BLUEPRINT FOR INCRA

AN INTERNATIONAL NON-PROFIT CREDIT RATING AGENCY

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Bertelsmann Stiftung

Bertelsmann Foundation

FOREWORD

With this report we want to make a contribution to addressing one of the key challenges of global financial governance: How to conduct and assess sovereign risk.

The European sovereign-debt crisis has made it obvious that this issue needs to be addressed from two angles: 1) the legal set-up of a credit rating entity and; 2) the methodology it employs to rate sovereign debt.

The first angle requires an answer to the question: Do we need alternative institutions in addition to the traditional for-profit credit rating agencies (CRAs)? The second angle focuses on the quality of the provided analysis and requires answers to these questions: Is the current set of indicators used by CRAs to evaluate a country's willingness and ability to pay back its debt sufficient? Do we need more comprehensive indicators that will also increase the predictability of a country's financial performance?

In times when political decision-makers around the globe are caught up in daily crisis management, partially caused by low-quality sovereign ratings, it is our obligation as a foundation to work on ideas that can help to overcome the deficiencies of the financial sector in the mid- and long-term.

With this report we make clear that the question of how to deal with sovereign ratings in the future is not just a European or a US question – it's a global one. It requires, therefore, a global solution. The emerging economies need to be on board and included in discussions on improving the sovereign-rating sector.

This report provides a blueprint for an international non-profit CRA (INCRA) based on a sustainable endowment solution. INCRA will minimize the existing conflicts of interest in the sector and will increase the participation of major stakeholders in our societies, such as governments and NGOs.

Our proposal also presents a new methodology that combines macroeconomic indicators with forward-looking indicators that reflect the socio-economic developments of countries. These forward-looking indicators have been developed and tested over years within the Bertelsmann Foundation's Transformation Index (BTI) and our Sustainable Governance Indicators (SGI).

Our report is the condensate of a highly experienced and committed team of in-house and external experts from around the globe. It combines the operational experience of practitioners from the financial sector with innovative thinking of academics. Our ideas have been tested with investors and government representatives, from Beijing to Rio, from Frankfurt to New York City.

We believe that we have to make a decision now – either to live with the shortcomings of the sovereign-risk sector or to have an international debate about how we can improve the system. With this report we make the case for INCRA as an additional player for the analysis of sovereign risk. The model is based on a detailed operational plan that can be brought to life if there is a broad coalition of able and willing funders.

Gunter Thielen
President and CEO
Bertelsmann Stiftung
Gütersloh, Germany

Annette Heuser
Executive Director
Bertelsmann Foundation
Washington DC, USA

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EXECUTIVE SUMMARY

The issue of sovereign ratings and how they are conducted must be addressed

The financial crisis in 2008 served as a catalyst to bring the shortcomings of the financial sector to the attention of the broader public. One of the key institutions put under the microscope regarding their operations and results are credit rating agencies (CRAs). CRAs are service providers that specialize in the provision of credit ratings on a professional basis. Their "job description" is to inform investors about the likelihood that they will receive all principal and interest payments as scheduled for a given security. In other words, they answer the question: what is the probability of default?

In particular, the sovereign ratings produced by CRAs have come under enormous attack. The last year marked the first time that the US and some European countries have been downgraded. Every sovereign downgrade has a measurable impact: an immediate increase in a country's cost of borrowing money. On a broader basis, sovereign ratings that are relevant to contractual and regulatory provisions can have a mechanical, pro-cyclical effect, if such provisions result in the forced selling of securities.

In light of these downgrades and their critical timing, the acceptance, transparency and legitimacy of sovereign ratings have been put into question. In addition, the sector is also characterized by an oligopoly, formed by the big three CRAs: Standard and Poor's, Moody's and Fitch Ratings. They account together for 95 percent of the market. Due to regulation and given the highly complex, cost-intensive business model of CRAs, the barriers to entry are fairly high.

Many actors, from governments to corporate players to civil society organizations, are calling for a reform of the sector. The disaffection for the credit rating agency world is widespread across key players in societies as much as it is spread around the world from the traditional industrialized countries in Europe and the US to the emerging powers in Latin America and Asia.

But national and regional solutions, such as the European Commission proposal calling for a European CRA, can't be the answer to an international challenge.

What needs to be done

The issue of sovereign risk needs to be addressed from two angles. The first is the legal and organizational setup of CRAs: Do we need alternative institutions in addition to the traditional for-profit CRAs and who is responsible for conducting the research?

The second angle focuses on the quality of the provided analysis: Is the current set of indicators used by CRAs to evaluate a country's willingness and ability to pay back its debt sufficient? Do we need more comprehensive indicators that will also increase the predictability of a country's financial performance?

The framework for an international solution

This report provides the first blueprint for an international non-profit CRA called INCRA. INCRA has the potential to merge the changing demands and interest of investors assessing sovereign risk and the desire of governments and the broader public for more transparency, legitimacy and accountability.

INCRA, a non-profit, international network of offices, would provide a new legal framework that is based on an endowment solution to guarantee sustainability and security for its long-term existence. Financially ***supported by a broad coalition of funders,*** from governments, corporate players, NGOs, foundations and private donors, it would be an independent entity. INCRA would be ***based on a sound governance model*** that would minimize and buffer potential conflicts of interest by a Stakeholder Council, which would separate the funders from the operational business. It would have offices in Europe, the US, Latin America and Asia.

In order to evaluate a country's "willingness to repay its debts", a more comprehensive set of indicators is needed. ***That's why INCRA would conduct its unsolicited sovereign-risk assessments on a set of macroeconomic and forward-looking indicators that would provide the basis for high-quality analysis.*** These forward-looking indicators would capture a meaningful picture of a country's long-term socioeconomic and political prospects and the potential political and/or social constraints on its ability and willingness to pay.

INCRA would pay tribute to the fact that the financial world needs a greater buy-in and participation from many different actors of society such as governments and NGOs. ***It would also reflect the realities of the globalized financial world, where the quality of sovereign ratings are not only crucial for Europe and the US but also for the emerging economies, such as China and Brazil.*** The appetite for borrowing money will increase in the emerging economies, giving them a high self-interest in having a reliable framework to analyze their sovereign risk. Therefore INCRA would guarantee the participation of all the relevant international players – it will be the first truly international CRA.

Changing the current system requires bold and big thinking. ***INCRA is a big idea based on a reasonable operational concept. It comes with a price tag of an endowment of US$400 million.*** This is a lot of money at a first glance, but only a small investment if divided among multiple funders. Put in perspective to the hundreds of billions of dollars already paid for public bailouts, that have been the result of faulty risk analysis, it is a relatively moderate and safe call.

The next steps

The ***G20***, the group of the most important economic and financial players in today's world, have already addressed the question of the need to reform CRAs. ***The G20 would be the best forum to evaluate the political will for giving a new institution a chance – an institution that would be embedded in the markets but also in the society overall.*** Additionally, corporate players, NGOs and foundations need to come on board with their commitment to improve the sovereign-risk sector.

Sovereign ratings could be defined as public goods and therefore it should be the responsibility of all the major players of the society to support the improvement of this sector of the financial world.

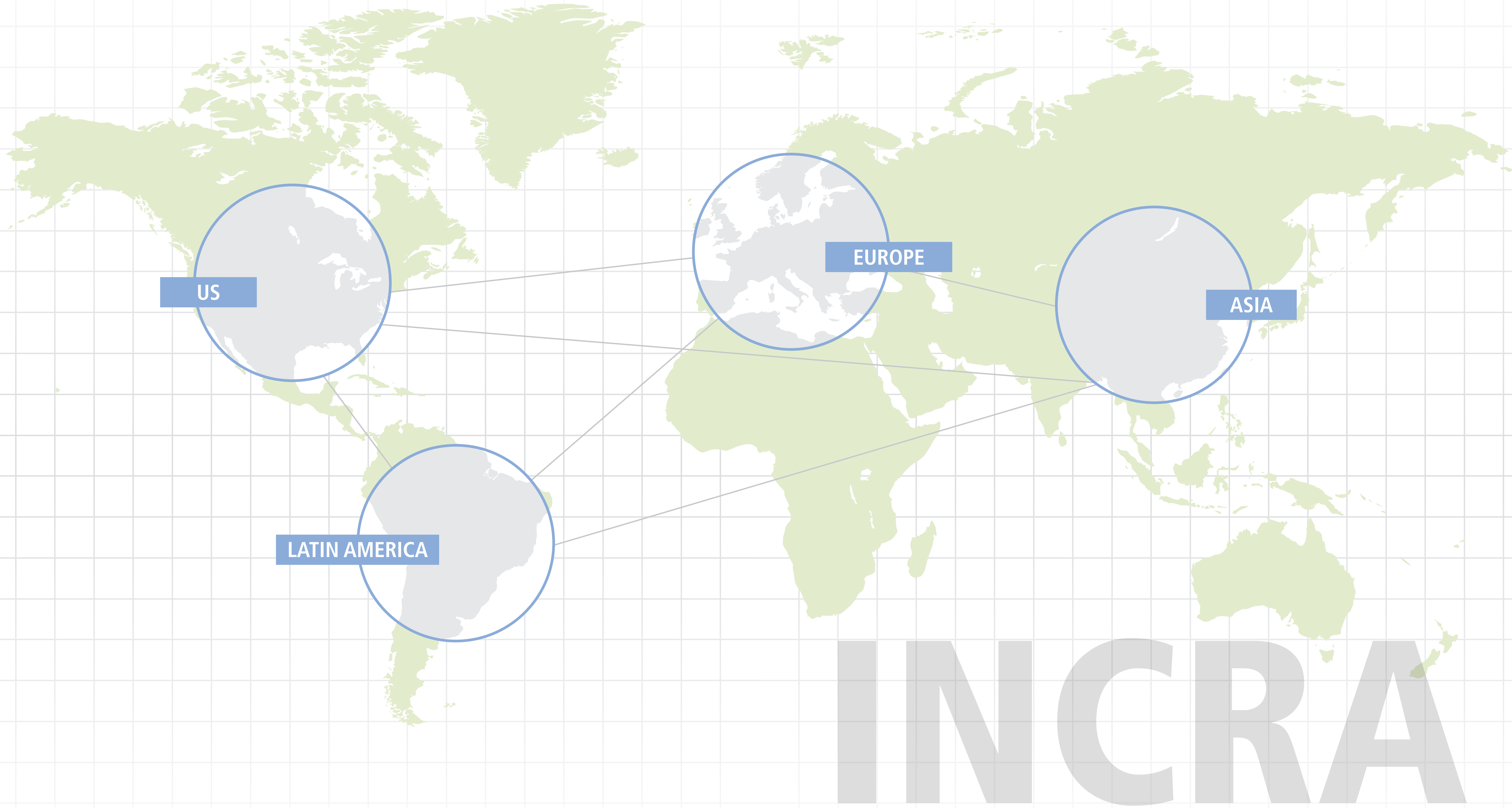
How the report was conducted

This report is the condensate of a highly experienced and committed team of in-house as well as external experts around the globe. It combines the operational experience of practitioners from the financial sector with the innovative thinking of academics. The ideas have been tested with investors and government representatives, from Beijing to Rio, from Frankfurt to New York City.

The new forward-looking indicators that INCRA would base its sovereign analysis on have been developed and tested over years within the Bertelsmann Foundation's Transformation Index (BTI) and the Sustainable Governance Index (SGI).

INCRA has the potential to improve the financial system of the future. This report makes the case for creating an international non-profit CRA as a cornerstone of the global financial architecture.

ORGANIZATIONAL STRUCTURE



INTRODUCTION

THE NEED FOR AN INTERNATIONAL NON-PROFIT CREDIT RATING AGENCY

The 2008 financial crisis served as a catalyst to bring the shortcomings of the financial sector to the attention of the broader public. In particular, credit rating agencies (CRAs) were put under the microscope regarding their operations and results. CRAs are service providers that specialize in the provision of credit ratings on a professional basis, to overcome "information asymmetries" between investors and debt issuers.[1] They are knowledge intermediaries that facilitate the exchange of capital between supply-side and demand-side actors. Their "job description" is to inform investors about the likelihood of receiving all principal and interest payments as scheduled for a given security. In other words, they answer the question: what is the probability of default?

Traditionally, CRAs provide three kinds of ratings: structured finance, corporate ratings, where the issuer is a company, and sovereign ratings, where the issuer is a sovereign entity, i.e. a national government. A third category, which is incorporated into the sovereign-ratings division, is quasi-sovereign ratings, which include multinational organizations and government-backed, for-profit enterprises.

Transparency and quality of ratings need to improve

The function of a CRA as an intermediary requires that the market participants trust in the integrity and reliability of the ratings, or in other words, in the competence and independence of the CRA. ***Especially in the last two years, CRAs have been in the public spotlight because of the subprime crisis[2] and the European sovereign-debt crisis[3], but the debate about an appropriate policy framework for CRAs is not new.*** The East Asian crisis in the mid-1990s provoked strong criticism of the late reaction by CRAs. They were blamed for the inconsistent analysis of, on one hand, excessive short-term private borrowing in foreign currencies and, on the other hand, fixed exchange-rate regimes and a currency-board regime.[4] In 2001, CRAs came under fire again, accused of inappropriately rating companies in the dot-com boom.[5] The fact is that CRAs have always played a major role in the financial world. Corporate and sovereign ratings are not only closely followed by the markets, but they also can have a major impact on investors, borrowers, issuers and governments.

In particular, the sovereign ratings produced by CRAs have come under enormous attack. The last year marked the first time in recent history that some European countries[6] – and for the first time in its history, the US – have been downgraded. In light of these downgrades and their critical timing, the acceptance, transparency and legitimacy of sovereign ratings have been put into question.[7] ***Governments have perceived these downgrades as a major insult to their performance and status, and every sovereign downgrade also has a measurable effect: an immediate increase in the country's cost of borrowing money.*** On a broader basis, sovereign ratings can have a mechanical, pro-cyclical effect if contractual and regulatory provisions result in the forced selling of securities.

In addition to these well-known and discussed deficits, the sector is also characterized by an oligopoly, formed by the big three CRAs: Standard & Poor's, Moody's and Fitch Ratings.[8] Standard & Poor's and Moody's together account for around 80 percent of the market, which constitutes a duopoly, while Fitch accounts for a further 15 percent of the market. Due to regulation and given the highly complex, cost-intensive business model of CRAs, the barriers to entry are fairly high. Still, the IMF lists approximately 74 CRAs around the world.[9] The US clearly dominates the sector; it is where the rating business originated and where the business activity of CRAs was predominantly confined between the 1930s and the 1970s, in issuing grades on corporate bonds. So it comes as no surprise that the big three have their headquarters in New York City, where the majority of national and international investors are located. As long as this oligopoly of the big three exists, there is little incentive for the agencies to change or reform.

Many actors, from governments to corporate players to academic scholars to civil society organizations, are calling for a reform of the rating sector. The disillusionment with the credit rating agency world is widespread across key players in societies and around the world, from the traditional industrialized countries such as the US and Europe to the emerging powers in Latin America and Asia. CRAs established in other countries, such as China, India and Japan, have attempted to provide an alternative to the big three. Their success so far remains limited, and CRAs such as Dagong Global Credit in China, CRISIL in India and JCR in Japan have been able to play a role only in their own country or region.

For the majority of their existence, CRAs have been directly regulated in neither the US nor Europe. Rather, regulators have influenced the CRA market indirectly, through requirements on the primary users of ratings, institutional investors and broker dealers. Banking and financial regulators have required those institutions to obtain ratings for debt securities that they wanted to incorporate in their portfolios in order to distinguish safe investments from speculative ones. As far back as 1975, the Securities and Exchange Commission (SEC) in the United States required that such ratings must be issued by so-called "nationally recognized statistical rating organizations", known by the lengthy acronym NRSROs.[10] This development meant that CRAs that have not been approved by the SEC as NRSROs provide less value than those that have the stamp of approval from the SEC.

