAs in the EDC, which is highly related to sovereign ratings, now the sovereign ratings will be regarded intently.

3.3.3. Sovereign rating

As already mentioned before, the first step in a rating process is the consultation with the contractee. In case of sovereign ratings the information exchange takes place between government representatives and the CRA. Besides this, once a year (in case of emerging countries more often) meetings for several days take place. During these meetings, the analysts of the CRA consult policymakers of the ministries and decision makers of the central bank as well as politicians, managers and other experts of the certain country. In order to determine the relative risk of non-payment, qualitative and quantitative methods are used by the CRAs. They are used to evaluate the overall economical, political and social situation in a country (Rosenbaum, 2009). According to this, Table 1 provides a brief overview on the aspects, the different CRAs focus on. These criterias are weighted with a special factor, which differs amongst the CRA as well as it is non-public. Lastly, the CRA acquires a final rating (Rosenbaum, 2009).

Table 1: Key Factors in Sovereign Credit Rating Assessments (cf. IMF, 2010, p.99)

Fitch	Macroeconomic policies, performance, and prospects; structural features of the economy; public finances; external finances
Moody's	Economic strength; institutional strength; financial strength of the government; susceptibility to event risk
Standard & Poor's	Political risk; economic structure; economic growth prospects; fiscal flexibility; general government debt burden; offshore and contingent liabilities; monetary flexibility; external liquidity external debt burden

Sources: Fitch (2010a); Moody's (2008); and Standard and Poor's (2008).

Some of the overall factors, having strong impact on the rating, will now be considered more extensively. However, the following consideration can only give a general overview due to the different rating particularities of the CRAs.

The economical factors refer to the ability of repayment whilst the political risk measures the willingness of repayment. In reference to the political risk, the focal point is on the transparency, stability and predictability of political institutions. The economical criteria contain microeconomical factors like the flexibility of the labour market and macroeconomical factors like the stability of money and the balance of payments. Although those economical criteria are known to be due to economic trends, the CRAs make a claim to create ratings that are not influenced by those economic trends. Therefore, there would be no influence on the determined relative risk of non-payment (Rosenbaum, 2009). However, Rosenbaum (2009) stresses that this does not contradict that the absolute risk of non-payment changes due to cyclical variations. Finally, it has to be mentioned, that “though sometimes difficult to achieve, a quality check of the data is an important part of the country risk analysis (IMF, 2010, p.99).”

3.3.4. Rating scale

The three big CRAs present their ratings in form of numbers and letters. Hiß & Nagel (2012) published a figure that demonstrates the different rating scales of the three big CRAs. As it can be seen in Table 2, the different rating scales all make use of letters in combination with plus and minus or with numbers. Although the symbols differ from CRA to CRA, they are good to compare in accordance to their statement about the creditworthiness. They can be seen as the briefest method to describe the prospective financial power and reliability of a company or state.

Table 2: Rating scale of Fitch, Moody's and S&P (cf. Hiß&Nagel, 2012, p.120)

	Fitch	Moody's	Standard & Poor's
investment grade	AAA	Aaa	AAA
	AA+	Aa1	AA+
	AA	Aa2	AA
	AA-	Aa3	AA-
	A+	A1	A+
	A	A2	A
	A-	A3	A-
	BBB+	Baa1	BBB+
	BBB	Baa2	BBB
	BBB-	Baa3	BBB-
non-investment grade	BB+	Ba1	BB+
	BB	Ba2	BB
	BB-	Ba3	BB-
	B+	B1	B+
	B	B2	B
	B-	B3	B-
	CCC+	Caa1	CCC+
	CCC	Caa2	CCC
	CCC-	Caa3	CCC-
	CC	Ca	CC
	CD	C	CD

Beside the detailed nuances of the rating grades, there is also a coarser classification of the ratings. The upper range with grades better than BBB-, Baa3 and BBB- is called investment grade. These grades in the range below BBB-, Baa3 and BBB- are called non-investment grades. Sometimes this range is also called speculative grade. However, these designations are not invented by the CRAs but built up on the market. Therefore the CRAs stress, that those ratings with an investment grade cannot be interpreted as an advice to invest in (Hiß & Nagel, 2012). However, despite this statement of the CRAs, the classification is used by legal obligations to regulate the equity base (Theurl & Schätzle, 2011).

3.3.5. Quality of ratings

After having examined the general method of operation of CRAs and the criteria for the creation of sovereign ratings, as well as the rating scale of the three big CRAs, now a critical view on the possibly consequential risks for the quality of ratings will be considered.

There are different aspects that can be expected to have negative influence on the quality of ratings. At first, the existence of economical dependency must be cited. According to Bauer (2009) the financial dependency of CRAs on their contractual partner inevitable leads to the question of the necessary autonomy of CRAs. Due to free markets and competition, the purchaser of a rating has the opportunity to choose the CRA he wants to work with. Certainly, there are several aspects that have strong influence on the choice of a CRA and which in turn can have a strong influence on the operating principles of the CRAs. For the purchaser it is important to obtain a good rating in order to get money for a cheap price at the financial market. The purchaser certainly wants to economize the costs of the rating later on. Therefore, he will most likely choose a CRA with good reputation, as only the rating of such a CRA will convince investors. However, the investor could also choose a CRA offering cheap prices. This criterion for making a choice of a CRA could in consequence lead to the fact that the CRA lowers its own costs as far as possible to be able to compete on the market. This could happen at the expense of the rating's quality (Bauer, 2009). However, due to the oligopolistic structure on the rating market this problem can probably be neglected up to the point of increasing competition. With reference to Bauer (2009) it is rather possible that due to the circumstance that the rating is not necessarily published without approval of the purchaser, there is an incentive of 'rating shopping'. The purchaser mandates different agencies and in the end, he only publishes the best rating. This can lead to a decline of requirements of agencies, as they want to seal subsequent orders. This phenomenon can be proven by the observation of Bauer (2009) who noted that ratings are slowly and regularly decreasing during the next additional ratings. This can be traced back to the fact that, after the first published rating, the rating will be reviewed annually without a separate mandate. Therefore, it is important for the CRA to get this first published rating. Afterwards, the CRA can correct its rating without any economic damage (Bauer, 2009). Summing up, it has to be stated that the issuer payment model causes a dependency of CRA and issuer and by this, conflicts of interests emerge.

