THE PRESIDENT
OF THE
GENERAL ASSEMBLY

New York, 28 June 2013

Excellency,

I have the pleasure to inform you that I will convene a thematic debate entitled "**The Role of Credit Rating Agencies in the International Financial System**", pursuant to General Assembly resolution 67/437. This event will be held at United Nations Headquarters in New York on Tuesday, September 10th, 2013.

Credit Rating Agencies (CRAs) aim to provide information on the creditworthiness of borrowers, serving as an intermediary between them and lenders. By reducing the information asymmetry between borrowers and lenders, CRAs lower the cost of finance and support economic activity.

Since the outbreak of the international economic crisis, a number of concerns have been raised about the work of CRAs.

This thematic debate will provide an opportunity to discuss the challenges connected with the current working methods of CRAs, such as the issue of transparency, liability, and objectivity; market concentration; and conflicts of interest. Member States will have occasion to be informed about the latest reform measures already undertaken, as well as engage with leading international experts, academics, representatives from CRAs and relevant financial institutions on additional measures which may be necessary to implement in order to establish a more objective and reliable rating system.

This one-day debate will start with an opening session, keynote addresses and remarks by special speakers, followed by two interactive panel discussions featuring distinguished public and private sector stakeholders. I am pleased to share with you the attached concept paper. A draft program will be sent to you in due course.

I extend an invitation to Member States to be represented at the highest possible level.

Updated information will be available on the website of the President of the General Assembly.

For any questions, please contact Ms. Jutta Edthofer, Adviser, at +1-917-623-3647 or edthofer@un.org.

Please accept, Excellency, the assurances of my highest consideration.

Vuk Jeremić

All Permanent Representatives and
Permanent Observers to the United Nations
New York

THEMATIC DEBATE

67TH SESSION OF THE UN GENERAL ASSEMBLY

"The Role of Credit Rating Agencies in the International Financial System"

10 September 2013

New York

- CONCEPT NOTE -

The General Assembly resolution on External Debt Sustainability and Development (GA/RES/67/437) adopted on 13 December 2012 "...*invites the President of the 67th General Assembly to convene a thematic debate on the role of credit rating agencies in the international financial system*....."

1. Background

The UN's Secretary-General most recent report (A/67/174) to touch on the issue of this thematic debate states that "the main objective of credit ratings agencies (CRAs) is to reduce informational asymmetries between lenders and borrowers by determining the ability and willingness of potential borrowers to meet their debt servicing obligations." CRAs aim to provide accurate and unbiased information on the creditworthiness of borrowers, thereby reducing the total cost of many agents separately collecting the same information. Their ratings support intermediation

between borrowers and lenders across the world which lowers the cost of finance and supports economic activity. CRAs have particular importance because their ratings are embedded or "hard-wired" into investment mandates, global banking regulations and securities rules and regulations. While recognizing that CRAs perform an important role in reducing transaction costs, there are concerns about whether they inadvertently have an adverse impact on financial stability.

The impact of CRAs on financial stability has long been contested, especially after the Asia financial crisis in 1997-1999. The global financial crisis has revealed a number of concerns relating to the objectivity and application of ratings, which may have added to the crisis. The awarding of top investment grade for some new structured products and their subsequent rapid downgrade at the outset of the crisis renewed the debate on the accuracy and objectivity of CRAs assessments. The rapid switch from high sovereign bond ratings to below investment grade for some European countries is also assumed to have added to market instability. In addition, the influence of CRAs guidance may limit government policy options in significant ways.

The CRAs stress that their ratings are ordinal (i.e. a ranking of the relative credit worthiness of securities versus other securities) which may not necessarily map into objective measures of credit risk or eventual loss. Moreover, their ratings methodologies have a subjective element in addition to relying on observable and therefore quantifiable data. They also aim to rate "through the cycle" which implies ratings may change less over time than other performance measures.

2. Issues to be Addressed

A. *Conflicts of Interest*

The remuneration of CRAs changed from investors subscribing to ratings services in the pre-1970s to borrowers choosing which agency to assess its securities and paying the fee ("issuer-pays"). It follows that borrowers have an incentive to choose the CRA which offers the most favorable ratings to lower their borrowing costs, which may lead to a conflict of interests and an upward bias in credit ratings. This has been particularly important in the development of large structured finance markets at the center of the global financial crisis. CRAs fees depend on the

size and complexity of the securities they are rating. The rapid rise in the volume of transactions may have influenced ratings to gain market share. The major agencies also provide ancillary consultancy services to issuers including advice on financial structures. In past years there have also been concerns that, on occasions, board members of CRAs have held positions in companies which issue securities they rate.