These SEC-approved CRAs continue to be the ones that institutions and broker-dealers refer to for their investments. Given the fact that in the following decades the SEC was extremely strict in providing CRAs with an "NRSRO-seal", the market developed its oligopolistic structure.[11] The corporate scandals of 2001 and 2002, including Enron, WorldCom and other major corporate players, fueled the criticism of NRSROs because they had clearly failed to provide an accurate rating of these companies.[12] As a result of this failure, the ***US Congress enacted the 2006 Credit Rating Agency Reform Act.[13]*** This new legislation aimed to create an objective legislative framework that would allow more CRAs to become NRSROs, grant oversight capabilities to the SEC, and to increase the accountability of NRSROs. ***The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 provides additional provisions on the transparency and accountability of CRAs.[14]***

As much as the European Union (EU) and its institutions are known for creating regulation, in comparison to their US counterparts, they have been inactive in the field of CRA regulation for many years. Even in the aftermath of the Enron crisis in 2001, the Committee of European Securities Regulators (CESR) came to the conclusion in a study that legislation in this field was unnecessary.[15] The European Commission, which tasked CESR with the study, requested that CRAs rely on the Code of Conduct developed by the International Organization of Securities Commissions (IOSCO). In practice, this meant that each CRA would adopt its own code of conduct, mostly based on the IOSCO code. CRAs could also deviate from the IOSCO code if they followed the EU's "comply and explain" system of self-regulation.[16]

The financial crisis in 2008 was the "game changer" for the EU's policy on CRAs. Part of the EU's reaction was EU credit rating agency Regulation (EC) No 1060/2009, which entered into force in December 2010.[17] The outcome of this legislation was the creation of the European Securities and Markets Authority (ESMA). Since its establishment on November 24, 2010,[18] ESMA has served as a pan-European supervisory authority over CRAs registered in the EU. Under the EU CRA regulation, CRAs must be registered with ESMA and are subject to its supervision. Furthermore, the EU regulation attempts to eliminate conflicts of interest, for instance by forcing CRAs to disclose their largest client base and also disclose their methodologies, models and rating assumptions.[19]

The current proposal to further amend the EU credit rating agency Regulation (EC) No 1060/2009[20] would establish some additional rules, in particular for sovereign ratings. Sovereign ratings would be assessed every six months instead of every 12, increasing both the transparency of the ratings and the frequency of publication.[21]

An additional layer of regulatory requirements has been provided by Basel II, issued by the Basel Committee on Banking Supervision.[22] The Basel Accords aim to ensure a sound international banking system and therefore to eliminate the over-reliance on credit ratings by banks and recommend that banks develop their own empirical models to assess creditworthiness. The precondition for using models developed in-house is the approval of their national regulators. The implementation of these requirements is slow and highly complex, given the different cultures, regulations and public policies in place around the world.

Additionally, the G20, the forum of the most powerful economies in the world, has called for a reform of the sector since the financial crisis broke in 2008. At their 2009 London summit, the G20 finance ministers agreed to control CRAs and their compliance with the code of conduct of the IOSCO.[23] At their meeting in February 2012 in Mexico, the ministers tasked the G20's Financial Stability Board (FSB) to coordinate with the World Bank and the IMF to develop a study that identifies the extent to which the agreed upon regulatory reforms may have unintended consequences for emerging markets and developing economies.[24]

The US government, the EU governments and the EU institutions in Brussels have been at the forefront of the debate in the last year in calling for a new model.[25]

The main proposals are:

- to change the issuer-payment model, which is the rule in corporate debt rating,
- to strengthen competition to overcome the oligopolistic market structure of CRAs,
- to increase civil liability for CRAs for "wrong ratings",
- to increase the regulation on specific situations to cope with conflict of interest situations that can arise,
- to establish a public-funded or private-funded European CRA.

As regards the last proposal, the ideas range from the establishment of an independent, *European Rating Agency Foundation*, as proposed by the European Parliament,[26] to the setup of a European CRA, as proposed by private actors such as Roland Berger.[27] The emerging economies broadly share the perspective of the Europeans but have not made an alternate proposal yet. Any new regional rating agency would likely face problems gaining traction and credibility, similar to those experienced by existing country-specific agencies.

Whether or not one agrees with the level of regulation in the US, Europe and on the international level, it must be acknowledged that in the last decade, policymakers have been forced to recognize the link between ratings and the financial sector, as they influence literally every investment that the sector makes. ***The integration of ratings into national as well as international regulations in the last years has bestowed on CRAs a quasi-governmental status and "quasi-public responsibility".***

But as much as CRAs have been given renewed focus in the national and global financial framework, other areas of the rating business remain untouched. In particular, under the SEC as well as the ESMA regulatory framework, there are obvious deficits in regarding sovereign risk that have not been addressed in a comprehensive way. For example, the conflict of interest that may arise as a result of the issuer-payment model has not been dealt with by regulation. Similarly, regulation has not yet effectively dealt with the oligopoly of the big three credit rating agencies. The same can be said about the regulatory efforts of Japan, India and Australia, among other countries, that all have started as a result of the recent financial crisis to create their own regulatory framework for CRAs.

So why is the focus on the analysis of sovereign risk? It's surprising that only recently the question of how and by whom sovereign risk analysis is conducted has been discussed broadly.

In a way, sovereign risk is the 800-pound gorilla in the room that everybody knows about, but fears to address. The fact is that sovereign risk is the highest asset class in the market; nearly US$70 trillion is allocated in the sovereign bond market worldwide.[28] Every other asset class, from corporate to banking, depends on the sovereign sector as a benchmark.

Although the rating agencies' current practice of assigning overall ratings for sovereign risk began only a few decades ago, Moody's has been rating bonds issued by foreign governments since 1919.[29] The rapid development of sovereign ratings was a result of the growing cross-border demand for new capital in the 1970s. At this time, developing countries started to raise money in global bond markets, and therefore investors had to assess which countries were eligible for loans. The CRAs took over the job of providing assessments on default risk, so that investors could make informed decisions.

Sovereign risk is the 800-pound gorilla that affects every sector of society

But while the analyses of corporate and banking ratings have been developed over more than a century and are highly complex and sophisticated, ***sovereign ratings have been managed in a kind of stepmotherly way.*** The set of indicators used for sovereign risk is fairly standardized and consists mainly of macroeconomic indicators.[30] Therefore a new debate needs to address how more qualitative indicators should be integrated in the analysis.

The number of sovereign-risk experts in the big three CRAs pales in comparison to the industry legends responsible for corporate or banking sector ratings. The revenues that CRAs generate with sovereign ratings are marginal. It took the two big players in the market, Standard and Poor's and Moody's, years before they generated any profits from the sovereign-risk business. Still, providing sovereign-risk analysis is key for CRAs to provide essential information to investors. The sovereign risk sector has a number of essential overlaps for the assessment of a country's banking sector, and vice versa. Although this is the official, logical explanation, even more importantly, the fact that a CRA can publish sovereign risk analysis gives the agency power and weight in the market. Making the headlines of the world's leading newspapers and magazines – when a CRA downgrades or in some rare cases upgrades a country – is a priceless public-relations and marketing tool.

But rather then defining sovereign ratings as an advantageous and convenient marketing tool, they need to be understood as a public good. In particular, sovereign ratings that affect the future of countries and their citizens need to be *non-rivalrous* and *non-excludable*,[31] meaning everyone has the same right and access to "consume" them. CRAs are the main actors in the field of analyzing sovereign risk. The future borrowing power and financial well-being of entire countries rely on the ratings produced by CRAs.

So the question needs to be asked: How do we more transparently rate a highly sensitive and critical asset class like sovereign bonds? Will more regulation – as intended by the EU – improve the general operation of CRAs and sovereign risk analysis?

Even if the regulatory framework on both sides of the Atlantic has advanced in recent years, the broader criticism and mistrust of the sector cannot be tamed by additional regulation in the near term. By nature, regulatory solutions take a country-specific or regional approach, fail to be comprehensive and fall short of ending the conflict of interest regarding payment for ratings. There is still a lack of transparency, accountability and legitimacy related to CRAs that needs to be addressed in a broader context.

More regulation is not the answer to improve the work of CRAs

Simply blaming the CRAs would be too easy. CRAs have not asked regulators for an "institutionalized" role in the system; regulators gave CRAs the important role that they play today in nearly every investment decision made in the markets. Blaming the regulators would also fall short because they tried to provide a framework for a private sector that seemed to spin out of control. Blaming the countries that have provided the CRAs – as in the recent prominent case of Greece – with inaccurate information about their fiscal liabilities would also be too simple. There could always be governments that do not play by the rules and instead try to interpret them in their own favor.

Therefore, the questions must be asked: what could an alternative model for a CRA look like? How can sovereign risk be analyzed in a more comprehensive way? How can a model be constructed that addresses the interest of the investor in a sound analysis of sovereign risk and addresses the call from the broader public and governments for more transparency and accountability?

This report will provide the first blueprint for an alternative legal and organizational setup of an international CRA based on a non-profit model. This new CRA will be called INCRA in the following text. Furthermore, this report will outline a new, forward-looking set of indicators that is more able to reflect the current and, more importantly, future financial abilities of countries to service their debt.[32] Besides these two important operational elements, the report will also outline the business plan for such an entity.

INCRA seems to be a feasible solution and alternative model, because the status quo needs to be challenged in order to find solutions for this highly important sector of the CRA world. Taboos must be abandoned in favor of forward-looking and creative thinking.

With this report the current system will be challenged primarily in two dimensions:

- in the way CRAs conduct sovereign ratings in a for-profit framework;
- in the way CRAs have developed their methodology and set of indicators on sovereign ratings.

Challenges with CRAs and Existing and Proposed Reforms

Challenge → Solution	Existing Regulation	Further Proposed Reforms
Oligopolistic Market **Results in:** High entrance barriers[1] Rating shopping[2] ↓ **Enhance Competition**	**US** • Federal agencies will remove requirements of reliance on CRAs[3] • The current regulatory framework is so reliant on ratings that significant changes can only take place over time[4] **EU** • Issuers that solicit ratings should request ratings from two separate agencies[5] • Licensing: the current regulation support credit ratings due to the fact that banks are required to assess credit risk based on ratings[6]	**US** • Research on feasibility and implementation of alternative payment models[7] **EU** • Establish a fully independent public European CRA[8] • CRAs could be assigned to clients and then rotated (not in the case of sovereign ratings)[5]
Quality Problems **Caused by:** Continued deficiencies in the methodology and rating process (PR) Rating Inflation[9] ↓ **Increase Quality of Ratings**	**US** • CRAs must submit an annual report to the SEC[3] • SEC can create rules about methodologies used by CRAs[3] • Accompanying rating publications must be information on data and methodologies related to the rating[3] • CRAs must disclose if they have received information from sources other than the issuer[3] • Employees of CRAs must be qualified to analyze data and create ratings[3] **EU** • CRAs must register with ESMA[5] • Methodologies used by credit rating agencies will be rigorous, systematic, continuous and subject to validation based on historical experience, including back testing[5] • Review of credit ratings and methodology will be done on an ongoing basis, and take place at least annually[5] • If there is a change in methodologies, models or key rating assumptions, a credit rating agency will disclose the change, review the affected credit ratings and re-rate all credit ratings that have been affected[5] • CRAs must provide an explanation of their methodology to the public[5] • Rating outlooks are held accountable to the same standards as ratings themselves[5] • CRAs must pay ESMA the cost of their supervision[16]	**US** • Standardization of rating terminology and methodology[3] • The SEC is undertaking a study to determine whether to create an independent professional organization for analysts that will help ensure standards[3] • CRAs must publish statistics for one, three, and ten years to ensure cross-sector comparability[10] • CRAs must disclose the frequency of rating reviews, whether different models are used for ratings surveillance than for initial ratings, and whether changes made to models are applied retroactively to existing ratings[10] • New employees of CRAs must meet certain quality standards[7] **EU** • CRAs will be required to assess sovereign debt every six months[1] • Internal rotation of staff members[1] • CRAs are required to disclose the time horizon of rating outlooks[1] • Duty to change rating agencies (not in the case of sovereign ratings) [5]

Challenges with CRAs and Existing and Proposed Reforms

Challenge → Solution	Existing Regulation	Further Proposed Reforms
Conflict of Interest ↓ **Transparency**	**US** • Ratings must be separated from the sales and marketing departments of CRAs[3] • The SEC must be notified if a CRA knows that one of its employees (current or employed at the CRA during the preceding 5 years) gains employment with a party for which a rating was issued[3] • At least half of the board of directors must be independent of the CRA[3] • CRAs must conduct "look back" reports to analyze whether conflicts of interest influenced ratings[10] • CRAs must not engage in unfair, abusive or coercive practices[10] **EU** • Rating analysts must not initiate or participate in negotiations regarding fees or payments[5] • Establishment of a rotation mechanism of the rating analysts and persons approving credit ratings[5] • CRAs must disclose their policies and procedures regarding unsolicited credit ratings and state whether the rated entity or third party participated in the rating and whether the CRA had access to relevant internal documents[5] • CRAs will make information on its historical performance available and will provide information annually to their home Member States and to ESMA[5] • An annual transparency report must be published by every CRA and submitted to ESMA for review[5] • At least one third, but no less than two, of the members of the administrative or supervisory board will be independent members who are not involved in credit rating activities[5] • CRAs should establish and maintain a permanent compliance function department which operates independently[5] • CRAs should comply with information duties in order to make any conflict of interests transparent[5] • Analysts and employees may not buy, sell or engage in any transaction of a financial instrument rated and may not accept money, gifts or favors from clients of the credit rating agency[5] • The name and job title of leading analyst will be displayed in a given credit rating activity, as well as the person who approved the rating[5] • CRAs are not allowed to provide consulting services anymore[5] • CRAs must publicly disclose fees[1] • Prohibition of cross-shareholding[5] • No entity should hold more than a 5% share in one agency; if so, this should be disclosed to the public[5]	**US** • SEC is undertaking a report to review fees and appropriate methods for paying fees[3] • Analysts working on ratings may not be involved in fee negotiation[10] • Government Accountability Office published a study of alternative payment models for CRAs[7] **EU** • Appropriate legislative proposals should be made to support the creation of a public CRA[5] • Fees charged to issuers should be nondiscriminatory, based on actual costs and not be dependent on the outcome of the rating[1] • For each credit rating, the identity of the rating analysts and the persons who have approved the rating as well as information as to whether the credit rating was solicited or unsolicited has to be included[1] • Ratings should be accompanied with a full research report when a rating is changed[1] • No publication of ratings during business hours[1] • CRAs should publish detailed descriptions of their rating methodologies[1] • CRAs will be responsible for publishing corrections of errors in their methodologies[1]

Challenges with CRAs and Existing and Proposed Reforms

Challenge → Solution	Existing Regulation	Further Proposed Reforms
Cliff Effect[11] and Systemic Risk **Caused by:** Deficit of quality internal ratings Overreliance on ratings ↓ **Reduce Reliance**	**US** • Federal agencies will remove requirements of reliance on CRAs[3] **EU** • Issuers that solicit ratings must request ratings from two separate agencies[5] • Internal Ratings-Based Approach allows banks to use their own estimated risk parameters for the purpose of calculating regulatory capital[6]	**US** • SEC is undertaking a report to review reliance on CRAs[3] **EU** • Prohibition of unsolicited sovereign debt ratings[8]
Liability ↓ **Enforcement**	**US** • Must have the same standards of liability and oversight as apply to auditors, securities analysts and investment bankers[3] • The SEC may suspend or revoke the status of an NRSRO if it does not produce credible ratings[3] • CRAs must submit an annual report on compliance[3] • An Office of Credit Ratings was established under the SEC to oversee the practices of CRAs[3] • The SEC has the power to establish penalties for CRAs that are not compliant or violate rules[3] **EU** • CRAs held accountable to national liability laws[12]	**US** • Ensure third party due diligence[7] **EU** • CRAs should be held liable if they infringe intentionally or with gross negligence any obligations imposed on them by EU standards[1] • Competent authorities will have the power to review agencies for accuracy and highlight strengths and weaknesses[13]

General disclaimer: *This table is intended to provide a general overview of some reforms and proposed reforms. It is in no way meant to serve as an exhaustive list; instead it illustrates different regulatory approaches to problem-solving.*

Note on Basel II:
Basel II is the second of the Basel Accords which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. Basel II extended the "three pillars" concept (minimum capital requirements, supervisory review and market discipline) from Basel I.