However, there are more factors that can have a negative influence on the rating quality. Due to the fact that CRAs are profit-maximising companies, they have to keep the costs for a rating as low as possible. As the staff is the most expensive element of expenditure in a CRA, it could be an objective of savings. This could in turn lead to a worse quality of ratings if more external information is used instead of own analysis, as well as if follow up-ratings are not made in time and therefore the rating will be no longer up-to-date (Bauer, 2009).

Another negative influence can be seen in the pressure of ratings without mandates. As mentioned above, CRAs are allowed to rate without a mandate and without collaboration of the emitter. These evaluations are often worse due to missing information. The fact that missing information or uncertainties of the CRA are evaluated as risks, thus causes the ratings to be lamed. CRAs can use this to put pressure on emitters to mandate them with a rating in order to receive a better rating (Hiß & Nagel, 2012). A result of this behavior is that mostly smaller companies have worse ratings due to the fact that they cannot afford a solicited rating (Bauer, 2009).

The previously outlined importance of information also leads to another risk for the rating quality. CRAs are dependent on the information they receive from their contractee. However, this information could be deliberately incorrect or incomplete, which leads again to an incorrect rating (Bauer, 2009).

Furthermore CRAs get to know a lot of insider information. This could encourage the incentive to not publish some of the information but to use it for own investment interests. As the big CRAs also started working in further areas of activity (for example the structuring of financial products), this could lead to the temptation to not publish all the information and therefore to use it for own investment decisions or advices (Bauer, 2009). A conflict of interest emerges.

Finally, the dominant market position of the three CRAs and the fact that none of these CRAs completely reveals its rating criteria leads to doubt that there is enough competition on the market to ensure high quality ratings (Bauer, 2009).

Summing up, it can be said that CRAs are very important for the financial markets, in two ways. Firstly, they solve the problem of information asymmetry and the absence of trust between investors and issuers. Furthermore CRAs make it possible to compare different issuers (Hiß & Nagel, 2012). However, there could be also some negative aspects revealed, regarding the method of operation of the CRAs. Those set the quality of ratings at risk.

3.4. Current legal requirements

Against the background of the beforehand identified factors, which can set the rating quality at risk, it will now be of interest to examine the current legal requirements. The aim of this part is to provide an overview of the current regulations on the International and the European level. It will be of special interest whether those regulations imply provisions against the factors that can set the quality of ratings at risk. Furthermore, at the end of this part, the current situation of the legal liability of CRAs will be evaluated.

3.4.1. International regulation

According to Korth (2010), the legal framework for the practice of CRAs is set on the International level by two legal regimes of the International Organization of Securities Commissions (IOSCO). The IOSCO "(…) is open to a securities commission, or a similar government or statutory regulatory body that has primary responsibility for securities regulation in its jurisdiction (OICV-IOSCO, 2012, 2. paragraph)". At present, there are 115 ordinary members (OICV-IOSCO, 2012).

The first legal regime is the "Statement of Principles Regarding the Activities of Credit Rating Agencies". It was published in September 2003 and declared by the IOSCO (2003, p.1) as "a useful tool for securities regulators, ratings agencies and others wishing to improve how CRAs operate and how the opinions CRAs assign are used by market participants." The IOSCO stresses that the principles are not a "one-size-fits-all" approach, as this would not be possible due to the fact that CRAs are acting differently depending on the particular jurisdiction. Due to this reason, the statement rather wants to "(…) state high-level objectives for which ratings agencies, regulators, issuers and other market participants should strive in order to improve investor protection and the fairness, efficiency and transparency of the securities markets and reduce systemic risk" (IOSCO, 2003, p.1). The decision if an implementation in national law should take place and the embodiment of it, rests on the national authorities. The principles for the activities of CRAs affect four aspects: Firstly to name is the "Quality and Integrity of the Rating Process", followed by the "Interdependence and Conflicts of Interests" as well as the "Transparency and

Timeliness of Ratings disclosure" and finally the fourth aspect "Confidential information" (IOSCO, 2003, p. 2- 4). After the publication, the IOSCO was asked by some commenter's, including a number of CRAs, "to develop a more specific and detailed code of conduct giving guidance on how the principles could be implemented in practice" (IOSCO, 2004, p.2). There upon the second legal regime was created. This set of rules, named "Code of Conduct Fundamentals for Credit Rating Agencies" contains 52 prescriptions which are assigned to the four aforementioned aspects. As a principle for the implementation of those, the IOSCO has the principle "comply or explain" (IOSCO, 2004, p.10). This means, that the CRAs should publish their code of conduct and also how they have implemented the prescriptions. In case that a CRA deviates from the prescriptions, it should explain how and why a deviation exists. The three big CRAs reacted on this code of conduct by self-imposed codes of conducts. As a study of the IOSCO could prove, they mainly fulfill the terms of reference. Concluding, it is to mention, that the efforts of the IOSCO have been well received by political institutions, as for example the European Commission (Korth, 2010).

3.4.2. European regulation

After examining the international solution regarding the regulation of CRAs, now the European handling will be considered. CRAs have been a long time without any specific regulation except of the prior described IOSCO Code. However, this code of conduct does not provide any legal binding and the outbreak of the financial crisis in the USA led to a rethinking in Europe, as the CRAs have been seen as jointly responsible for the outbreak of the crisis. Against this background, the regulation (EC) No 1060/2009 on rating agencies has been issued by the European Parliament and the Council. It is therefore the first specific regulation of CRAs within the European Union and direct applicable law within the member states (Veil, 2011). The aim is to achieve that "credit rating activities are conducted in accordance with the principles of integrity, transparency, responsibility and good governance in order to ensure that resulting credit ratings used in the Community are independent, objective and of adequate quality" (EU, 2009, p.1). By this, a high degree of consumer and investor protection is the aim to achieve. The regulation contains, on the one hand, requirements for the release of ratings and constitutes organisational guidelines as well as behavioral codes which shall both foster independency of the CRAs and at the same time avoid conflicts of interest. On the other hand, the regulation aims to increase the quality of ratings. Furthermore, it introduces transparency rules and implements a registration requirement for CRAs (Veil, 2011). According to Article 16, the decision of registration is issued by the competent authority of the Member State in which the CRA is located (EU, 2009). In respect of Article 14, only CRAs with a place of business within the European Union have to request a registration. However, it is also interesting for a CRA outside the European Union to get a registration, as only ratings of registered CRAs are accepted by the regulatory law (Veil, 2011). Therefore, the national authorities keep prove of banks and other institutions listed in Article 1, if they only make use of those ratings published by registered CRAs. The supervision of the CRAs is consistently done by the European Securities and Markets Authority (ESMA). From June 1, 2011 the ESMA is also responsible for the sanctions according to the administrative law and can, for example, withdraw the registration of a CRA. However, a decision of prosecution is due to each member state and a matter of subject to the national authority and not of the ESMA (Veil, 2011).