Concerns about potential conflicts have been expressed by the official sector, for example the U.S. Securities and Exchange Commission (SEC). Agencies recognize these concerns and claim to have adopted internal procedures which minimize inappropriate incentives.

B. Competition

While there are at least 74 CRAs worldwide, the three largestagencies (Standard & Poor's, Moody's and Fitch) have a global market share of revenues in excess of 90%.[1]The large CRAs earned a steady but unspectacular stream of profits until the end of the 20th century when the size and volatility of profits increased significantly. The degree of market concentration of the three largest agencies may be due to the economies of scale inherent in the provision of information. Gathering and analyzing information has a high fixed cost, but distributing that information has low marginal cost, making CRAs cost structure similar to other network industries.

Such a high degree of market concentration is also capable of adding to instability and even supporting anti-competitive market behaviors. The importance of reputation and perceived influence acquired over many decades may be another barrier to entry for new agencies challenging incumbents. The issuer-pays model may lead to a "lock-in effect" whereby issuers are reluctant to switch ratings agencies, as it might cause investors to suspect that borrowers are trying to avoid a downgrade. This lock-in effect is at its strongest when issuers consider changing to new market entrants with a shorter track record, which may also act as a barrier to entry. The degree of concentration can also lead to an overreliance on only a small number of rating

[1]Caouette, Altman, Narayanan, Nimmo (2008), *Managing Credit Risk: The Great Challenge for the Global Financial Markets*, 2nd Edition, Wiley report thatthe big three CRAs have 94% of the market shareby revenues.

assessments, which may further amplify the so-called "cliff effects".[2] This overreliance is further heightened in the case of the 17 developing or emerging sovereigns that are rated by only one of the major CRAs.[3] These sovereigns might be particularly vulnerable to the practice of "notching", or the threat of rating agencies who have not been hired by an issuer to reduce the credit rating by a notch relative to the competitor that was hired.

C. Liability

The lack of civil liability for malfeasance is another distinguishing feature of the credit ratings industry. CRAs are careful to style themselves as "publishers" offering only "opinions" so that they may avail themselves of freedom of speech protection.[4] This lack of civil liability may support a wide variety of potential biases and incentive problems. By contrast, auditors who examine and certify company finances accept civil liability in most jurisdictions. For example, when Enron collapsed in 2001, its auditor Arthur Andersen also failed. Securities firms have responded to litigation by restructuring internal sales and research operations with full disclosure of any potential conflict of interest between the analyst, the firm and the investments.

There is a debate around whether CRAs should also be held accountable for the accuracy of their ratings that could be based on verifiable data and objective and transparent criteria, such as those on corporate bonds or on structured products.[5] Sovereign ratings may be less quantifiable, in the sense that they might be expected to depend on sensitive judgments on a country's political stability, which might be more difficult to measure and verify.

[2]A cliff effect describes a one or two notch rating change which leads to a step change in investment portfolios and therefore an outsized impact on market prices.

[3] Bosnia and Herzegovina, Burkina Faso, Cape Verde, The Gambia, Georgia, Grenada, Honduras, Iran, Kenya, Lesotho, Madagascar, Malawi, Mauritius, Namibia, Senegal, Seychelles and Uganda.

[4] White (2010), "Markets: The Credit Ratings Agencies," *Journal of Economic Perspectives* 24(2), 211-26, also notes that Standard & Poor's standard disclaimer states: "Any user of the information contained herein should not rely on any credit rating or opinion contained herein in making any investment decision."

[5] SEC rules introduced in 2009 require that ratings agencies publish their methodologies and assumptions, as well as their track records (Federal Register, vol. 74, February 9, 2009, pp. 6456-84 and Federal Register, vol. 74, December 4, 2009, pp. 63832-65, as cited in White, 2010).

D. Regulatory compliance

Credit ratings are unique from other investment appraisals (such as audits and brokers reports) in that they are embedded in many contracts, regulations and laws. Ratings therefore confer compliance to certain regulations. To the extent that compliance can be achieved by only a limited number of CRAs, this confers a degree of market power to the agencies. For example cross-currency swaps often require the counterparty (typically large banks) to have investment grade ratings from at least two CRAs. The value of the ratings becomes as closely connected to the regulatory requirements as the information content they contain.