For CRAs, who are operating in an oligopolistic environment, the Basel Accords are very important as they make recommendations on regulations for the banking sector.[14]

Basel III is nothing more than a strengthening of the three Basel II pillars, especially pillar 1 with enhanced minimum capital and liquidity requirements. Basel III proposes many new capital, leverage and liquidity standards to strengthen the regulation, supervision and risk management of the banking sector. The capital standards and new capital buffers will require banks to hold more capital and higher quality of capital than under current Basel II rules. The new leverage ratio introduces a non-risk-based measure to supplement the risk-based minimum capital requirements. The new liquidity ratios ensure that adequate funding is maintained in case of crisis.[15]

THE LEGAL AND ORGANIZATIONAL SETUP

GOVERNANCE

In order to overcome the described shortcomings of the current credit-rating system, a new legal and organizational setup is needed to provide a framework for increased transparency, legitimacy and accountability. Not only will the new rating system need to function more effectively to prevent future financial crises, it must win the confidence of the global financial sector, world leaders and the public. Accordingly, the objectives of the proposed agency are two-fold:

- to develop trust from investors in the integrity and reliability of the ratings and in the competence and independence of the rating agency; and
- to utilize a well-rounded and diverse set of indicators.

This agency – an international, non-profit credit rating agency called ***INCRA – would focus exclusively on sovereign risk because of the unique challenges that these ratings present.***

At the core of the new model are the sources of funding and the internal governance of the institution. These factors impact the legitimacy, transparency, accountability and sustainability of INCRA. As Vanguard Group Founder John C. Bogle has written, for-profit, publicly traded rating agencies possess an inherent conflict of interest because they are accountable to shareholders for continually increasing profits, rather than being solely motivated by high-quality analysis.[1] INCRA would provide a valid alternative to the flawed status quo.

Given the fact that sovereign ratings hardly provide any income for CRAs, in particular in the first years of their existence, the financial basis for INCRA must be stable and sustainable. At the same time, the funding of the agency will influence INCRA's appearance of independence, especially if the funders provide support without adequate compensation in return.

The governance of the agency is a tool used to enhance the appearance and reality of actual independence of INCRA from its funders. There can be no doubt that the questions of financing and governance of INCRA are highly intertwined. The model presented here pays tribute to these two concepts.

Three models but only one sufficient solution

As regards the legal and organizational structure, two criteria are important:

- sufficient flexibility in the internal design and governance structure to allow the legal form to respond to possible changes (e.g., amendments to INCRA's governing documents to find ways to introduce new stakeholder groups);
- a legal setup that reflects the international and impartial approach of the new entity.

In general, there are three legal models under which the new entity could be set up: (1) a for-profit corporation; (2) a cooperative; and (3) a non-profit organization.

A *for-profit corporation* would seem to be a less-desirable option because it is highly unlikely that the corporate sector would have a strong interest in an agency that presents an unprofitable sovereign risk business model. This would create a high level of uncertainty for the entity and for investors, who would not be sure that the CRA would have a long period of viability. Moreover, a new for-profit agency is hardly a departure from the status quo.

In the *cooperative model*, sovereign issuers would form a cooperative membership organization and hire a staff to provide the credit ratings. Each member's interest in the cooperative – and its financial contribution – would be determined by the magnitude of its issued and rated debt. However, a cooperative structure could prove unwieldy to operate and might face challenges of real or perceived conflict of interest.

Based on the main objective of INCRA, not to create profits but to improve the quality of the sovereign risk assessment, a *non-profit* solution seems the most desirable. A non-profit structure resolves many of the criticisms about accountability and conflicts of interest that arose in the wake of the 2008 financial crisis. There is no doubt that, in comparison to other traditional models such as for-profit CRAs, ***a non-profit model can best ensure the transparency, accountability and quality of the ratings.*** It is the most sustainable option and, via a carefully constructed internal governance structure, would minimize the potential conflict of interest between the funders and the operational management of the entity.

Because there is no supranational legal structure under which such an international, non-profit entity could be set up, ***INCRA would be set up as a network of offices that are founded and established under the national laws of the countries in which they are based.*** There would be country representation in Europe (for example, as a Dutch foundation), the US (where there is no federal corporate law regulating non-profit corporations), Latin America, and Asia. Each of the offices would be licensed by the regional/country authorities (the SEC and ESMA for the US and the EU). An overall code of conduct for the operations of INCRA would need to be developed and approved.

INCRA: The first truly international, non-profit CRA for sovereign risk

An overall holding structure would be proposed to give the network a joint legal structure, provide a secure framework for investors and ensure the safety of INCRA's endowment. The holding non-profit corporation could be formed either in Europe or the US. All INCRA offices would be equally affiliated counterparts of the holding corporation with a multi-faceted sharing agreement. The final decision on the holding structure for INCRA should be made by its funders and needs to take into account the highly complex and evolving regulatory frameworks for CRAs in particular in Europe and the US.

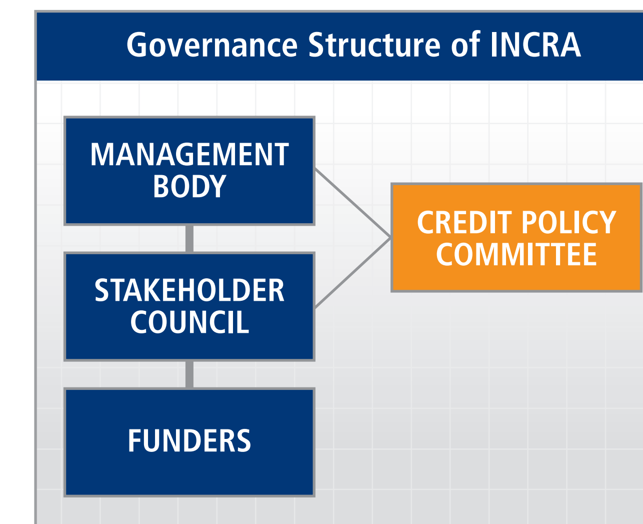
The regional offices would serve two purposes: to underline that INCRA is a truly international body; and to increase the accuracy of the information that it collects. These offices would be responsible for on-the-ground coordination of research and would consult with regional experts to have access to the most up-to-date and accurate information. These regional experts would include investors, members of civil society and academics.

Governance Structure

As indicated, the aim is to develop a governance model that enhances the independence of the management from the funders. ***Therefore, the governance structure of INCRA would involve four bodies: (1) the Funders,*** who would be responsible for maintaining the agency's funding; ***(2) the Management Body,*** which would be responsible for the operation of the entity and ensuring its competence; ***(3) the Stakeholder Council,*** which would appoint and oversee the Management Body; and ***(4) the Credit Policy Committee,*** which would ensure the quality of the ratings.

Function of the Stakeholder Council

As there is a potential conflict of interest between the Funders and the operational business of INCRA, it is essential to ensure the independence of the Management Body from the Funders to minimize the conflict of interest. This independence can be promoted by delegating the key decisions that influence the Management Body to the



Stakeholder Council, whose main function would be to ring-fence any potential influence of the Funders on INCRA.

Composition of the Stakeholder Council

The Stakeholder Council is a body that would be pluralistic and "supranational" in nature. Its composition would be truly international, including representatives from all major parts of society and from all geographic regions in which INCRA would be issuing sovereign ratings. ***The Stakeholder Council would serve as a mirror of society in the regions it represents (North America, Europe, Latin America, and Asia).***

It should be emphasized that the composition of the Stakeholder Council would not be based exclusively on the entities that finance INCRA. Stakeholders would be defined as representatives of society, so possible stakeholders could be professional analysts and investors, corporate representatives, lawyers, academic experts, representatives of NGOs and foundations, and government officials. Of course, the Funders would have the right to appoint delegates to the Stakeholder Council. The bylaws of INCRA would have clear rules and regulations in place for the composition of the Stakeholder Council to guarantee a well-balanced international and interdisciplinary representation.

Competencies of the Stakeholder Council

The Stakeholder Council should be responsible for at least the following decisions: (1) appointment of the CEO; (2) dismissal of the CEO; and (3) approval of the Code of Conduct, general rules, guidelines, and procedures to ensure a transparent and high-quality rating process and outcome. Additionally, the Stakeholder Council should periodically receive reports from the Management Body and supervise its actions.

The Stakeholder Council would remain informed about the challenges that the organization is facing. Similarly, the Stakeholder Council would have regular meetings with the Funders and provide them with status updates on the operations of the entity. It would also be responsible for appointing the members of the Credit Policy Committee.

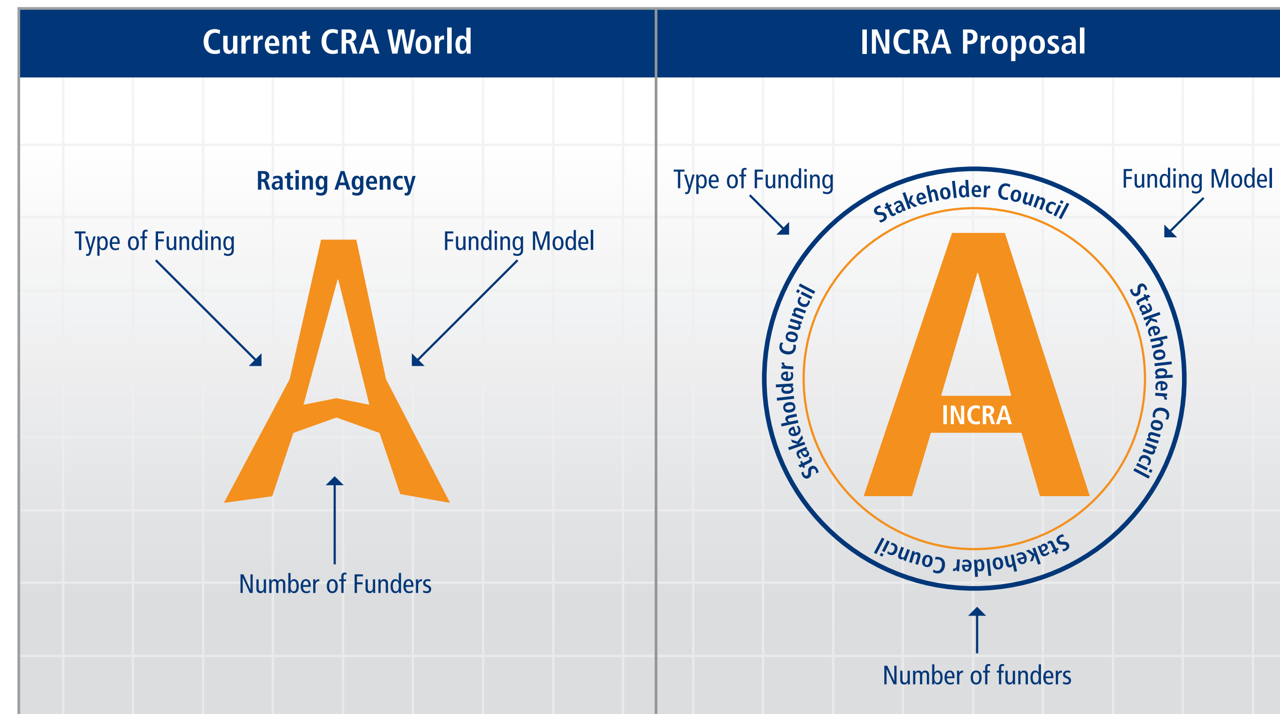
A transparent governance structure is key to ring-fence interests

Minimizing the influence of the Funders

It must be stressed that the Stakeholder Council's main function would be to mitigate any potential direct influence of the Funders on the operation of the business, represented by the Management Body. The Funders would still have opportunities to influence the rating agency by amending its articles of association or by reducing its financing. Of course, it would be possible to limit such influence, such as by long-term financial commitments of the Funders or by introducing veto rights of third parties, such as the Stakeholder Council. However, even if the Funders would have these opportunities to influence the rating agency, such influence would be transparent to the public if the CRA's articles of association were open to the public, which is strongly recommended. In this instance, the Funders would have to publicly justify each and every amendment of INCRA's articles of association.

Credit Policy Committee

To guarantee the high quality of INCRA's work, a Credit Policy Committee should be installed. While the Stakeholder Council's primary function would be to ensure the independence of the operational business of INCRA, ***the Credit Policy Committee serves as the "quality control body."*** The Credit Policy Committee would be comprised of internal experts (ex officio members of the Stakeholder Council) and external experts (e.g., academics and industry experts). This committee would have regular meetings to offer advisory opinions on the methodology of the ratings (indicators, weighting of the indicators, etc.) but would have no decision-making ability. Regular reviews of the methodology by the Credit Policy Committee would ensure the highest possible quality of ratings. The Stakeholder Council would appoint the members of the Credit Policy Committee; the committee would report periodically to the Stakeholder Council.



Governance of INCRA

	Composition	Competence	Function
Funders	• General Meeting (if the legal form has membership or shareholders)	• Financing Scheme • Governance structure	• Ensures adequate funding • If necessary: can amend the governance structure (e.g., in case of a change of Funders), but cannot eliminate the Stakeholder Council
Stakeholder Council	• Supervisory Board (in a two-tier system with a separate supervisory board)	• Approval of general rules and guidelines of INCRA • Appointment and dismissal of CEO • Supervision of the Management Body • Appointment of Credit Policy Committee	• Serves as "buffer" between the Funders and the Management Body; in order to enhance the (institutional) independence of the rating agency, it ring-fences the potential interest of the Funders and guarantees the independence of the Management Body
Management Body	• Board of Directors (in a two-tier system with a separate supervisory board)	• Conducts business	• Ensures the substantive competence of the rating agency
Credit Policy Committee	• Academics, finance experts, experts from the corporate sector, ex officio members of the Stakeholder Council	• Meets once a year to discuss methodology and indicators • Delivers periodic reports to the Stakeholder Council	• Ensures quality of ratings

FUNDING

Based on the assumption that in the first years of its existence INCRA would need to position itself in the market, and that the process of producing ratings should be available to the broader public, INCRA would conduct only unsolicited ratings for sovereigns, meaning that one traditional revenue stream, issuer-payment, would be unavailable to the operation. INCRA would start unsolicited ratings for supranationals such as the World Bank or the IMF in year two. The only source of income would be generated from additional research projects commissioned by investors on specific sovereign ratings or additional consulting services that could be undertaken after the first year of its operation.

Considering these limited sources of revenue, and that the overall objective of INCRA is to increase the quality of ratings rather than to generate profits, ***INCRA cannot be self-sustaining and would have to seek other sources of funding.*** It would be important that INCRA start out with enough capital to cover the first years of its operation but also to convince the markets that it would be a source of high-quality analysis for a long period of time. Therefore, the preferred method of financing is an endowment, because it would underline the independence of INCRA. If, every year, INCRA must request support for the next business year to avoid insolvency, its dependence on the funders would be obvious. These recurring payments would

make INCRA vulnerable to the interests of the Funders. On the contrary, if the Funders have committed to give long-term support and pledged not to reclaim their endowment, their influence would be much more limited.

Governments as Funder

Many observers feel that governments should not be allowed to finance a CRA that would issue sovereign ratings because of possible or, at least, perceived conflicts of interest. But is this assessment completely fair? Several examples exist of governments' funding institutions that rule on possible actions by those governments; one widespread example is the court system. Judges, after all, are paid by the governments they serve, and often rule against their "employers".