Next to the regulation, as an important matter of fact, the content-related statutory provisions are certainly of high relevance. Besides others, the regulation approaches the issue of credit ratings in the Articles 6 to 13. According to that, a CRA has to ensure that conflicts of interest are studiously avoided. Furthermore, by requiring a minimum standard due to the methods of operation, the quality of ratings shall be ensured. Additionally, Article 12 states that the CRAs have to publish a transparency report once a year (EU, 2009).

To sum it up, the regulation (EC) No 1060/2009 on rating agencies can be seen as an effort to reduce the factors that can put the quality of ratings at risk. It is responsive to afore recognised problems which can be seen by the incorporation of the problematic, concerning the conflict of interest. Furthermore, the existence of a legal binding is a main advantage towards the code of conduct published by the IOSCO. However, although the regulation demands a transparency report once a year, no CRA publishes the detailed circumstances relevant to the creation of its rating (Bauer, 2009). This also leads to the last aspect that has to be considered in accordance to legal requirements; the liability of CRAs for their ratings. In case that a rating is considered to be false, it is difficult for a court to prove, if the complex procedure of creating a rating was undertaken without any mistakes. According to Bauer (2009) it is only possible to check the origination process on the basis of minimal requirements. Against this background, it can be doubted if the European regulation can really accomplish improvements on the rating market.

3.5. The political influence of rating agencies

CRAs are counted amongst the most important actors of the global financial markets due to their importance regarding the coordination of the global financial flows and their influence on the financing costs of states and companies. Furthermore, they take part in the regulation of the financial markets (Rosenbaum, 2009). Against this background, it can be assumed that CRAs also have political influence. The direct influence of CRAs according to their method of operation has already been discussed before. Now the focus will be on the influence that can be implicitly derived from their work.

The political influence of CRAs can be seen in a variety of ways and is discussed controversy in literature. The aspects of the discussion, that seem to be most important, in accordance to the EDC, shall now be examined.

Rosenbaum (2009) identified Timothy Sinclair as one of the first political scientists who systematically grappled with the political role of CRAs. According to Sinclair, Rosenbaum (2009) states that CRAs influence, in which way, private investors observe and define credit risks. Therefore, governments would be set under pressure to adapt their politics according to these criteria. In terms of this, CRAs would not be a neutral institution with the aim to improve the asymmetries of information, but rather private actors who gain power on the international financial markets by setting standards. Neither companies, nor states could strip from these standards (Sinclair, 2005). Sinclair (2000, p.490) views CRAs as „Embedded Knowledge Networks (EKN)" which set a benchmark. Subsequently, other market players would adjust their affairs to this benchmark. Especially those countries, that have a different organisation of society than the USA, would be punished with a worse rating, as the rating criteria are dominated by US-American perceptions. As a consequence, this would lead to a convergence to the Anglo-American perception of economy (Sinclair, 2000). However, this argumentation can be constrained or even neglected, taking in consideration that governments would not pursue a special kind of politics only because of the criteria of CRAs, but also consider their chance of reelection. Politicians always have to justify their political behaviour in front of their voters. Furthermore, there is no empirical evidence that the criteria of ratings lead to a convergence of the market-based economic order to an Anglo-American perception of markets (Rosenbaum, 2009). According to Rosenbaum (2009) it is rather like this; CRAs have a political influence by affecting the circumstances for the acting of voters, governments, investors and companies. What Rosenbaum (2009) understands by this, is that the ratings can influence the economic growth and distribution but not the policy itself. However, although the CRAs would not directly influence the behaviour of politicians, they can influence the economical prosperity, especially in times of crisis. As ratings are also used for regulation, the protection of investors depends on the quality of ratings. Therefore, the rating influences the financial situation of private and institutional investors (Rosenbaum, 2009). Against this background, the importance of a high quality of ratings becomes evident. Though, as it could be seen in former crisis, ratings do not absolutely guarantee a protection of investors, as they do not guarantee macroeconomic stability. Consequently it becomes evident, that it is a risk to give regulatory tasks to CRAs, as this can jeopardize the tangibles of the population (Rosenbaum, 2009). Nevertheless, we have seen in the EDC that this phenomenon is not only limited to the population but also can affect an entire state. Finally, it has to be ascertained that besides the above discussed influence on policies, the current crisis identified, that CRAs can put politicians under pressure by downgrading states. Thereby they indirectly cause a necessity of political reaction but without influencing the exactly kind of reaction.

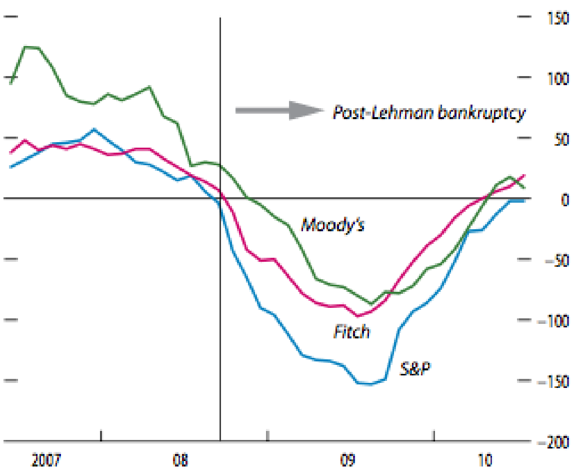
Concluding the first part of the analysis, I would like to refer to Rosenbaum (2009) who stated, that there is no theoretical framework that does justice to the complex position of CRAs on the financial market on the one hand and at the same time gives a profound and accurate description of the stress ratio between the CRAs and governments on the other hand. This underlines how complex this problematic is. It can be expressed that CRAs do not only have an economical but also a political relevance. However, this political dimension is complex and partly contradictory. Nevertheless, it became evident that CRAs have an impact on the financing costs of a state and by this on the framework of action of politicians.