The most important regulations to embody credit ratings are the Basel Capital Adequacy Requirements. Under Basel II banks are required to hold capital against risk weighted assets. The risk weights can be either based on banks' own "internal ratings based" approach or the "standardized" approach which is based on ratings produced by External Credit Assessment Institutions (ECAIs).[6] Although regulators have the authority to recognize other CRAs, only the three largest agencies have been granted ECAI status by all members of the Basel Committee. This again confers a degree of market power. Prior to the crisis, measures of bank assets and bank risk weighted assets followed divergent paths. The interaction between incentives created by the "issuer-pays" model and consultancy services with rating dependent regulations raises concerns that the divergence might in part reflect regulatory arbitrage rather than economic reality.

The role of ECAIs may amplify financial instability by creating further "cliff effects". For example, if a class of securities is downgraded (e.g. sub-prime securities), banks, as leveraged investors, may need to reduce or eliminate their positions to remain regulation compliant. Such a sell-off risks further decreasing the asset value and initiating a downward spiral of losses. Another possible "cliff effect" arises from the general principle of a sovereign ceiling, where the credit rating of banks cannot exceed their sovereign rating. This is embedded in the "standardized" approach which may leave a trail of implicit downgrades for private sector banks in the wake of a sovereign downgrade, resulting in capital outflows and higher borrowing costs.

[6]Due to the complexity and costs involved in the internal ratings based approach, the standardized approach is likely to be more relevant for banks in emerging and developing markets.

E. Unrated Sovereigns

Developed country sovereign ratings are often unsolicited, while developing countries often must solicit and pay for a rating. As of 2010, a total of 77 countries – 65 of which were developing – had not been rated by any of the three major CRAs.[7] Being unrated may lead to substantial uncertainty about the borrower's creditworthiness, making access to credit more difficult. Private sector entities may be affected as well, due to the sovereign ceiling.

F. Reform Proposals

A variety of reforms to CRAs have been proposed. These reforms have three main aims: to reduce the regulatory reliance on CRAs, to avoid or minimize "cliff effects", and to increase transparency and competition. The Financial Stability Board (FSB) has set out some detailed recommendations to reduce the reliance of regulators on the ratings produced by the CRAs.[8] Although Basel II and Basel III retain key roles for CRAs via the use of ratings produced by ECAIs, they also allow for the recognition of the country risk assessments produced by Export Credit Agencies using the OECD methodology.[9] It is unclear whether this resolves the overreliance issue or ameliorates "cliff effects".

Basel III requires that "the general procedures, methodologies and assumptions for arriving at assessments used by the ECAIs should be publicly available".[10] This increased transparency goes some way towards meeting the FSB's recommendations of reduced reliance on CRAs, as it promotes a better understanding of the factors involved in a ratings decision and may assist users in forming their own judgments. Basel III contains provisions which allow national regulators to restrict the use of unsolicited ratings.[11].

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[7] Ratha, D. et. al. (2011),"Shadow Sovereign Ratings for Unrated Developing Countries," *World Development* 39(3), 295-307.
[8] "Principles for Reducing Reliance on CRA Ratings," Financial Stability Board, October 2010.
[9] "Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version," BIS, June 2006.
[10] "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems," BIS, June 2011.
[11] "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems," BIS, June 2011.

The SEC is studying several measures that aim to reduce barriers to entry in the CRA industry, including assigning credit ratings agencies to issuers, regular rotation among CRAs and encouraging unsolicited ratings.[12]

3. Objectives of the thematic debate

This thematic debate will provide the occasion to discuss the above referred issues and assess the challenges connected with the current and future working methods and polices of CRAs, by inviting Member States, international experts and academics, as well as representatives from CRAs and relevant financial institutions, to consider a number of open questions, including:

- How can conflicts of interest between CRAs, issuers and investors best be ameliorated?
- How should regulators best respond to the challenge posed by the high degree of concentration among CRAs?
- Should CRAs be held accountable for their ratings, and if so how and to whom?
- Should credit ratings rely exclusively on verifiable data and 'hard' quantitative analysis, or should an explicit role for the use of 'soft' information and judgment be retained?
- Should ratings standards be *absolute*, so that credit ratings tend to be pro-cyclical? Or should each debtor be rated *relative* to other debtors at a given point in time, presumably leading to more stability over the cycle?
- How can incentives be set for CRAs to rate all sovereigns, to level the playing field for access to bond markets for developing countries?
- How to promote a reduction in the reliance of the financial system on the services of CRAs and increase incentives for investors to implement their own risk assessments? What could be the future effects of measures undertaken by some Member States on the international system as a whole, especially in the context of the ongoing debate about the post-2015 sustainable development agenda?