Nevertheless, in many countries the judges are regarded as independent, even if they have to decide a case in which the government is a claimant or a defendant. Why does this model of financing the courts obviously work – at least in many countries – although the same conflict of interest ("who pays the piper calls the tune") exists? There are two main reasons: (1) the judges have had the opportunity to establish a good reputation; (2) usually there are rules that guarantee the independence of a judge: Judges can generally be dismissed only in certain severe cases (e.g., crimes), but not because of their decisions, even if they are questionable from an academic point of view. The same would be true for a government's national bank.[2]

To categorically exclude governments as potential funders for a CRA focusing on sovereign risk seems unnecessarily limiting, given the fact that corporations are allowed to pay for their ratings under the current CRA system. Of course, INCRA would need time to build its reputation, and it would be necessary to ensure its institutional independence. Even if governments are involved in the funding of such an entity, it seems reasonable that a solution can be found to give the operational staff the independence that ensures credibility, similar to that of the courts or the central bank.

For these reasons, a partially publicly financed CRA should not be taboo but be possible. At the same time, it is important that conflicts of interest (real or perceived) be minimized by means of diverse sources of funding and by rules that ensure the organizational independence of INCRA. Ultimately, INCRA's success could mark a paradigm shift in the sector by convincing investors that states can participate in the private market.

In addition to governments, multinational organizations such as the World Bank and the IMF (labelled as "supranationals" in the CRA world) would also qualify as funders. They have an interest in improving the assessment of sovereign risk to base their investments in or their loans to specific countries on a more solid and comprehensive footing. The ratings provided by INCRA could serve as a source of risk analysis in addition to the in-house analysis on which these organizations rely.

If governments would be among the funders of INCRA, the following rules would minimize the conflict of interest:

- ***Minimal influence of governments on the entity*** (e.g., public funding by the World Bank, the IMF, or the European Central Bank, or other international organizations or supranational institutions such as the EU may help to mediate attempts to influence INCRA by single governments).
- ***The greater the representation of different national governments and governmental institutions among the funders, the less likely they would be to apply pressure to alter the rating of a particular sovereign borrower.*** Indeed, in these circumstances it is more likely that they would seek an independent assessment process and a uniform application of criteria.

For governments and supranational institutions, INCRA could be an answer to the risk of "market failure" in the field of sovereign ratings. As "objects" of sovereign and supranational ratings, they also have an interest in increasing transparency and legitimacy in the rating process, as well as in increasing the number of credible CRAs.

Civil Society Funding

As much as the involvement of governments in the CRA world is seen as taboo, civil society actors have played an equally minimal role in the financial sector. At present, civil-society actors do not exhibit any influence in the rating industry. Representatives from the field are conspicuously absent from the board of directors of CRAs.

But why are civil-society actors so under-represented in the financial sector? For one thing, there is a lower potential for emotion-based mobilization. Finance is a "dry affair" and more emotionally charged issues like peace, human rights, or the environment offer easier affective attachment. The abstract nature of banking and macro-finance doesn't help either, which makes the hurdle relatively high to translate passive animosity and frustration into an active involvement.

There is also what could be called the "complexity-attractiveness" issue. Activists have to overcome relatively high barriers to enter the discussion on financial issues and to be taken seriously by experts. If activists invest in this costly endeavour, they encounter a wide salary gap between civil society and business, and many experts thus get drawn into the financial sector, which leads to a "brain drain" of leadership personalities in civil society.

Representatives of the sector, such as NGOs or foundations, have dual independence that makes them attractive as funders. They are financially and politically independent from the market and the ballot box. This means that they possess sufficient autonomy, which can be paired with expert knowledge and generate a high degree of legitimacy over time. These representatives could interconnect the mobilization potential of member organisations with the political expertise and know-how of think tanks (like *YouFinance* or *Oikos*) and consumer advocacies.[3]

NGOs and foundations have the ability to help generate structural folds connecting the two segments of civil society and international finance. A structural fold would help mitigate the complexity-attractiveness problem by implanting civil-society experts inside the financial system. By holding a distinctive network position at the intersection of the two groups, they are able to facilitate the exchange of ideas and may build a common normative framework through inter-cohesion.[4] INCRA could be at the center of such a fold. Thus for NGOs, foundations, and individual donors, funding a non-profit CRA could be seen as an "investment" in the improvement of financial global governance under the aspects of transparency and legitimacy.

Corporate Funding

Funding INCRA by for-profit corporations would be seen as a measure of corporate social responsibility – an "investment" in a system that aims to improve sovereign ratings and the public's perceptions of credit rating agencies. The corporate sector has a key interest in improving the quality of sovereign ratings that are crucial for many of their investments, as well as operational business decisions.

To have a convincing funder base, INCRA would rely on investments from all the groups listed above. ***A broad and international funder base would be the best insurance for INCRA to operate on the basis of broad public support.***

Funding – the endowment solution

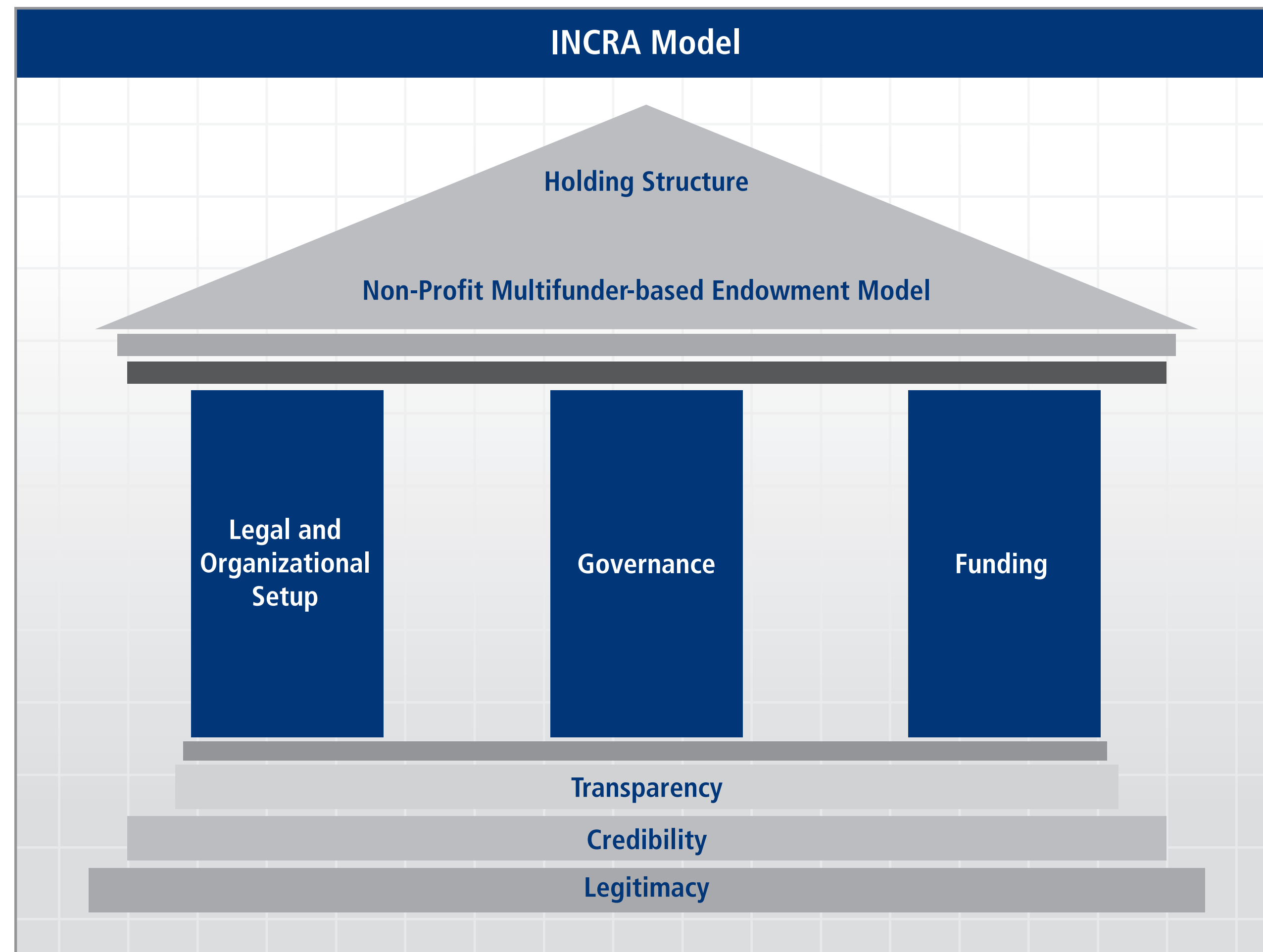
The financial basis of INCRA needs to give the entity a high degree of security for its long-term existence. Additionally, possible conflicts of interest between the funders and INCRA's operational management would need to be minimized.

As mentioned above, if INCRA has to ask its funders every year for financial support for the next business year, its dependency and vulnerability is obvious. Therefore, an annual or biannual financial funding model for INCRA is not desirable. But if the funders have already given adequate support for a long period their influence is much more limited. Consequently, an endowment would best underline the independence of INCRA from the financer. ***An endowment of about US$400 million would guarantee INCRA's long-term existence.*** The business plan for INCRA lays out further financial details.

Creating sustainability and certainty through an endowment

As indicated above, the endowment should be defined by the funders as an investment. ***This investment would provide each funder with a contingent claim, so in case INCRA does not deliver on its business model, which could be evaluated after the first five years of its existence, the funders would get their money back.*** To ensure INCRA's real and perceived independence from its funders, the Stakeholder Council would be tasked with putting rules and regulations in place for an outside evaluation.

The administration of the endowment should take place under the "prudent investor" rule and be managed by a blind trust. The portfolio of the trust will be highly diversified (e.g., no more than one percent allotted to each investment) to avoid conflicts of interest between the funders and the investments of the endowment. The endowment would be held in a separate, remote entity to ensure its protection in the event the operating subsidiary or holding company is held financially liable in a legal or regulatory action.



MANAGEMENT AND BUSINESS PLAN

The business plan for INCRA should be that of a truly global entity, which means it would have offices in Europe, Latin America, Asia and the US. When considering where to locate regional offices, it is important to look at the amount of local expertise, financial-market structure, labor laws and costs associated with maintaining an office and staff in those cities. Wherever the funders decide to set up the holding structure, all regional offices would play an equal role in the management of the operations and the rating process.

The key for the success of the operation of INCRA would be the quality of its analysis. Therefore, it is of utmost importance that it be based on ***a senior staffing model.*** This means that analysts with more than 10 years of experience would need to be hired as senior analysts. They would oversee a team of junior analysts. In total, 13 senior analysts and 13 junior analysts would need to be hired in the startup phase. By year four, INCRA would be staffedwith 20 senior analysts and 20 junior analysts. The average sovereign portfolio size per senior analyst would be eight countries, with approximately 100 ratings conducted by INCRA by the end of year one of its incorporation. It would be important that staff members have an international background and, at a minimum, hold degrees in economics with additional study or experience in political science.

The staff of INCRA would be overseen by an executive team that consists of a CEO, a CFO, CAO and a CMO, who would be based at the headquarters of INCRA. INCRA would need to offer competitive salaries and benefits for its entire team to attract highly qualified experts.

Country-rating committees would be made up of analysts from all of INCRA's regional offices. Analysts would be reassured that they are considered genuinely independent in their thinking and voting and that their views would not be held against them by their superiors. ***After a country committee would deliberate and vote on a rating, their votes (but not the identities of the analysts who cast each vote) would be made public. This would give investors a sense of the confidence that INCRA has in each rating, which provides an additional layer of information for investors to evaluate.***

The profits that INCRA would generate by conducting research after the first year of its existence would be used to supplement the endowment to consider setting up additional offices in regions such as the Middle East and Africa, in the mid- and long-term future.

In a year-long startup phase the offices would be set up in the four key regions, and the legal framework under which the different entities would operate would be approved. The nearly US$14 million for the year-long startup phase of INCRA must be defined as an expense provided by the core funders that have agreed to support the institution from the beginning.

Given the fact that INCRA provides analysis on sovereign risk by merging macroeconomic indicators with forward-looking indicators, the investments in the development, execution and presentation of the rating products would require an investment of approximately US$2 million during the startup phase.

INCRA would then rely on an operational budget between US$15 million at the first year of its existence, up to nearly US$25 million at year five of its operation. ***To ensure this budget, the endowment size, based on a five percent rate of return, would need to be around US$ 400 million*** (assuming that the year 5 projected net expense establishes a reasonable running rate for the enterprise).

CRA Projections
Sovereign and Supranational Ratings
Financial Summary in US$

REVENUE	STARTUP	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Total Number of Staff *(End of Pd)*	37	44	44	54	58	58
of which Senior Analytical (End of Pd)	13	13	13	18	20	20
Total Number of Ratings Assigned	-	100	111	137	156	156
of which Sovereign Ratings	-	100	100	118	128	128
of which Supranational Ratings	-	-	11	19	28	28
Sovereign Rating Revenue	-	-	-	-	-	-
Supranational Rating Revenue	-	-	-	-	-	-
Subscription Revenue	-	-	413,400	1,273,272	3,095,539	4,560,761
Total Revenue	0	0	413,400	1,273,272	3,095,539	4,560,761

EXPENSE	STARTUP	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Total Direct Salary and Benefits	7,668,750	10,978,500	11,323,000	14,781,416	16,787,470	17,527,406
External Consulting	-	1,216,800	1,265,472	1,695,732	2,053,102	2,189,975
Real Estate	1,153,752	1,599,870	1,663,864	2,224,447	2,313,425	2,405,962
Technology and Operations	1,023,670	258,749	255,773	534,926	358,254	349,030
Rating Product Development	2,000,000	250,000	260,000	270,400	281,216	292,465
Marketing, PR and Advertising	100,000	150,000	166,000	199,280	206,851	214,725
Legal and Compliance	1,000,000	250,000	260,000	270,400	281,216	292,465
Other Professional Fees	-	100,000	104,000	108,160	112,486	116,986
Travel and Related	590,000	613,600	670,592	798,653	912,490	948,989
Stakeholder Council	150,000	156,000	162,240	168,730	175,479	182,498
Total Expense	13,686,172	15,573,518	16,130,942	21,052,144	23,481,989	24,520,500
Net Income/(Expense)	**(13,686,172)**	**(15,573,518)**	**(15,717,542)**	**(19,778,872)**	**(20,386,449)**	**(19,959,739)**

CRA Projections
Sovereign and Supranational Ratings
Endowment Funding Request

FUNDING REQUEST	STARTUP	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Net Income/(Expense)	(13,686,172)	(15,573,518)	(15,717,542)	(19,778,872)	(20,386,449)	(19,959,739)
Endowment Rate of Return	5%					
Endowment Requirement	399,194,775					
Start up Funding	13,686,172					
Total Funding Request	412,880,948					

OPERATING PERIOD	ENDOWMENT VALUE	RETURN	CRA NET INCOME
Year 1	399,194,775	19,959,739	(15,573,518)
Year 2	403,580,996	20,179,050	(15,717,542)
Year 3	408,042,503	20,402,125	(19,778,872)
Year 4	408,665,757	20,433,288	(20,386,449)
Year 5	408,712,595	20,435,630	(19,959,739)

METHODOLOGY AND INDICATORS: A WIDER VIEW

How to rate sovereign risk in a new way

The global financial crisis exposed flaws in the methodologies used by the big three CRAs, particularly in the area of structured finance. These inadequacies were a key contributor to a misallocation of capital on a grand scale[1] and the dramatic results of this imperfect system included the collapse of financial giants AIG and Lehman Brothers. As the US real estate crisis morphed into a global financial crisis, no CRA gave a timely warning regarding Europe's sovereign debt crisis, which eventually engulfed Greece, Portugal and Ireland, with its reverberations still being felt today.