4. The reaction of rating agencies in the European debt crisis

The aim of the second part of the analysis is to present what happened during the EDC which started in 2009 and is present to this day. The focus will be on the development of ratings and in relationship to this the trend of yields of government bonds. Hereby the attention will be directed to the ratings and government bonds of Greece, as Greece can be seen as the starting point of the EDC. Furthermore, up to the present, Greece appears to be the state with the most serious financial problems. The degradation of sovereign ratings raises concerns about the creditworthiness of the affected states. Furthermore, due to the involvement of external ratings in regulations and private contracts, it exists immense concern that rating downgrades can destabilize the financial markets (IMF, 2010). According to the IMF (2010, p.102) “overall, the sovereign rating environment began deteriorating significantly in the spring 2008, with a strong downward trend evident starting in September 2008".

However, this statement is referred to worldwide changes of sovereign ratings as it can be seen in Figure 2. The beginning of the reactions of the CRAs towards European states started with the downgrade of Greece by S&P on January 14, 2009 (Table 3). This action was followed by several outlook changes of the three big rating agencies. Yet, at first there was only the aforementioned downgrade by S&P. It adjusted the rating from 'A' to 'A-' in January 2009. Furthermore, it can be seen in Table 3 that the starting point of a range of downgrades of Greece was in the beginning of December 2009.

Figure 2: Sovereign rating changes and warnings (IMF, 2010, p.102)



Sources: IMF staff calculations using data from Fitch; Moody's; and Standard & Poor's.

Note: This figure shows rolling 12-month cumulative sums of all sovereign foreign currency rating actions across all sovereign ratings by each credit rating agency. For example, each positive (negative) rating outlook is +1 (–1); a review for upgrade (downgrade) is +2 (–2); and a positive (negative) rating change is +3 (–3).

Table 3: Chronology of Greek Sovereign Rating Actions, January 2009 - August 2010 (cf. IMF, 2010, p.107)

Date	Agency	Action
January 9, 2009	S&P	Outlook changed from stable to watch negative
January 14, 2009	S&P	Downgraded one notch to A-; outlook stable
Februrary 25, 2009	Moody's	Outlook changed from positive to stable
May 12, 2009	Fitch	Outlook changed from stable to negative
October 22, 2009	Fitch	Downgraded one notch to A-; outlook remains negative
October 29, 2009	Moody's	Outlook changed from stable to review for downgrade
December 7, 2009	S&P	Outlook changed to watch negative
December 8, 2009	Fitch	Downgraded one notch to BBB+; outlook remains negative
December 16, 2009	S&P	Downgraded one notch to BBB+; remains on watch negative
December 22, 2009	Moody's	Downgraded one notch to A2; outlook negative
March 16, 2010	S&P	Outlook changed from watch negative to negative outlook
April 9, 2010	Fitch	Downgraded two notches to BBB-; outlook remains negative
April 22, 2010	Moody's	Downgraded one notch to A3; on review for downgrade
April 27, 2010	S&P	Downgraded three notches to BB+; outlook remains negative
June 14, 2010	Moody's	Downgraded four notches to Ba1; outlook stable

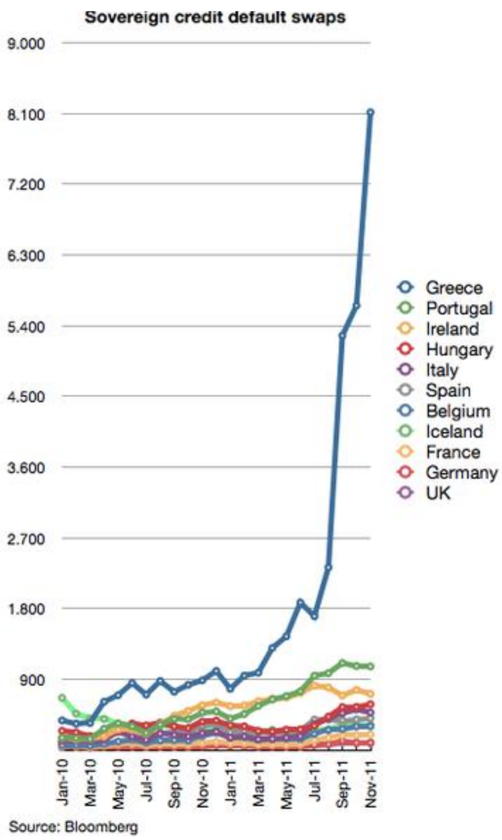
Sources: Fitch; Moody's and Standard & Poor's.

During this time, concurrently the yield of Greece's government bonds increased enormously. As it can be seen in Figure 3, the yield of Greece's 2 years government bonds increased at the end of 2009 from less than 2 % up to 4% at the beginning of 2010 and finally increased dramatically up to more than 17% until the end of 2010. This leads to the assumption that the ratings have influence on the performance of government bonds and by thus on the financing costs of states.

Figure 3: Yield of Greece's 2 Year government bonds (FAZ, 2010)

However, it seems remarkable that during the year 2009 the yield of Greece's 2 year bonds was stable at 2% even with a trend of declining yields (Figure 3). This should be called into question against the background of outlook changes of the CRAs which have already taken place during the year 2009. It indicates that the markets first reaction occurred once Fitch downgraded Greece to A- in October 2009 (Table 3 and Figure 3).

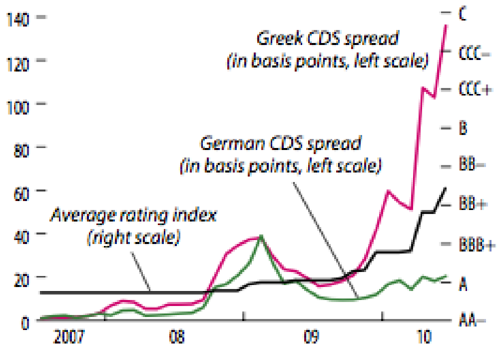
Figure 4: Sovereign credit default swaps (Bloomberg, 2011)



Once the trend of downgrading Greece has started, the loss of confidence into Greece continued until the end 2011. This can be proven by Figure 4, which demonstrates the development of sovereign Credit Default swaps (CDS). "The CDS spreads measure the market price of creditworthiness and, as expected higher spreads are associated with lower ratings (IMF, 2010, p.106)." In the case of Greece's government bonds, the CDS can be seen as an insurance against the risk that Greece will not be able to pay back the nominal amount of the bond at the end of its time to run.