[12] SEC roundtable on Credit Ratings Agencies on May 14, 2013, agenda available at http://www.sec.gov/news/press/2013/2013-71.htm

- How to establish, in the medium term, the basis for an objective and reliable ratings system, which could include, in line with Secretary-General report A/67/174, the "creation of a United Nations observatory of credit rating service providers" which could, inter alia, "certify credit rating products and build consensus on international standards for rating methodologies"?

4. Timing and Format

This one-day thematic debate will take place on September 10th, 2013 at United Nations headquarters in New York. It will begin at 10h and conclude by 18h30.

It will include an opening session, a high-level morning session, an interactive debate between Member States, two consecutive interactive panel sessions in the afternoon, as well as closing remarks.

The first afternoon panel, entitled "The Issues and Current Challenges", will focus on the main issues surrounding the current functioning of CRAs. It should also include the point of view of the CRA industry itself, other sovereign borrowers, as well as the private sector.

The second afternoon panel, entitled "Policies and Proposals for Solutions", will focus on recent regulatory changes and assess the advantages and disadvantages of various future-oriented policy proposals.

5. Outcome

The President of the General Assembly will submit a summary of the debate which will be distributed to Member States and posted on the website, emphasizing conclusions reached and proposals made.

Thematic debate
"The role of Credit Rating Agencies in the International Financial System"

10 September 2013, New York
Trusteeship Council

This event will be broadcast live. Link available at: http://webtv.un.org

10:00 – 11:15	***Opening Session*** • Vuk Jeremic, President of the UN General Assembly • Wu Hongbo, UN Under-Secretary-General *Key-note speakers:* • Vassily Nebenzia, Deputy Foreign Minister of the Russian Federation • Paul Taylor, President & Chief Executive Officer, Fitch Ratings • Douglas Peterson, President of Standard & Poors Rating Services • Stephen Pagliuca, Managing Director Bain Capital • Yves Leterme, Deputy Secretary General of the OECD
11:15 – 13:00	***Statements by UN Member States and Observers*** *Speakers may register their intention to speak directly in the meeting. In principle, national statements are foreseen for the morning session, while the afternoon panels which should be reserved for an interactive dialogue with panelists.*
15:00 – 16:30	***Panel 1: The issues and current challenges*** This session will discuss the main issues surrounding the current functioning of credit rating agencies. It will also include the point of view of the credit rating industry other sovereign borrowers as well as the private sector. *Moderator* Dr. Angus Armstrong, National Institute of Economic and Social Research, and Centre for Macroeconomics, UK *Panel participants* 1. Michael Kanef, Chief Regulatory and Compliance Officer, Moody's 2. Christopher Towe, Deputy Director, Monetary and Capital Market Department, IMF 3. Kevin Buehler, senior partner, McKinsey & Company 4. Merli Baroudi, Director and Chief Credit Officer, the World Bank Group ***5.*** Professor Yin Jianfeng, Institute of Finance and Banking, Chinese Academy of Social Sciences

	Interactive Debate
16:00 – 18:00	***Session II: Policies and proposals for solutions*** This session is dedicated in particular to what has been done in terms of regulatory changes and will assess the advantages and disadvantages of various policy proposals linked to the issues discussed in the first session. It should also look into the future and outline what still needs to be done. *Moderator:* Michael Casey, editor and columnist, The Wall Street Journal *Panel participants* 1. Thomas Wieser, President of the Euro Working Group, Council of the European Union 2. Thomas J. Butler, Securities and Exchanges Commission, Director of the Office for Credit Ratings 3. Shaukat Aziz, former Prime Minister and Finance Minister of Pakistan 4. Makoto Utsumi, President and CEO of Japan Credit Rating Agency 5. Professor John Coffee, Columbia Law School ***Interactive Debate***
18:00	***Concluding remarks*** • Vuk Jeremic, President of the General Assembly