In the wake of these crises, rating agencies, institutional investors and government oversight bodies have tightened their standards dramatically for judging creditworthiness, with the assessment of sovereign credit risk being particularly impacted. Without a fundamental reform of the system for rating sovereign debt, we are likely to be plagued, once again, with crises in the future. In an ideal world, sovereign-debt ratings should be robust enough to withstand pressures emanating from prevailing financial or market conditions. This raises analytical issues as well as issues regarding the structure of rating agencies themselves, particularly surrounding potential conflicts of interest. ***In order to maintain confidence in sovereign ratings going forward, two factors are required: 1) introduce more forward-looking socioeconomic indicators into the sovereign rating process; and 2) reduce any concerns regarding potential conflicts of interest, either actual or perceived.***

One criticism of rating agencies, which is at the core of the concern regarding potential conflicts of interest, is the fact that CRAs are paid by issuers. There is widespread concern that the profit motive might contaminate the decision-making process. This is not an accusation that such conflicts distort the CRA's analysis, but it is hard to remove these concerns as long as rating agencies are for-profit institutions. A non-profit structure, funded by a variety of sources, as described in the legal and organizational chapter of this report should successfully address this perceived conflict of interest. ***In a sense, the proposed international non-profit credit rating agency, INCRA, would be more an agency, in the truest sense of the word, than the for-profit firms that currently provide ratings, since INCRA's structure would be founded upon a broad spectrum of international stakeholders.***

In addition to reducing conflict-of-interest concerns, INCRA would attempt to provide superior ratings by aiming to deliver ratings and country reports that incorporate a more dynamic, multidisciplinary and forward-looking evaluation of sovereign default risk. It would try to avoid what often appears to many as a somewhat static approach used by traditional CRAs. Indeed, the big three rating agencies have themselves already begun to incorporate more qualitative factors into their analysis.

It seems intuitive that a more comprehensive and transparent evaluation of a country's willingness and ability to repay its debt ought to place more emphasis on non-traditional sovereign-risk indicators that are likely to capture, more fully, political and socioeconomic dynamics over time, and especially through business and political cycles.

GOALS OF THE NEW INDICATORS

The overarching goals of the new set of indicators, which would be used in addition to traditional macroeconomic factors, would be to more accurately reflect the socioeconomic, institutional and political underpinnings of the country over time, and thus better align them with the needs and expectations of investors.

For many years, a focus of discussion within the global investor community has been how to consider those factors, which go beyond simply measuring a country's macroeconomic reality. Sophisticated investors are already developing their own indicators to include so-called *sustainability factors* in evaluating sovereign risk, such as Bank Sarasin in Switzerland.[2] The big three CRAs are also rapidly moving in this direction, albeit to outside observers such attempts have lacked adequate transparency, and as such lay open the traditional CRAs to accusations, whether real or imagined, that their ratings are not based on a comprehensive, underlying methodology.

No less important, these new indicators aim to include changing perspectives and expectations of investors by better accounting for the stability of a country's political leadership and taking into account the nature of each country's civil society. For years, the global investor community has been discussing the inclusion of such forward-looking indicators, especially those of a socioeconomic nature. In 2005, the UN Secretary-General launched the landmark initiative to develop the Principles for Responsible Investment, which were unveiled in an early version in 2006. As of March 2012, over 1000 investment institutions had become signatories, with assets under management of more than US$30 trillion.[3]

Another example where investors are relying increasingly on novel indicators, in particular those that have a sustainability component, is the 35 percent growth in the European high-net worth individuals (HNWIs) sustainable-investment market over the two-year period since the data was previously collected in 2010.[4] In fact, 53 percent of total socially responsible investment is made in sovereign bonds, indicating that investors have an interest in new indicators and sovereign debt.[5] The European Sustainable Investment Forum (Eurosif) predicts that the investment in sustainable portfolios will increase in 2013 by a further 15 percent, accounting for almost €1.2 trillion.[6]

All these efforts can be viewed from a normative ("Can we protect the world against destructive shocks of the financial markets?") and analytical angle ("Are there non-economic factors that influence the debt-burden capacity of sovereigns?"). Under either viewpoint, there is sufficient rationale to include specific indicators of a social, political or environmental nature in sovereign risk analysis. The SGI (Sustainable Governance Indicators) and BTI (Bertelsmann Transformation Index) have already established a number of explicative indicators. All such indicators considered by INCRA share a forward-looking element regarding socio-political developments, complementing the groundwork of macroeconomic variables. It is hoped that as a result, these indicators would add another dimension that improves the predictive quality of the final rating outcome.

THERE IS NO PERFECT SET OF INDICATORS

Given the variety of circumstances facing different governments and their differing stages of economic development, and the non-forecastability of trigger points, it is impossible for one set of indicators to perfectly reflect sovereign credit risk across all countries.

Just as there is no perfect set of indicators, no organization has found a good forecasting model capable of signaling financial crises, never mind sovereign default. There have been too few countries that have defaulted and too few crises to allow anyone to construct such a model. This is why INCRA needs to have an experienced team able to interpret data and arrive at subjective probabilities in their analysis, and thus construct a rating.

INCRA would utilize the most up-to-date data sources. As outlined, INCRA would have offices in the US, Europe, Latin America and Asia, which would serve as analytical hubs and data-collection centers. These regional offices would work with local experts, including academics, investors and industry professionals, to gather data for the country report. This on-the-ground expertise should enable INCRA to provide nuanced analyses.

The IMF's Early Warning Exercise (EWE)[7] uses macroeconomic indicators similar to those proposed here, but has not yet been able to develop analytical tools to quantify "vulnerabilities" and "triggers", tail risks, and the like. Methodologies, such as probit models or non-parametric techniques, are missing. As stated by the IMF publications series: "Even a perfectly designed EWE may give rise to too many false alarms."[8]

Neither the 1997 East Asian crisis, nor the global financial crisis of 2008, would have been forecasted by the EWE.[9] EWE exercises have been unable to predict the outbreak of a crisis because they cannot predict event risk or tipping points. Furthermore, apart from global and regional crises, country-specific sovereign crises have never been flagged by the IMF.[10] For instance, in the IMF's Article IV consultation reports for Greece, the reports in advance of the crisis were silent on the potential for a Greek default.[11] It is argued that the IMF was and remains anxious not to trigger so-called self-fulfilling prophecies or to cry wolf at the wrong moment. As such, even the IMF is perceived as subject to potential conflicts of interest.

By definition, a crisis must come as a surprise. Otherwise, it is only a problem that can be dealt with. Similar to scientists' inability to predict earthquakes, the best institutions and processes cannot predict all events. Although CRAs have been working on developing a better set of indicators, they have been continually chasing and analyzing the last crisis. Nonetheless, that is important to do, because at least now, CRAs can avoid and better predict those crises whose origins are similar to past crises, through identifying and assembling warning signs. ***The intention for INCRA is that it would be able to better signal coming crises before they happen, with investors and issuers knowing that INCRA has no other agenda but to provide independent, conflict-free opinions.***

While there is no perfect system, there is clearly room for improvement. The proposed indicators set would be disclosed ahead of time and deployed in a transparent voting process by the country committee. This committee would not tie its hands by using a rigid numerical weighting system that keeps a blind eye to political ingredients for sovereign risk, such as the willingness or unwillingness of a government to tax the private sector to meet its debt service obligations. It is worth noting that most CRAs rely upon information from their analysis of corporate bank debt when they compile sovereign ratings. INCRA would not produce ratings and would not have access

to the same kind of information. But the resulting clear, sophisticated assessment – based on a code book that explains the process and identifies sources of information – would reduce subjective biases and improve the quality of sovereign ratings.

WHAT WOULD INCRA RATE?

INCRA would rate only national government securities, and then supranationals[12] after the first year of its existence. Therefore, no general transfer risk assessment would be required, as would be the case if a broader universe of securities were being rated, such as bonds issued by corporations or sub-national governments. If non-sovereign debt is rated, then a government bond's foreign-exchange risk would become relevant in determining the risk of potential exchange controls that might limit a borrower from repaying outstanding debt in foreign currency. While INCRA would not explicitly rate the banking sector, the rating committees would take into account the soundness of that sector in rating each country's debt.

Forward-looking indicators would increase the likelihood of signaling coming crises

Countries are eligible to be included within the potential universe of ratable governments as long as data is available and the country has issued bonds. See the annex for the 162 countries at present deemed eligible to be rated, based on their World Bank per capita gross national income level division: low income, US$1,005 or less; lower middle income, US$1,006 - US$3,975; upper middle income, US$3,976 - US$12,275; and high income, US$12,276 or more.[13] ***Since INCRA is not based on the classic for-profit structure for ratings, the agency is therefore not dependent on solicited sovereign ratings.***

Issuing unsolicited ratings were common practice for CRAs in the 1980s and 1990s. However, following the widespread outcry against unsolicited ratings, the major CRAs dramatically reduced, if not eliminated, producing new unsolicited ratings. As a result of problems with structured finance ratings, the US in 2010 adopted the Dodd-Frank Wall Street Reform and Consumer Protection Act, which not only encouraged rating agencies to provide unsolicited ratings but also supported an environment where agencies could, and would, disagree on their ratings.

Conducting unsolicited ratings does not mean that there is no contact with the issuer, or in the case of sovereigns, with the government. Quite the contrary is true. From the moment governments are made aware that a rating process is underway, they have a vested interest in keeping lines of communication open, and have almost invariably cooperated in the rating process with the traditional CRAs, even for unsolicited ratings.

INCRA would collect primary data through its own experts' assessments. Additionally, its highly skilled research team would collect relevant data from governments and from other publicly available sources.

The practical time horizon of ratings would be three to five years, in keeping with both accepted practice by other rating agencies and investor expectations, as well as with the available statistical data provided by the IMF and similar institutions. A shorter time horizon for rating medium- to long-term bonds would likely lead to more volatile ratings, and as such would create problems for many investors. If ratings change often they usually have a mandatory effect on buy-sell decisions because of internal investment guidelines.

In its second year of existence, INCRA would begin producing unsolicited ratings for supranational institutions. There are many analytical overlaps between the ratings of sovereign governments and supranationals. In general, sovereign analysts are the best qualified to rate supranationals. Many countries that are rated are, at the same time, members, shareholders and clients of supranationals, such as the World Bank or the various regional development banks. Therefore, the sovereign-risk analysis of these member countries has a significant impact on the performance and stability of these entities. Given the fact that there are no regulators for supranationals, these institutions have a vested interest in external risk analysis.

INCRA would release the following ratings:

- Medium/Long-term Local Currency Government Bond Rating
- Short-term Local Currency Issuer Rating
- Medium/Long-term Foreign Currency Government Bond Rating
- Short-term Foreign Currency Issuer Rating

How were the indicators chosen?

The indicator-selection process began with traditional macroeconomic indicators such as net lending, export volume and debt service. The objective was to screen all the macroeconomic indicators available and strip the list down to those that are absolutely necessary, avoiding too many positive correlating indicators and insuring limited duplication.

There are a number of possible sources for both macroeconomic and forward-looking indicators, including the World Bank, the IMF, data released by national governments themselves and the INSEAD Innovation Index. These indicators can be cross-referenced with data sets relied upon by private investors.

Although the soundness of the banking sector is not summed up by any individual indicator, the country-rating committees in their final analysis would take into account the soundness of that sector and its relevance to that country's creditworthiness. Unlike any other sector, banks represent a special contingent claim on national governments because of their immensely important intermediary function between the savings and investment decisions of governments, companies and households. If they cease to function, an economy grinds to a halt. If a banking system's weakness is only centered around its foreign-currency position, then a country's creditworthiness against foreign lenders on an orderly basis is potentially at risk.

In analyzing such issues, a single framework is not applicable across countries. Much depends on the country's general governance structure for its banks. For instance, even in high-income countries, it recently became obvious that the sovereign's creditworthiness was seriously damaged by problems centered in the banking system, and not by the government's fiscal position. Still, there are other countries where banking-sector problems have not caused crises.

In the case of Icelandic banks, the financial crisis was caused by their foreign asset and liability position. This is a problem usually faced by emerging-market country banks, where foreign currency-denominated debts are the root cause of the crisis. By contrast, in Ireland the problem centered around a deterioration in domestic credit quality emanating from a collapse in the property market. Despite the fact that the root cause was different, banking crises in both countries played havoc with each government's own creditworthiness. However, this was true only because in both cases, banks were expected to remain solvent. This may seem a somewhat controversial statement, but expectations regarding the need for bank solvency depend on a country's traditional expectations regarding how banks in that country should operate.

When it comes to local-currency debt in particular, bank solvency is not necessarily required. Even when looking at foreign-currency debt, as long as the net foreign-currency asset/liability position of a bank is equal or positive, then even if the overall bank is insolvent, there is not necessarily a problem. There are many examples around the world where bank insolvency has been contemporaneous with economic stability, and even rapid economic growth, such as China and Japan. Even the largest banks in China and Japan in the past would have been judged insolvent, sometimes for long periods of time, using Western accounting and business practices. However, the governments in both countries used accounting forbearance and central bank action to prevent problems internal to the banks from creating a financial crisis similar to the one in Ireland.

Given that national policies may differ across countries and over time, it is necessary to determine not only the level of contingent liabilities embedded in the banking system, but also to make judgments about how such contingent claims might be dealt with by a specific government, and then how such policies might affect the overall economy, and therefore, a government's creditworthiness. For countries that participate in IMF Article IV consultations, as discussed earlier, INCRA would review these reports, and other pertinent sources of information, to gain a perspective on the country's banking situation.

THE NEW SET OF INDICATORS

The ambitious goal of merging forward-looking indicators with the traditional macroeconomic factors for rating sovereign debt is necessary because, as the United Nations Conference on Trade and Development (UNCTAD) writes, "the people who borrow the money are not always the people who must pay it back. In this lie grave risks and heavy responsibilities. Separating the sweetness of borrowing money from the sourness of having to repay it contradicts a basic principle of justice – that the consequences of an act should fall on the actor, not on an innocent third party. Licentiousness, whether of the moral or the financial variety, is at least occasionally held in check by this principle."[14]

Given this inherent problem, INCRA must assess not only a government's ability to repay its obligations, but the political will and socioeconomic capacity to meet debt service in the medium term. For instance, demographics may play a vital role in limiting the debt capacity of a country. Not only the shape of the demographic pyramid but also health, the quality of education and social mobility help determine the cash flow that a government can generate – the key variable for debt amortization and interest payment.

The new indicators make no value judgment as to the type of government in place, as long as debt repayment is not impaired by the political structure. For instance, an authoritarian government with high legal certainty and a low level of corruption can be creditworthy despite lacking political liberties and civil rights often viewed as desirable. By contrast, a highly democratic government can experience difficulty mustering the political will to instill fiscal order and repay government obligations in full and on time. The indicators are concerned only with factors that lead to transparency, accountability, effectiveness and predictability of decision making, rather than judging the relative superiority of any particular form of government.

Another important factor in analyzing a government's creditworthiness is an analysis of the country's economic history. History shows that countries whose governments have defaulted are more likely to use default as an option than countries without a history of default. Some countries, like Greece or Argentina, can even be labeled as *serial defaulters*.

The new indicator sets would be used transparently and made available to investors. For instance, although rating committees would weigh the indicators using the guidelines, the outcome would be nuanced by the experience and breadth of knowledge of committee members and would be made fully transparent in the final analysis.

INCRA merges macroeconomics and forward-looking indicators

INCRA would follow the existing letter-grade rating scales of the big three rating agencies (Standard & Poor's and Fitch use the same rating scale; in the US the SEC has proposed requiring a standard rating scale to minimize investor confusion). ***INCRA would also use the general CRA practice to signal possible rating changes, including rating outlooks and rating reviews.*** Communicating possible rating changes is important because many investors have internal investment guidelines, which may be tied to ratings. This is particularly important for securities rated at what is generally called the *investment grade* frontier (BBB-/Baa3 and BB+/Ba1).

INCRA would produce regular country reports, which would present a joint analysis of macroeconomic and forward-looking socioeconomic indicators. The timing of the reports would be regularly scheduled and would not be based on political events in a country, unless such events are so significant that they might change the government's credit risk. Even if the recent downgrades of European governments provoked a debate about the timing of publishing a rating change, one has to acknowledge that there is never a "right" or "wrong" moment for making a rating public, except when a rating committee judges that credit risk may have changed for the better or for the worse. Additionally, since INCRA would be issuing outlooks, rating reviews or rating changes should not come as a complete surprise to investors or governments.