Figure 5 illustrates that "(…) CDS spreads on Greece began to diverge from the general market trend in the summer of 2009 (IMF, 2010, p.106)." This leads to the assumption that the issuers of CDS reacted a bit earlier in comparison to the investors whose reaction became plainly visible only at the end of 2009.

Figure 5: Credit Default Swaps (CDS) and Average Rating (IMF, 2010, p.106)



Sources: Bloomberg L.P.; and IMF staff estimates.
Note: The average rating shown on the right-hand side reflects the average of three rating agency (Fitch, Moody's, and S&P) levels (shown are Fitch and S&P symbols; see Table 3.1 for corresponding Moody's symbols). In addition, in order to capture more fully the information content of the outlook, the rating level is also adjusted by −0.3 (+0.3) for a negative (positive) outlook or negative (positive) watch.

It can be assumed that the issuers of CDS have reacted to the changes of outlook which have been carried out by the CRAs. Therefore, it is questionable if the investors maybe neglected the first signs of a possible negative development of Greece. However, besides a possible wrongdoing of the investors, it has to be critically looked at the numerous negative changes of outlooks and ratings of the CRAs regarding Greece. Although it is difficult to define "rating failure", the IMF created a definition that seems applicable to the situation during the EDC: "(…) a failed rating is defined as one that is lowered or raised by three or more notches within 12 months, excluding downgrades or upgrades into, out of, within, or between the categories from 'CCC' or 'Cca' downward (Bhatia, 2002)." Against the background of this definition, Table 3 presents that S&P, Moody's and Fitch have to admit that their sovereign ratings of Greece have been failures.

Concluding, it has to be stated that the performance of the three CRAs within the EDC regarding Greece was unsatisfactory. It could be demonstrated that all of them were incorrect with their ratings. At the same time, the investors' neglection of outlook changes gives rise to the question if the investors have a share on the decline of Greece's ratings and in turn on the problem of refinancing for Greece due to increasing interest rates on government bonds. This could be reasoned by the following argumentation: A degradation of Greece's ratings means that the creditworthiness of Greece has decreased and the risk of investing into Greece's government bonds has increased. Therefore, many investors sell their bonds. This is in turn a negative signal for the markets, and a decline of the prices of the bonds is the most likely consequence. Logically, from this point on, Greece has to pay higher interests to find investors for its bonds. However, at the same time the declining market prices for bonds and increasing interest rates could be a signal for the CRAs to downgrade again if they expect that due to the loss of faith of investors the financial situation of Greece will become even worse.

After all, it has to be stated that the behavior of the CRAs during the financial crisis offered occasion for several critics, but nevertheless at the same time, the complex structure of the financial market and the consequential impacts must not be neglected. In addition to the problems derived from the first part of the analysis, this part has revealed new problems regarding the behavior of rating agencies and the ratings themselves. The next part of the analysis will try to find solutions to this difficult problem area.

5. Possibilities for change

After having examined the organisation of the rating market as well as the proceedings related to the CRAs within the EDC, the third and last part of the analysis will focus on possibilities for change in order to solve the previously revealed problems. The aim is to present different options that are discussed in the public, by politicians, actors on the financial market or researchers. The different proposals will be evaluated against the background of the findings of the previous analysis and simultaneously the merits and demerits of the single proposals will be considered.

5.1. European Rating Agency

The Europeans have heavily criticized the three US-American CRAs for their behavior in the financial crisis and therefore plans arose to create an individual European Rating Agency (ERA) (Dohms & Clausen, 2012). However, it should not be surprising that the call for an ERA intensified and gained relevance especially after the three big CRAs had steadily graded down the government bonds of Greece, and later on also those of other South European states. It seems that it was easy to make the CRAs the scapegoat for the financial problems in the European Monetary Union (Financial Times Deutschland, 2012). Besides the aspect that the market of credit rating should become more competitive, there are mainly two vast aims that stimulate the demand for an establishment of an ERA. On the one hand, it is discussed that the purpose of private CRAs to make profit has to be abolished. On the other hand it is argued, that the work of the three big CRAs is geared to the US Financial markets and its regulations. Therefore, they would pay insufficient attention to the particularities of the European way to finance enterprises and states (Theurl & Schätzle, 2011).

As a consequence of the different perceptions concerning the problems an ERA should remedy, there are various proposals concerning the organisation of an ERA. Especially the financing of such a CRA is the focus of the discussions. Firstly, the possibility of an ERA that is financed or partly financed by the member states of the European Monetary Union will be discussed. Afterwards, the suggestions of an ERA, which does not receive governmental money, will be presented.

The postulation of an ERA that is state-funded originates from the purpose to solve the problem of conflicts of interests. It is an established fact that private CRAs are bottom-line oriented and therefore they are dependent on their contractee. In contrast to this, a publicly funded CRA would not be dependent on its contractee due to financial matters. But how could such a CRA be put into practice? One idea is to associate the ERA with the European Central Bank (ECB) as it already has a department for the analysis of credit risks. In the eyes of the proponents of this suggestion the advantage of this solution is the supposed high reputation and independency of the ECB. These qualities could lead to lower entrance barriers to the rating market (Theurl & Schätzle, 2011). In this context, Beck and Wienert (2010, p.467) ascertain that an ERA "(…) should rate independent and without conflicts of interest, work non- profit-oriented and the ECB and the national central banks should be included in its work". However, it can be discussed controversial if the postulation of Beck and Wienert is realistically realizable. It is questionable, if this kind of ERA, in case that it could be successfully established on the market, would solve the problem of dependency and conflicts of interests. However, the question of the establishment on the market seems to be the first obstacle. A CRA, which is specialised on the European market and does not work on the significant American markets would probably not be accepted by international market participants and European market participants that are looking for international investors. Indeed, the creation of a law which places the investors under obligation to use the new ERA could be a necessary solution. The new law could, for example, determine that only investments rated by the new ERA are allowed to fulfill regulatory capital requirements. Furthermore, it is questionable if an ERA could provide qualitative better ratings owing to the missing cash incentive to offer good results (Beck & Wienert, 2010). However, from another point of view, it could be possible that this missing financial incentive even makes the quality of ratings worse. The incentive of a financial reward could be motivating for the employees and by this in turn increase the quality of ratings. Related to this, it is dubious how the new CRA can acquire highly qualified analysts which are indispensable in order to make profound ratings available. The ERA would compete with the private CRAs for the best analysts and possible salary differentials could be indicative that the analysts would prefer to work for the private CRAs and not for a non-profit CRA. In turn, it would be hard to acquire a good reputation without good personnel (Theurl & Schätzle, 2011). Besides this, there is another potential problem of gaining good reputation. In the first instance, the connection of the ERA with the ECB was denoted as good for the reputation of the CRA. However, the reputation of the ECB has been lately reduced as a consequence of buying Greece's government bonds. In case that the ECB would participate in the ERA, a further loss of political independency was the consequence and therefore it was presumably that the markets again loose trust in the ECB (Beck & Wienert, 2010). In that case, a connection of the ERA and the ECB would neither help the ERA nor the ECB. Furthermore, the conflict of interest would devolve from the private CRA upon the states. Especially sovereign ratings towards the European member states would probably be seen with skepticism by the markets. Finally, a last point of criticism on the plans of an ERA financed by the public, the political dimension will be mentioned. In case that the ERA has been incorrect with a rating, the investors could argue that a state has attracted them to invest into a bad investment. In the worst case, the investor could claim for remuneration (Beck & Wienert, 2010).

Summing up, it can be identified, that the idea of an ERA that is financed by public money seems to be a good proposal at first glance. The possibility to overcome the high entry barriers on the oligopolistic rating market, due to the reputation of the ECB, seems attractive. Furthermore, the elimination of the conflict of interest of private CRAs seems to be an advantage. However, after having a closer look at this proposal, it must be recognized that at the same time that simultaneously problems will be solved and new ones will emerge. Due to this reason, a public-funded ERA does not seem to be a useful tool to overcome the problems on the financial markets related to the rating system.

In contrast to the first proposal, the second one refuses a financing by states as this would facilitate the aforementioned political influence and by this, new conflicts of interests. Therefore, the second idea of an ERA implies a governmental independent foundation, which should finance the ERA (Theurl & Schätzle, 2011). An example for this proposal is the effort of the German consultant company "Roland Berger" which expressed interest in June 2011 to develop and establish such a foundation as an answer to the call for an ERA by the European Parliament (Pascu & Stan, 2012). The aim was to find about 30 investors who would pay each 10 Million Euro for the establishment of the foundation. Roland Berger planned that after five to seven years, the new created ERA should be established on the market and therefore the investors could be paid back from the cash-flow. The business model by Roland Berger would have changed the rating market as the model of payment should change from issuer payment to investor payment. By this the often mentioned conflict of interest should be circumvented (Süddeutsche Zeitung, 2012). Whereas the conflict of interests between the CRA and the emitter can be eradicated with this concept, again a new conflict of interest comes up. This time the conflict of interests refers to the relationship of the CRA and the investor. Due to the fact that investors are interested in conservative ratings, as they prefer long-dated and stabilized ratings with few downgrades, it develops the risk of ratings that are too low and less frequent downgrading of ratings. The investor's interest can be reasoned by the fact that downgrading of their investments goes along with depreciations. Hence, it is questionable to what extent an ERA based on a foundation but with ratings that are paid by investors can improve the rating quality regarding the problems with conflicts of interests (Theurl & Schätzle, 2011). Furthermore, again the question regarding the acquisition of good analysts arises and also remains unanswered. Especially the creation of reasonable sovereign ratings needs a lot of personnel (Süddeutsche Zeitung, 2012). However, at present the plan of Roland Berger has more or less failed due to few investors who are up to investing money to establish the foundation. Consequently, the possibility to create the ERA vanishes, due to insufficient funds. Nevertheless, Roland Berger does not want to completely distort the project to establish an ERA. Instead the company will further work on this idea with little money of a small group of investors (Zeit, 2012a). Besides strong and weak points, as well as possible improvements and new problems at the same time, the interpretive executions of this proposal shall close up with one big question that dominates the whole debate concerning Roland Berger's idea: Why should investors pay for something that was for free up to now (Schröder, 2011)?

Finally, after having examined two different proposals regarding the conceptualisation of an ERA, it becomes clear that both have several strong points which are likely to solve problems of the "old" rating system. However, at the same time both proposals implicate certain weak points which would in turn cause new problems for the rating system. Therefore, none of the two solutions seems to be the solution to the current problems.

5.2. International Non-Profit Credit Rating Agency

"In light of the intense criticism leveled against credit rating agencies for their perceived failure to analyze adequately sovereign creditworthiness, the Bertelsmann

Foundation has developed a blueprint for an international non-profit credit rating agency (INCRA), whose rating criteria are designed to increase credibility and international acceptance (Bertelsmann Stiftung, 2012a.)” In contrast to the idea of an ERA, this proposal provides an international solution. Moreover INCRA should work not-for-profit and only concentrate on sovereign ratings. The principal aim of this model is to combine the interests of the investors with those of the public (Bertelsmann Stiftung, 2012c). This signifies to the Bertelsmann Stiftung (2012c) to combine ratings of high-quality that are transparent due to the rating criteria at the same time. However, the Bertelsmann Stiftung (2012c) sees itself as a think tank to offer a serious and operative concept but not as the financer of this project. From their point of view it is now the task of states, enterprises and non-governmental organisations to discuss the proposal and to define a group of those, who want to put the plan into practice (Bertelsmann Stiftung, 2012c). The members of this group should pay money into a fund, which would than finance the INCRA. The funds would need approximately 306 Million Euro in order to have payouts that are high enough to defray the running costs (Zeit, 2012b). Nevertheless, in April 2012 the German government stressed that it refuses government funds for new rating agencies, as the markets would see this as political influence (Zeit, 2012b). As an answer to the critics, regarding possible conflicts of interest, the Bertelsmann Stiftung (2012a) stresses that the structure of governance, as well as the operating procedures, will provide transparency and legitimacy. The interdependency should be provided by a supranational “Stakeholder Council” that serves as “(…) a buffer between funders and the operational business” (Bertelsmann Stiftung, 2012a, p.1). Furthermore, a quality control body shall be established to ensure that the methodology by which the ratings are created are competent and comprehensive. The fact that INCRA would work non-profit-oriented should also benefit its accountability and at the same time reduce potential risks of interests (Bertelsmann Stiftung, 2012a).