Given the degree of detail embedded in the existing rating scales, it is possible to amalgamate the ratings into broader categories, which might make the ratings more understandable for the broader public. The following four rating clusters are envisioned:

- AAA to AA- (prime 1 investment grade quality/high investment quality)
- A+ to A- (prime 2 investment grade quality/medium investment quality)
- BBB+ to BBB- (prime 3 investment grade quality/low investment quality)
- <BB+ (speculative grade quality/speculative quality)

MACROECONOMIC INDICATORS*

* See the annex for detailed descriptions of each macroeconomic indicator.

1 GDP

- Nominal GDP (US$)
- Nominal GDP Growth (Local Currency %)
- Real GDP Growth (%)
- GDP per capita (current exchange rates in US$)
- GDP per capita (PPP basis: US$)

2 Country Specific

- Population Growth (% Change)
- Inflation-CPI (%)

3 Domestic Dependency

- Domestic Credit (% Change)
- Domestic Credit/GDP (%)
- Gross Domestic Investment/GDP (%)
- Gross Domestic Savings/GDP (%)

4 Government

- General Government Revenue/GDP General (%)
- General Government Expenditure/GDP (%)
- General Government Primary Balance/GDP (%)
- General Government Financial Balance/GDP (%)
- General Government Debt/GDP (%)
- General Government Debt/General Government Revenue (%)
- General Government Interest/General Government Revenue (%)

5 Foreign Dependency

- Real Effective Exchange Rate (REER)
- Real Exports (% Change)
- Real Imports (% Change)
- External Debt/Exports ratio (%)
- Short-term External Debt/Total External Debt (%)
- External Debt/International Reserves (%)
- Reserves to Imports (months)
- Foreign Exchange Reserves (US$)
- M2/Foreign Exchange Reserves (%)
- Debt Service Ratio (%)
- External Short-Term Debt + Current Maturities on Medium-to-Long External Debt/FX Reserves (%)
- Contractual Obligations on Outstanding Long-Term External Debt

6 Debt Related

- Current Account Balance (US$)
- Current Account/GDP (%)
- External Debt (US$)
- External Debt/GDP (%)

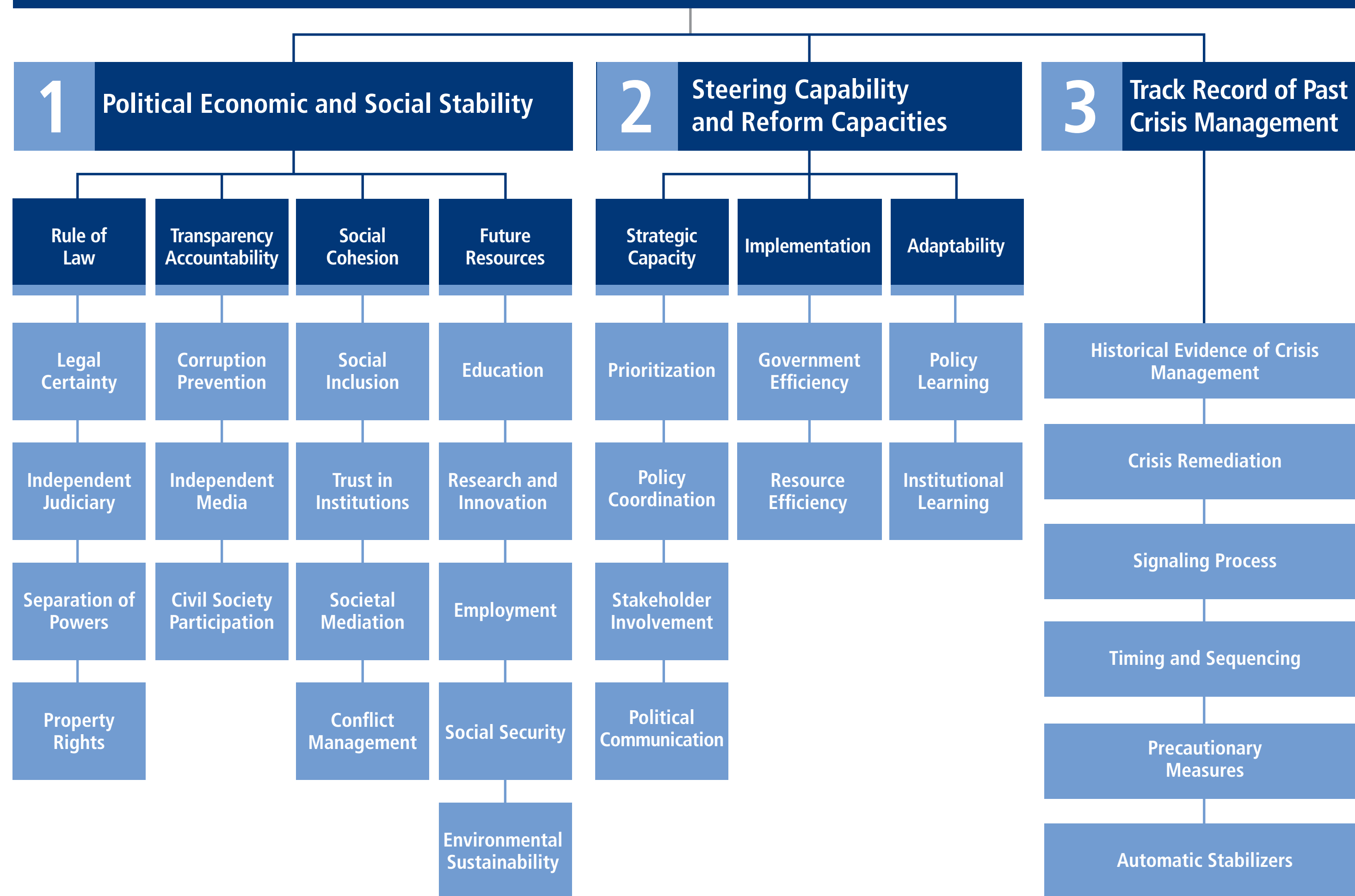
7 Liquidity Factors

- Liabilities Owed to BIS Banks Due within one year/Total Assets Held in BIS Banks (%)
- Total Liabilities Owed to BIS Banks/Total Assets Held in BIS Bank (%)

FORWARD-LOOKING INDICATORS

As already indicated for gauging a country's ***ability*** and ***willingness*** to repay its debts, it is necessary to take into account a broad array of indicators. Any meaningful assessment of a country's "willingness to pay" has to reflect the potential risk that even if the country has the *capacity* to pay, it may not be *willing* to pay if it judges the social or political costs to be too high. To capture this element, the indicators have to go beyond purely economic indicators to capture a meaningful picture of a country's long-term socioeconomic and political prospects and the potential political and/or social constraints on a country's ability and willingness to pay. For instance, aspects such as legal certainty, the effectiveness and transparency of institutions, governmental steering capacities, as well as questions of sustainability are crucial for assessing a country's long-term stability, reliability and predictability and thus have to be included in sovereign credit ratings.

The following section sketches out three basic thematic dimensions encompassing those "forward-looking" indicators that are essential for INCRA's analysis of sovereign debt. ***Forward-looking indicators are defined as indicators that depart from qualitative assessment of a country's institutional and socio-political status to make judgments on the future capacity and willingness of the country to service its debt.*** It is important to note that some macroeconomic indicators could also include forward-



looking elements as they are quantitatively available as forecasts or projections (such as debt composition in developing countries from the IMF Debt Tables.)

I: Political, Economic and Social Stability – Factors for Future Growth and Financial Reliability

This dimension encompasses those indicators that are essential for judging a country's long-term political and social stability, as well as its performance in delivering sustainable public finances and setting the right priorities for promoting future growth. In this regard, it is necessary to take into account the following forward-looking indicators, each of which can be measured through clear-cut qualitative indicators and (sometimes) additional quantitative data (see Appendix *Codebook*).

Political and Institutional Stability

A high level of legal certainty and institutional stability, as well as a clear commitment to the rule of law and independent media structures, are not just essential to the preservation of social capital and trust; such principles are also the foundation of a prosperous economy. Investors need to know whether government actions – and this also includes a government's approach towards servicing its financial obligations – are predictable. If the degree of legal certainty is limited – e.g., due to high levels of corruption, lacking institutional checks and balances or weak property rights – the predictability of a government is also limited and, as a consequence, the risk increases for investors to face financial embarrassments. Therefore, INCRA would measure these basic political requirements for judging a sovereign's predictability and reliability by using seven qualitative indicators:

1. Rule of Law

Legal Certainty: To what extent do government and administration act on the basis of, and in accordance with, legal provisions or culturally accepted norms to provide legal and practical certainty?

Independent Judiciary: To what extent do independent courts control whether government and administration act in conformity with the law?

Separation of Powers: To what extent is there a working separation of powers (checks and balances)?

Property Rights: To what extent do government authorities ensure well-defined property rights and regulate the acquisition, benefits, use and sale of property?

2. Transparency/Accountability

Corruption Prevention: To what extent are public officeholders prevented from abusing their position for private interests?

Independent Media: To what extent is the media independent from government?

Civil Society Participation: To what extent does the government enable the participation of civil society in the political process?

Socioeconomic Indicators – Preconditions for Social Stability and Future Growth

Social security and the ability to take part in economic life are among the preconditions for claiming individual, political and participatory rights. However, the subjective experience of marginalization can not only lead to economic marginalization but can also increase polarization between privileged and disadvantaged social groups, which serves to weaken social cohesion. If social polarization trends are becoming too extreme, the stability of a political system can be endangered – with negative effects for a government's ability to act in a long-term, oriented way. If a government's room to maneuver is severely constrained (e.g. the Greek government fears implementing necessary social reforms because of massive social protests), this is without doubt a negative feature from an investor's point of view. Reducing the various risks of social exclusion is thus a core task of social policy. The prevention of poverty and the provision of enabling conditions for equal opportunity in society are essential elements of such a policy. In order to achieve a high level of social trust and stability, governments are well advised to incorporate competing social interests and to foster cooperation between different groups.

In addition to indicators on social stability, this approach also comprises forward-looking indicators on a country's future prospects for growth and prosperity (Future Resources). These indicators go beyond questions of social and political stability but are clearly linked to these aspects.

Labor-market and employment policies. These policies are structurally and functionally linked with the economy. In addition to capital, labor is a central factor in wealth accumulation.

Fiscal sustainability of social security systems. With a view to a country's ability to serve its current and future financial obligations, social-security schemes should be based on distributional principles that do not erode the systems' fiscal stability. Accumulating public and private implicit debt is therefore undesirable. At the same time, social-security schemes should be effective in compensating for social risks and uncertainties; this contributes to the aim of ensuring social trust and stability.

Environmental aspects. "Sustainability" here assesses the extent to which specific forms of market failure, such as externalization of costs or inadequate time horizons, are avoided or restrained by environmental regulation. Moreover, it can be argued that long-term economic prosperity can be ensured only through careful energy use and the development of environmentally friendly manufacturing methods.

These, as well as other potential innovations, *require investment in research and development* and in the accumulation of specialized knowledge. Research and innovation policy promote the accumulation of economically relevant knowledge that is not specific to any one individual. The depth and breadth of a country's "knowledge capital" determine its future competitiveness and growth.

Finally, these forward-looking indicators also have to include the aspect of education. Educational attainment has a substantial effect on an individual's opportunity and capacity for self-determination, as well as on a society's future economic growth. Improvements and declines in educational performance have a profound effect on sustainability in absolute terms, as well as in comparison to other states.

3. Social Cohesion

Social Inclusion: To what extent is exclusion and decoupling from society effectively prevented?

Trust in Institutions: How strong is the citizens' approval of political institutions and procedures?

Societal Mediation: To what extent is there a network of cooperative associations to mediate between society and the political system?

Conflict Management: To what extent is the government able to moderate domestic economic, political and social conflicts?

4. Future Resources

Education: To what extent does education policy deliver high-quality, efficient, and equitable education and training?

Research and Innovation: To what extent does research and innovation policy support technological innovations that foster the creation and introduction of new products and services?

Employment: How successful is a government in reducing unemployment and increasing employment?

Social Security: To what extent are social security schemes based on principles of fiscal sustainability?

Environmental Sustainability: To what extent are environmental concerns effectively taken into account in both macro- and microeconomic terms?

II. Steering Capability and Reform Capacities

This dimension gauges a country's capacity to repay its debts by capturing essential indicators for assessing the effectiveness, efficiency, transparency and accountability of institutions and governmental processes. Any meaningful and forward-looking rating of a country's creditworthiness should take these indicators on political management into account. It is more than ever incumbent upon governments to react resolutely in the short term and to assess competently the long-term consequences of their political activity. The indicators in this dimension address the issue of the state's actual reform capability and ability to act; that is, the question of whether the quality of a state's political leadership allows it to identify pressing problems and formulate a range of strategic solutions, and thus advance sustainable policy outcomes. Political steering includes not only the activity of core executives, but also their interactions with other institutions and social actors in the various phases of the policy cycle.

5. Strategic Capacity

Prioritization: To what extent does the government set and maintain strategic priorities?

Policy Coordination: To what extent can the government coordinate conflicting objectives into a coherent policy?

Stakeholder Involvement: To what extent does the government consult with major economic and social-interest groups to support its policy?

Political Communication: To what extent does the government actively and coherently communicate and justify the rationale/goals of its policies to the public?

6. Implementation

Government Efficiency: To what extent can the government achieve its own policy objectives?

Resource Efficiency: To what extent does the government make efficient use of available human, financial, and organizational resources?

7. Adaptability

Policy Learning: How innovative and flexible is the government?

Institutional Learning: To what extent does the government improve its strategic capacity by changing the institutional arrangements of governing?

III. Track Record of Past Crisis Management

This dimension analyzes a country's institutional settings and procedural track record of managing past crises (if applicable) to capture a sovereign's capacity to deal with future crises. Learning from past crisis-management experiences, and the implementation of institutional changes constraining systemic imbalances that had caused former crises, enhances response options to tackle future crises.

Historical Evidence of Successful Crisis Management: Is there evidence from historical events that the country and its society have already mastered economic and political shocks?

Crisis Remediation: Does the political system facilitate crisis remediation in a timely manner?

Signaling Process: Is the signaling process among decision-makers (government, central bank, employers, employee representatives) so well established that confusion (and resistance) on the expected outcome of decisions by one decision maker on the others can be avoided or at least minimized?

Timing and Sequencing: Are there constitutionally anchored and politically accepted procedures for sequencing and timing of countermeasures in a crisis?

Precautionary Measures: Are precautionary measures (e.g., deposit insurance, foreclosure procedures) in place that can protect the most vulnerable groups against the full effect of a crisis?

Automatic Stabilizers: Are automatic stabilizers in fiscal policies sufficiently strong to contain surges of massive unemployment?

Operationalization of the Assessment

Operationalizing and measuring forward-looking indicators would rely on the established and tested methodologies of the Sustainable Governance Indicators (www.sgi-network.org) and the Bertelsmann Stiftung's Transformation Index (www.bti-project.org). The country ratings for the forward-looking indicators would be based on qualitative assessments of country experts. Statistical quantitative data drawn from official sources would be taken into account to contextualize the qualitative assessments. Country experts would access these indicators through an online database, allowing them to rely on standardized information.

Statistical data are often seen to be more reliable than expert opinions, particularly when they are collected by official institutions and by using methods that conform to cross-national standards. At the same time, however, such data often do not adequately cover the full meaning of a concept. Therefore, complex concepts can be measured best through the use of expert assessments that take the country-specific context into account and provide rich descriptions capturing the nuances of phenomena.

The codebook for operationalizing the forward-looking indicators that is part of this report's annex is designed to improve the validity and reliability of expert assessments through the use of different tools and procedural steps. First, many assessment questions are formulated so as to elicit detailed factual evidence rather than broad – and, consequently, more subjective – assessments. In fact, many questions ask for responses that may be cross-checked with responses to other questions, statistical data or data from opinion surveys.

Second, the codebook provides detailed explanations of and four tailored response options for each question. This information is intended to illustrate the purpose of a question, to structure the way the experts word their assessments, and to provide a standardized framework for the production of the country reports. The experts would be instructed to adapt the standardized response options to the individual context of the particular country they are evaluating and to substantiate their ratings (numerical assessment) with evidence in their country report. The rating scale for each question would range from 1 to 10, with 1 being the worst and 10 being the best. The scale is differentiated by four response options provided for each question. Although the written assessments do not allow for a direct reconstruction of the numerical ratings, they do provide an explanatory background for them.

Third, each country surveyed would be independently examined by several experts with established expertise in the respective countries. To identify subjective bias and reduce any distortion it might cause, the experts would be selected so as to represent both domestic and external views. The assessment process would be based on a clear and transparent review procedure, to ensure that all experts assess the questions independently.

WEIGHING THE INDICATORS

INCRA analysts would use a general framework for weighting the indicator set, with differences dependent on the per capita income of the country. The analysis would classify countries as high income, upper middle income or lower middle income countries, using World Bank classifications. If a country is generally stable, it would probably be more useful for investors to look at forward-looking indicators, since the outlook is not likely to change in the near future. For countries that are more susceptible to economic or political volatility, it would probably be more important to take macroeconomic indicators into account. Therefore, with such distinctions in mind, INCRA would analyze high income countries using approximately 60 percent forward-looking indicators and 40 percent macroeconomic indicators; for high middle income countries, the breakdown would be approximately 50 percent forward-looking indicators and 50 percent macroeconomic indicators; for lower middle income countries, the weights would be approximately 40 percent forward-looking indicators and 60 percent macroeconomic indicators. Again, these are rough guidelines and would not be fixed in all cases.

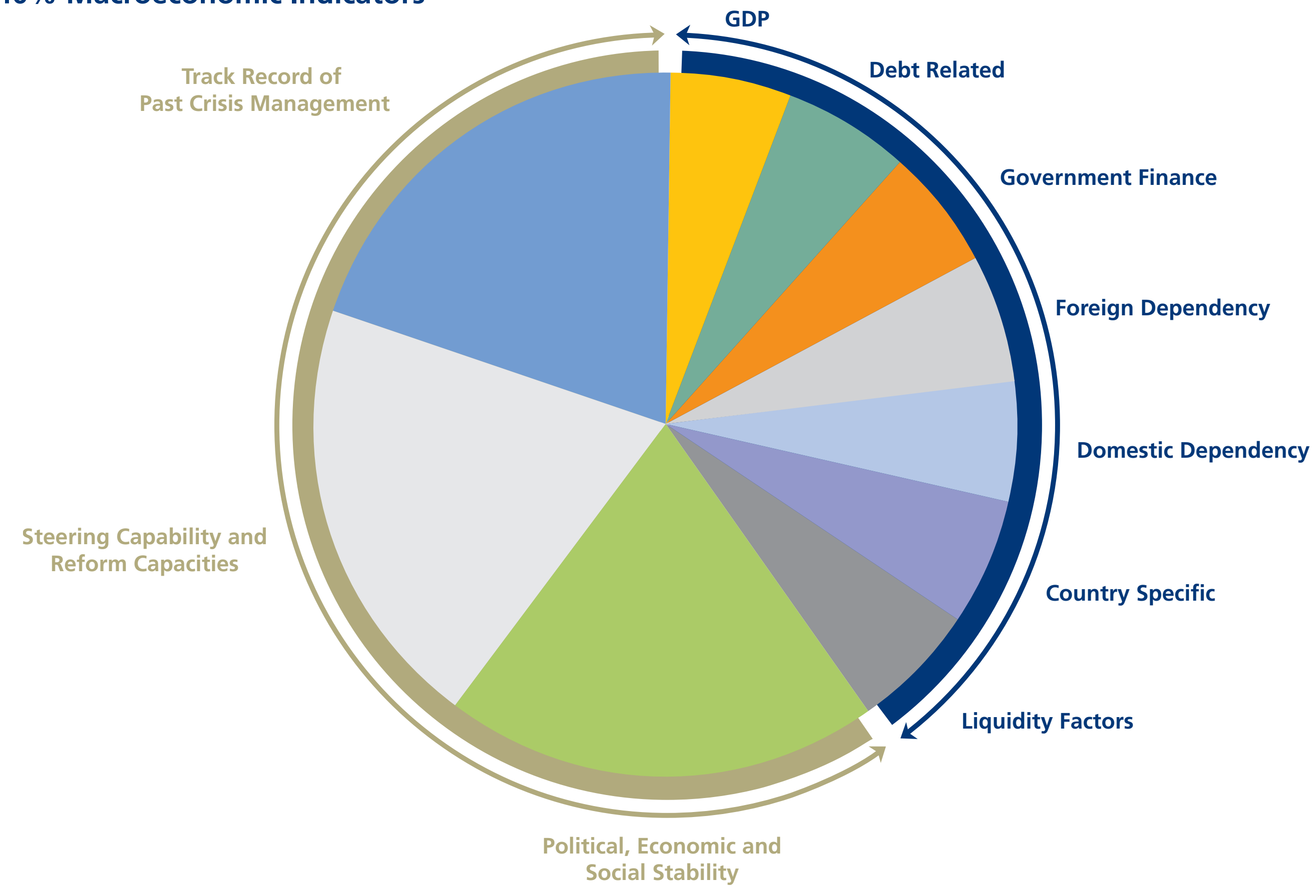
Comparisons between and among countries and regions are usually problematic. For instance, the assessment of "true" income-level differentials (purchasing power parity-based) is fraught with analytical problems. The US National Bureau of Economic Research (NBER) has published a working paper in which Purchasing Power Parity (PPP) income levels for China are revised significantly upward, compared to recent World Bank estimates.[15] One size does not fit all.

Giving forward-looking indicators a higher weight in high-income countries can also be legitimized by the fact that these countries contribute much more resources and political attention to distant developments such as ecological or demographic changes. ***In a nutshell: higher-income countries have lower time-preference rates than lower-income countries***. According to the Chinese proverb, "The rich man plans for tomorrow, the poor man for today."

Additionally, given the high levels of resource consumption and debt loan in high-income countries (much higher than in lower-income countries), there is a need to give forward-looking indicators a greater importance in higher-income countries.

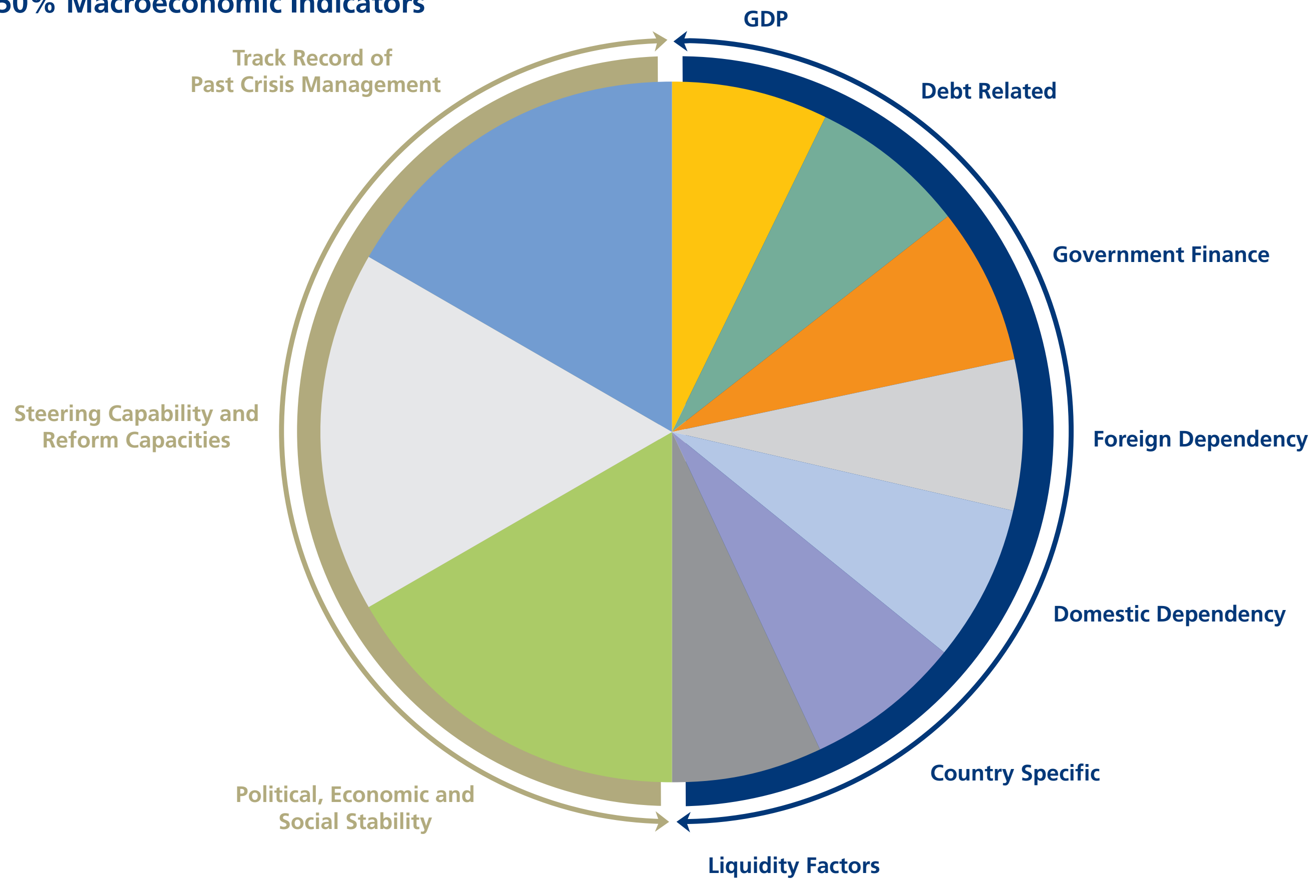
High Income Countries*

60% Forward-Looking Indicators
40% Macroeconomic Indicators



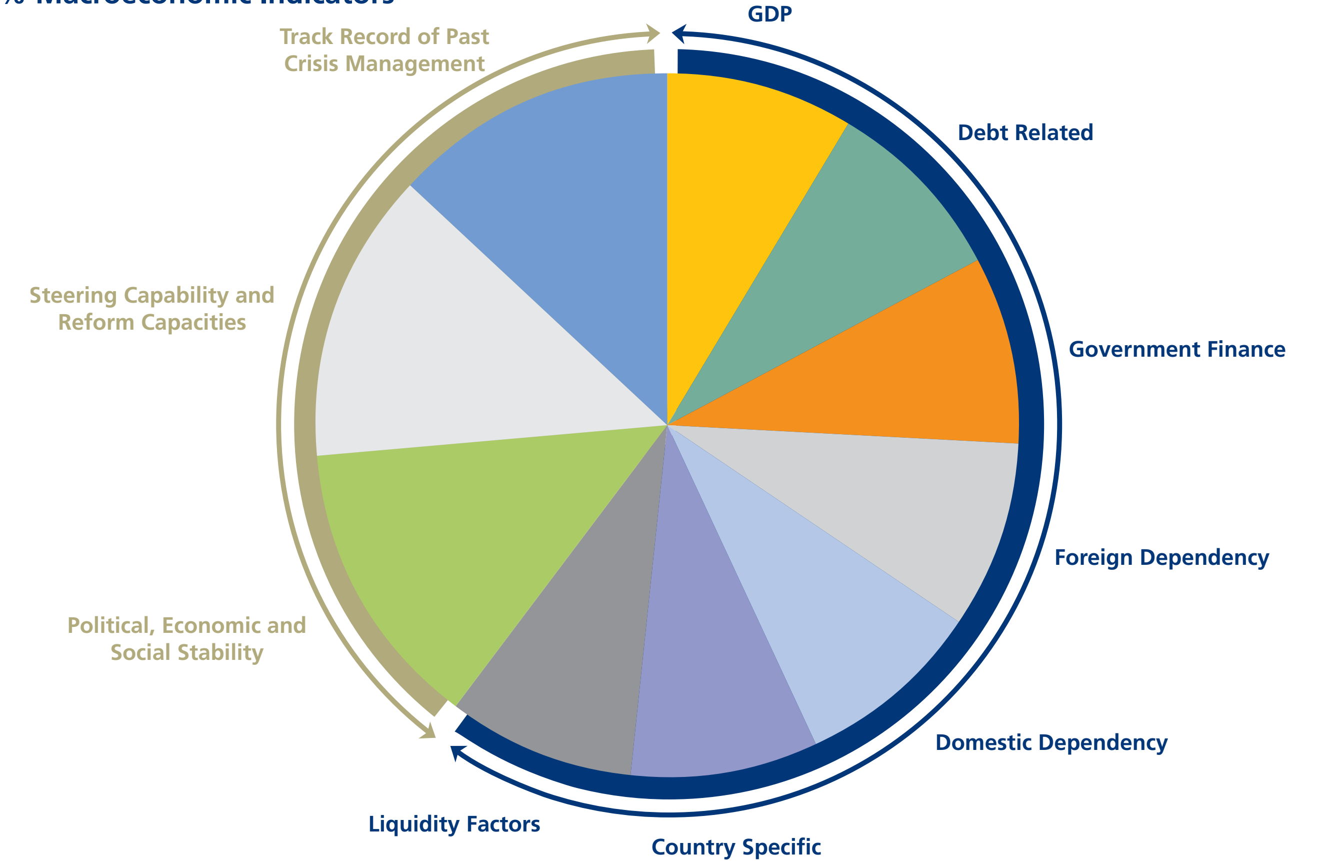
Upper Middle Income Countries**

50% Forward-Looking Indicators
50% Macroeconomic Indicators



Lower Middle Income Countries***

40% Forward-Looking Indicators
60% Macroeconomic Indicators



Qualitative Indicators | Quantitative Indicators

*According to the World Bank, GNI per capita is at or above $12,276
**According to the World Bank, GNI per capita is between $3,976 - $12,275
***According to the World Bank, GNI per capita is between $1,006 - $3,975

CONCLUSIONS

This report has shown that there is an alternative way to address the highly important and sensitive issue of how sovereign ratings are conducted. ***The proposed institution, INCRA, is an innovative solution that merges the changing demands and interests of investors assessing sovereign risk and the desire of governments and the broader public towards more transparency, legitimacy and accountability.***

INCRA, the international non-profit credit rating agency, would provide a new legal framework that is based on an endowment solution to guarantee its sustainability and security for long-term existence. Financially supported by a broad coalition of funders – from governments, corporate players, NGOs, foundations, and private donors – it would be an independent entity. INCRA would be based on a sound governance model that would minimize and buffer potential conflicts of interest through its Stakeholder Council, which separates the funders from the operational business. Furthermore it would increase transparency and legitimacy, due to its governance structure, operating procedures and international composition. This new institution can also pay tribute to the fact that the financial world needs greater buy-in and participation from different actors of society, first and foremost the non-profit sector.

To evaluate a country's willingness to repay its debts, a more comprehensive set of indicators is needed. That is why INCRA would conduct its sovereign-risk assessments using a set of macroeconomic and forward-looking indicators that will provide the basis for high-quality analysis. These forward-looking indicators will capture a meaningful picture of a country's long-term socio-economic and political prospects and the potential political and social constraints on its ability and willingness to pay. Therefore, INCRA would also be an incubator for best practices in sovereign-risk analysis.