Finally, it can be seen that also this proposal has some strong as well as weak points. The international operation as well as the focus on sovereign ratings could facilitate the establishment of the INCRA on the rating market. Especially the concentration on a niche, as in this case sovereign ratings, could offer the chance to establish a new CRA on the rating market (Paudyn, 2011). However, there are also some weak points regarding this proposal. Again, it is questionable how this new CRA could acquire good analysts and if the non-profit-model lacks on incentives for delivering qualitative good work.

5.3. European Rating Fund

The third proposal, which combines aspects regarding the idea of an ERA and the foundation of an INCRA, will be examined in the following. It is attributed to Hanno Beck and Helmut Wienert who are two professors of the University of Pforzheim. Their idea is to create a European Rating Funds (ERF) in order solve the problem regarding conflicts of interests. This should work out by using the ERF as a blind pool. This means that the rating orders are given to the fund and the CRA with the cheapest offer receives the award of contract but the contractual partners do not get in contact and therefore do not know each other. Due to this reason, the risk of ratings by courtesy should be reduced to a minimum (Beck & Wienert, 2010).

The payment of the rating is made by the money of the fund which was previously deposited by those who commission a rating. However, it would be also reasonable, as Beck and Wienert (2010) notice, that also the investors will be included in the financing of the ratings as they also benefit from ratings with high quality. They suggest different possibilities which range from a legal obligation of payments for investors to a duty for special purposes that all participants involved in this business would have to pay. However, eventually it would be of interest for the investors to participate in the financing of the fund even without any obligation of payments, in order to gain influence on the quality requirements of CRAs as the criteria are determined by representatives of those, who finance the fund. All CRAs who fulfill these criteria can be accredited by the fund and afterwards they are allowed to apply for contracts. This would reduce the entry barriers of the market and at the same time open the market for smaller and yet unknown CRAs as the fund assumes the reputation. Furthermore, the rating quality could be improved due to the quality criteria of the fund and regularly reviews of the CRAs. In case of insufficient performances the fund could temporarily exclude CRA from the bidding process (Beck & Wienert, 2010).

It seems as if this proposal is one that can manage to eliminate the conflict of interest and avoid the problem of rating shopping as the emitter does not know who created its rating. For a moment the concept of a blind pool seems to be a great idea due to the fact that it seems to solve those problems that the concepts of an ERA and an INCRA could not solve. However, the blind pool leads to new questions concerning feasibility. If the emitter does not know and shall not now the CRA, how should the CRA attain information that go beyond those that are publicly available? Personal communication and a presentation of confidential information seem to be not realizable. Furthermore, it is questionable if the emitter would commit paper-based confidential information to employees of the fund as intermediary. Beside these problems of practicability, there are some other problems regarding the acceptance of the market participants.

The implementation of an ERF would probably not be easy due to an elementary change of the rating market's structure (Beck & Wienert, 2010). Why should the emitters, investors as well as CRAs participate in the concept? This would probably require extensive legal regulations.

Summing up, it can be stated that this proposal found a solution to one of the main problems but at the same time the practicability of the ideas has to be challenged. However, in case that all those who are affected are willing to collaborate, the proposition of an ERF could be a good basis for further discussions.

5.4. Regulatory aspect

After having examined some proposals regarding the creation of new institutions in order to solve the problems on the rating market, this part will consider some ideas to improve the rating market which are based on new regulations. Therefore these proposals do not offer a new concept as a whole but focus on specific problems that arised during the crisis.

5.4.1. Method of payment

One of the main points of criticism is the payment of ratings by the credit users as it would enhance conflicts of interests and as a consequence lower the quality of ratings. This problematic was already examined in different contexts before and shall therefore not be explained in detail again but the general problems of returning to the old model of investor payment will be revealed. In reference to Theurl and Schätzle (2011) a rating is after its publication a public good. Therefore the new remuneration model would evoke the free-rider problematic which was already the reason to change to an issuer payment model in earlier times. However, even if it would be possible to limit the access to specific users, this would diminish the information function of the rating (Theurl & Schätzle, 2011). Nevertheless, this should not be in the interest of a credit user, as a widely spread rating increases the number of possibly investors. To express it differently, if the rating accessibility is reduced, it will be more difficult for issuers to find investors.

Furthermore the investor pay model would lead to a new conflict of interest. As this new conflict was already described before, it will not be elaborated on it at this point again. However, a third conflict of interest could arise: Rating agents would be brought closer to the profession of investment advisors if they are paid by the investors. This has to be seen critically, as the original task of the analysts is to create good ratings but not to give advice on investments. The problematic is figuratively underlined by the EU's Market Financial Instruments Directive (2004/39). According to MiFID firewalls have to be constructed between analysts and sales departments of banks (Lannoo, 2010).

5.4.2. Intensification of competition

A further proposal is to increase the competition on the rating market as some blame the oligopolistic structure for the poor quality of ratings within the EDC. According to Theurl and Schätzle (2011) this is one of the reasons why an increase of competition is postulated. However, there was a wide range of CRAs who tried to enter the rating market but have not been able to capture a market share. This can be lead back to the special characteristic of the rating market which differentiates it from other markets. As the quality of a rating is only ex-post evaluable, it is a good that will only be used if it seems reliable to the user. That is one of the reasons that makes it difficult for new CRA to enter the market as they do not have the reputation which the other CRAs obtained over decades. Furthermore, assessments are based on long-term experiences and are continuously improved by those. However, new CRAs do not have these experiences and a successful market entrance therefore depends on the acquisition of good analysts. Certainly, this could be a challenging task. Additionally, the acceptance obligation of CRAs for regulatory purposes is another obstacle for new CRAs (Theurl & Schätzle, 2011).

Against the background of these characteristics it is questionable if any measures to intensify the competition can indeed accomplish their purpose (Theurl & Schätzle, 2011).

But would a more competitive market really improve the rating quality? In case of more CRAs on the market, the danger of 'rating shopping' could rise and by this the quality of ratings would even be lowered. As a consequence this could even lead to a race to the bottom due to the fact that the CRAs give better ratings to get the contract (Theurl & Schätzle, 2011).

Against the background of this problematic and the aforementioned specifics of the rating market, it does not appear to be a promising solution to solve the problems of the rating market.

5.4.3. Liability of rating agencies

Another regulatory proposal is to introduce a liability for CRAs. The European parliament suggests a severe liability according to civil law (FAZ, 20.6.2012). The aim of this demand is to impose sanctions on CRAs for failing behavior which is mostly revealed in ratings of poor quality. Against the background that "any error in the credit rating process has an immediate and significant impact on buyers and sellers of credit" and that this "(…) also impacts the overall performance of the financial markets", a liability should help to improve the rating quality (Ryan, 2012, p. 5).

However, the CRAs stress that their ratings are merely an estimation of the prospective ability to pay of the credit user. Out of this reason, the liability of ratings is up to the present limited to an obvious misuse regarding the creation of the rating. In addition it is questionable in how far at all European law is applicable to the US-American CRAs (Theurl & Schätzle, 2011).

Besides these juristic problems, there would be the risk of recourse to CRAs even without any misconduct. This could in turn lead to a limitation of rating but without raising the quality of those due to the fact that they are still estimations. A limitation of ratings, especially those of smaller emissions, which are more risky, would foster the asymmetry of information and by this lead to higher borrowing costs (Theurl & Schätzle, 2011).

Summing up, it can be stated that a liability for CRAs is a good idea at first glance. To make the CRAs accountable for their actions does not seem to be more than fair. Though, having a closer look at the consequences of this proposal the negative effects seem to prevail and therefore also this idea does not seem a reasonable solution to solve the problems of the rating market.

5.4.4. Regulation of financial markets

The last regulatory revision that shall be examined refers to the regulation of financial markets on the basis of ratings. In case that the investment grade of an investment is lost, this can cause a heavy selling. However, this phenomenon does not have to be based on the fact of a downgrading itself but on the change of investment grade to non-investment grade. This can be reasoned by the fact that the investment grade is in many cases an investment requirement to fulfill legal obligations. Therefore, as a logical consequence, the investor has to sell those investments that have no investment grade any more. Furthermore, these legal obligations can lead to a neglection of an individual analysis and thus to an excessive consideration of external ratings. However, as already depicted before, external ratings shall only help to make an investment decision but not replace the individual responsibility of investors (Theurl & Schätzle, 2011). Due to this reason, the European Parliament calls for an easing of the importance of ratings. This shall be reached by a change of legislation. Investors should not be obligated anymore to automatically use these ratings in order to be able to fulfill legal requirements (FAZ, 2012).

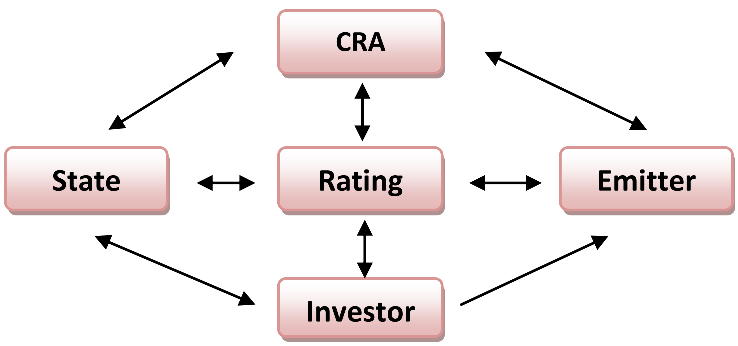
Summing up, this proposal can be assessed as a step in the right direction. The change of legal obligations which separates the dependency of the regulation of financial markets from ratings could lead to several positive effects at the same time. On the one hand, the self-accountability of the investors would be promoted which could lead to a better consideration of investments. On the other hand, the automatically market mechanisms can be avoided which leads to a worsening on the markets.

6. Conclusion

Although the European media coverage seems to be in agreement to blame the CRAs for misbehavior, this thesis demonstrated that it is necessary and important to consider these reproaches more sophisticated.

On the one hand, it is not deniable that CRAs have influence on the interest rates of emissions and by this on the financing possibilities of states or other emitters, as could be illustrated by examining the situation of Greece in the EDB. On the other hand it could be identified, that the organisation of the rating market itself reveals weaknesses which can lead to undesired results on the financial markets. Aside from that, it was demonstrated that legal obligations can cause a self-fulfilling prophecy, which finally leads to an endless spiral of decreasing ratings and rising interest rates. Finally, the examination of different proposals regarding the improvement of the rating market has identified how difficult it is to implement improvements, which finally lead to ratings of a better quality. This is attributed to the very complex structure of the rating market (see fig.5).

Figure 6: Complexity of the rating market (own version)



All actors on the rating market are interrelated, except of the emitter and investor. In this relationship only the investor has influence on the emitter but not the other way around.

The emitter needs the rating to exert influence on the investor. This underlines the importance of ratings. At the same time it becomes obvious how difficult it is to find solutions in order to improve the rating market. A change, which seems to be good at first, can cause new problems at another point. This complexity is also the main point to mention when assessing this study critically. The possibilities regarding this bachelor thesis have been limited to time and resources. Against the background of this complex of themes, it would be interesting to focus more intensively on the individual actors. Furthermore, a more detailed analysis of the cause – effect-relationship of ratings and yields would be interesting and necessary to draw one's conclusion from it. However, whilst the latest ratings are published in the news, only professional investors have comprehensive access to the history of ratings and compilation of those developments interesting to analyse. Finally, the consultation of specialists could have provided a valuable insight into the perception of those.

In conclusion, with respect to the initial research question, one can say that the special characteristics of the rating market have a big say in the method of operation of CRAs and by this on the behaviour of CRAs in the financial crisis. At the same time it is difficult to find possibilities to improve this organisation of the rating market. Therefore the focus of the current discussion should rather be on the function that ratings can fulfill in reality. It has to be stressed that ratings can only be one element of an investment decision but cannot replace an own analysis, as ratings are only a projection without any warranty that issues occur as predicted.

After all, this bachelor thesis has revealed that CRAs play an important role in the EDC, which can be partly traced back for one part to the development of CRAs, for another part to legal obligations of investors. The possibilities for change have all strong and weak points but an acceptable solution for all those affected could not be found yet.

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Name, Vorname: Düker, Stephanie

Matrikelnummer: 363660 / s1245503

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