The financial realities of the 21st century have already outpaced the transatlantic partners and their desire to work things out, either together or on their own. INCRA would reflect the realities of the globalized financial world, where the quality of sovereign ratings is crucial not only for Europe and the US, but also for emerging economies such as China and Brazil. The appetite for borrowing money will increase in the emerging economies, giving them a strong considerable motivation to establish a reliable framework to analyze their sovereign risk. ***Therefore, INCRA would guarantee the participation of all the relevant international players – it would be the first truly international CRA.***

But to create a more coherent international system for CRAs, whether they are for-profit or non-profit, a broader dialogue must be facilitated on how to overcome the irresponsible fragmentation of regulatory requirements around the world. ***That is why a broadly accepted and implemented international regulatory framework must be developed to oversee and govern the sector in the future.***

Of course, there are more challenges ahead to bring INCRA to life:

1. ***Investors need to change their organizational behavior.*** Most of them, besides their partial frustrations with the current system, rely on information from the big three CRAs. INCRA will be seen as the "new kid on the block" of the CRA world. Its model needs to convince investors that it will provide added value for their investment decisions.
2. ***Governments must take a stand.*** They must choose between further criticizing how sovereign ratings are conducted and reforming the system in a way that is convincing and sustainable.
3. ***Representatives of the non-profit sector, whether they are NGOs or foundations, need to be encouraged to play a meaningful role in the financial world.***

The G20 has already made clear that CRAs need to be reformed. It would be the best forum to evaluate the political will of the most important economic and financial players in today's world to give a new institution a chance – an institution that would be embedded in the markets but also in society.

The G20 could bring INCRA to life

Changing the current system requires bold and big thinking. INCRA is a big idea based on a reasonable operational concept. It would come with an endowment of US$400 million. At first glance this is a lot of money, but in reality it becomes a small, manageable investment if divided among multiple funders. In comparison to the hundreds of billions of dollars already paid for public bailouts (that have been the result of flawed corporate and sovereign-risk analysis) it is a moderate and safe call.

INCRA has the potential to become a cornerstone of a functional financial system of the future. What it needs now is the political will and support of visionary leaders around the world.

ANNEX

CRA Projections (ANNEX)
Sovereign and Supranational Ratings
Financial Detailed Summary in US$

REVENUE

SUBSCRIPTIONS	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Target Investors for Subscriptions	1,060	1,060	1,060	1,060	1,060
Penetration	0%	5%	10%	25%	25%
Number of Subscriptions	-	53	106	265	265
Sales *($15.000 per subscription + 4% inflation)*	-	826,800	1,719,744	4,471,334	4,650,188
Revenue *(assumes 6 months new sales effect)*		413,400	1,273,272	3,095,539	4,560,761
Total Revenue	0	413,400	1,273,272	3,095,539	4,560,761

EXPENSE

STAFFING & SALARY *(Competitive with peers in the industry)*	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Total number of Staff	44	44	54	58	58
CEO	1	1	1	1	1
Salary Expense CEO *($500.000 + 4% inflation)*	520,000	540,800	562,432	584,929	608,326
Other C-level *(CFO + CMO + CAO)*	3	3	3	3	3
Salary Expense Other C-level *($350.000 per person + 4% inflation)*	1,092,000	1,135,680	1,181,107	1,228,351	1,277,486
Senior Analysts *(full time equivalent)*	13.0	13.0	16.8	19.5	20.0
Salary Expense Senior Analysts *($350.000 per person + 4% inflation)*	4,732,000	4,921,280	6,594,515	7,984,285	8,516,570
Junior Analysts *(full time equivalent)*	13.0	13.0	16.8	19.5	20.0
Salary Expense Senior Analysts *($100.000 per person + 4% inflation)*	1,352,000	1,406,080	1,884,147	2,281,224	2,433,306
Other Staff	14	15	15	15	15
Salary Expense Other Staff *($50.000-$75.000 per person + 4% inflation)*	1,014,000	1,054,561	1,096,743	1,140,613	1,186,237
Benefits *(25% of salaries)*	2,177,500	2,264,600	2,829,736	3,304,850	3,505,481
Recruting Costs *(25% of first year professional salary)*	91,000	0	632,736	263,218	0
External Consulting *(20% of senior + junior salaries)*	1,216,800	1,265,472	1,695,732	2,053,102	2,189,975

REAL ESTATE *(Offices in US, Europe, Latin America and Asia)*	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Office Space Required *(7 - 11 square meter per person + common space)*	983	983	1,187	1,269	1,269
Price *($100 - $250 per square meter + 4% inflation)*	1,454,427	1,512,604	2,022,224	2,103,113	2,187,238
Utilities and Other *(10% of rental cost)*	145,443	151,260	202,222	210,311	218,724

INFRASTRUCTURE AND TELECOM	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Telecom Expenses *(3.600 per associate + 4% inflation)*	164,736	171,325	218,674	244,266	254,037
Technology Infrastructure	62,813	52,000	282,506	78,892	58,493
Other *(publishing, production and office supply)*	31,200	32,448	33,746	35,096	36,500

EXPENSE *(Continued)*

TRAVEL AND RELATED	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Total Number of Analyst Trips *(25% of rated entities)*	27	29	36	41	41
Expenses Analyst Trips *(10.000 - 15.000 per trip for 2 persons + 4% inflation)*	405,600	454,272	573,681	678,518	705,659
Investor Outreach Trips	8	8	8	8	8
Expenses Investor Trips *(10.000 - 15.000 per trip for 2 persons + 4% inflation)*	114,400	118,976	123,735	128,684	133,832
CEO Travel *(9 trips per year, 10.000 per trip + 4% inflation)*	93,600	97,344	101,238	105,287	109,499

OTHER EXPENSES	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Rating Product Development	250,000	260,000	270,400	281,216	292,465
Marketing, PR and Advertising	150,000	166,000	199,280	206,851	214,725
Legal and Compliance	250,000	260,000	270,400	281,216	292,465
Other Professional Fees *(accounting, audit etc)*	100,000	104,000	108,160	112,486	116,986
Stakeholder Council *(1 meeting per year, fees and travel expenses + 4% inflation)*	156,000	162,240	168,730	175,479	182,498
Total Expense	15,573,518	16,130,942	21,052,144	23,481,989	24,520,500

STARTUP PHASE

DIRECT SALARY, RECRUTING AND BENEFITS	
Analysts *(50% of year 1)*	2,925,000
Recruting Costs *(25% of first year professional salary)*	1,762,500
Other Staff *(CEO, other C-level and support staff)*	1,800,000
Benefits *(25% of salary)*	1,181,250
TECHNOLOGY AND OPERATIONS	
One Time Development *(data acquisition, website design and product development)*	675,000
Telecom	133,200
Technology Infrastructure	185,470
Publishing, Production and Office Supplies	30,000
OTHER EXPENSE	
Real Estate, 4 Offices *(US, Europe, Latin America and Asia)*	1,153,752
Rating Product Development	2,000,000
Marketing, PR and Advertising	100,000
Legal and Compliance	1,000,000
Travel and Related	590,000
Stakeholder Council	150,000
Total Expense	**13,686,172**

MACROECONOMIC INDICATORS

GDP

1. Nominal GDP (US$): Gross Domestic Product attempts to measure all value added of goods and services produced within a country's borders, but translated into US$ in order to allow for international comparisons. There are a number of deficiencies in using GDP, including the fact that it excludes income earned from foreign investment, which in some countries (especially mature and aging ones, like Japan) might be substantial. In these cases, the Gross National Product (GNP) is the better indicator. The GDP also excludes what some might call the informal or gray economy, or unreported economic transactions. In some countries, the informal economy is estimated to equal a third or more of GDP. Furthermore, GDP turns a blind eye to all economic activities that impair and damage the natural capital stock, such as environmental damages, or the human capital stock, such as health damages because of drug use.

2. Nominal GDP Growth (Local Currency %): This is calculated by comparing annual GDP growth measured in local currency using current prices. This is relevant to country risk analysis, because government finance is often more closely aligned with changes in nominal GDP rather than real GDP. Government expenditures and revenue are usually more sensitive (what economists call "elastic") to changes in nominal income than to real income. Changes in nominal GDP growth are an important factor in determining a government's fiscal position over time. In some countries, growth of nominal GDP is also becoming a target indicator ("internal anchor") for monetary policies.

3. Real GDP Growth (%): In order to measure the underlying change in a country's economic performance, we usually turn to real GDP growth, which is calculated by taking nominal GDP growth in local currency and removing changes in prices, as measured by the GDP deflator. The GDP deflator differs from the consumer price index in that it uses different weights for the components of the index. Real GDP growth is an important indicator because it captures the fundamental change in domestic economic output, and excludes inflation, which can distort the economic picture.

4. GDP per capita (current exchange rates in US$): This is just a simple ratio of nominal GDP measured in US dollars at the current exchange rate divided by the country's population. Since exchange rates are often volatile, annual changes in GDP per capita may also be much more volatile than GDP growth as measured in terms of local currency. This is a useful measure in that it indicates the relative income individuals may have to purchase products, which may be based on international prices.

5. GDP per capita (PPP basis: US$): For reasons of comparability of real income between countries, this is a much more important indicator than GDP per capita using current exchange rates. Purchasing power parity (PPP) attempts to take account of the fact that prices for non-tradables (such as labor-intensive services) differ substantially between countries while prices for tradables are subject to price convergence because of trade. In low-income countries prices for non-tradables are generally lower than in high-income countries. This is why income is usually much higher in low-income countries when international prices (or prices in the US) for non-tradables are taken as numéraire. Thus, such PPP income comparisons reduce the income gap between rich and poor countries. Measuring this is difficult, to say the least, and often is the subject of controversy. However, in general, despite concerns about the entire exercise, the figure produced by the World Bank is accepted as the norm. There are often large differences between this measure and GDP per capita in US$ using current exchange rates.

Country Specific

6. Inflation-CPI (%): The consumer price index measures changes in prices of a basket of goods and services used by an idealized consumer within the country. The nature of the basket can have a significant effect of the outcome. Generally the basket of goods and services is rebalanced every 3-5 years to capture changes in consumption patterns. The CPI index has often been used to index wages, prices, and government benefits. Although the CPI includes changes in food and fuel prices, many analysts, when discussing the CPI, exclude these items because they tend to be more volatile than other consumer prices. This narrower definition is often called the core rate of inflation. Since the CPI is narrowly focused on consumer purchases, analysts often prefer to use the GDP deflator as a measure of inflation since it includes all domestically produced goods, including capital goods and exports. In some emerging market countries, which lack good governance, governments have been known to manipulate the basket used to determine the CPI for political advantage. Discrepancies between CPI and producer price inflation (PPI) can give hints to hidden subsidies, for instance export subsidies in export industries. This is usually obvious to most analysts. Another reason that inflation is important for sovereign risk analysis is that inflation is the traditional way most governments have reduced the real burden of their existing stock of government debt. Low inflation or deflation makes rebalancing a government's fiscal position much harder, especially if it has a large debt burden. However, if inflation is excessive and moreover volatile, relative price distortions can occur, which are detrimental to economic growth. In the extreme, if hyperinflation occurs, where prices are rising at triple-digit annual rates, the economy is threatened with demonetization, where the real value of money collapses, as does output. Governments in recent decades have chosen, on several occasions, to prefer default to the risk of hyperinflation. A major shortcoming of measuring inflation through CPI is that it excludes asset price inflation and thus underrates the extent of liquidity, which can give rise to price bubbles in asset markets. CPI also neglects the contribution of quality changes to price movements. This is why statistical offices try to measure this effect through so-called hedonic price indices.

7. Population Growth (% Change): This is not a significant indicator for near-term analysis, but is relevant to the medium-to-long-term outlook for a country. High population growth is equivalent to a high dependency ratio (high share of young people in total population) and offers advantages in that the country is not likely to be burdened by a major pension problem for decades. On the other hand, a high rate of population growth in an emerging market economy puts stress on government finance through the need for greater education, medical care for the young, and infrastructure. In addition, a rapidly growing population requires significantly higher growth rates to absorb the growing labor force. A failure to achieve that may lead to political unrest over time.

Domestic Dependency

8. Domestic Credit (% Change): This is an important indicator of credit risks within the economy. In most countries where financial intermediation is intact, credit growth is usually concentrated within the banking system. A rapid rise in domestic credit is usually associated with a deterioration in credit quality, which can affect a sovereign rating. This is because banking system liabilities are usually considered a contingent claim on the government, since governments cannot allow a complete collapse of their banking system (implicit bailout). The more rapid the growth in domestic credit, the higher the probability that the contingent claim might become a real claim on the government.

9. Domestic Credit/GDP (%): This is a good measure of the overall depth of financial markets within the country. A higher ratio is usually associated with more advanced economies. If there is a high ratio in an emerging market country, this is possibly an indication of potential problems in the future in terms of implicit bailouts.

10. Gross Domestic Investment/GDP (%): Investment is generally defined as any expenditure that adds to the country's capital stock, including housing, infrastructure, plant, and equipment. A high rate of investment is generally associated with a high rate of economic growth in the future, since the capital stock forms the basis for producing goods and services in the future. However, another determining factor is how efficiently the capital stock is used. With decreasing returns to scale and thus with marginal productivity of the capital stock being lower than the average productivity, a high rate of investment does not guarantee a high growth rate in and of itself forever. A measure of the efficiency is the incremental capital output ratio (ICOR). If countries use their investment wastefully, then growth will be slower than it otherwise would have been.

11. Gross Domestic Savings/GDP (%): This is important in that ex-post, investment always equals savings. If the investment ratio exceeds the domestic savings ratio, then the difference must be made up through foreign capital inflows. If savings exceed investment, then the country must find investments abroad. The former can potentially lead to balance of payments problems, especially for emerging market countries. Such countries are often labeled as "balance of payment constrained." Over time, with ever more lower barriers between domestic and foreign capital markets, these constraints have been relaxed so that financial markets today tolerate much higher net capital inflows relative to GDP than in the past. The latter is generally associated with countries that if continued over time, eventually become net creditor nations. A so-called "full debt cycle" would mean that debtors with net positive capital inflows over time become creditors with net positive outflows.

Government Finance

When examining government finance, we use general government statistics, relevant for indicators 12 through 18. General government includes the national (or central) government, state or provincial governments, social security, and all other non-budgetary items not intended for commercial use. This is the definition used by the IMF in its Government Financial Statistics standards. A problem faced by analysts is that general government

statistics are not always available for non-OECD countries. For these countries, only central government statistics are available. This is a problem for analysts when state or provincial governments finance their expenditures by debts (with little information on the extent of indebtedness of these lower authorities) that ultimately have to be served by the national government. Historical examples for such problems have been "federalist" countries like Brazil and Argentina. For those countries where general government statistics are not available, it may be estimated using national and International Financial Institution (IFI) figures. If estimating general government statistics is likely to lead to faulty analysis, it may be best to turn to public sector debt, a broader measure of public indebtedness in that it includes debt of government-owned enterprises. Since the problems in estimating general government statistics are usually centered on emerging market countries, public sector figures may often prove superior in the end because in many instances in the past, governments were forced into debt restructurings caused by problems emanating from public sector indebtedness and not directly from the budget itself. When public sector debt is used, it will be noted.

12. **General Government Revenue/GDP (%):** General Government Revenue/GDP is a good indicator of the size of the government relative to the overall economy. Ironically, perhaps even counterintuitively, a larger ratio implies that if revenue needs to be raised, the proportionate change in revenue (including taxes) is lower than for countries with lower general government revenue/GDP ratios. As such, it is usually easier for countries with a high ratio to make significant revenue rebalancing than for low ratio countries.

13. **General Government Expenditure/GDP (%):** A similar phenomenon is true for the general government expenditure/GDP ratio.

14. **General Government Primary Balance/GDP (%):** The primary balance is simply the fiscal surplus or deficit excluding interest on consolidated government liabilities. This is an important indicator for determining the medium-term fiscal balance. A primary surplus is a necessary but not sufficient condition for controlling or reducing an excessive debt burden.

15. **General Government Financial Balance/GDP (%):** The financial balance is simply the net borrowing requirement and includes interest payments on the existing debt stock.

16. **General Government Debt/GDP (%):** General government debt/GDP is one of the most widely used measures of a government's debt burden. There are significant differences between high-income and medium- and low-income countries in their ability to carry debt burdens measured by this ratio. High-income countries usually have much deeper financial markets and normally have greater access to cross-border finance. As such it is not uncommon for high-income countries to be able to carry debt ratios in excess of 100% without witnessing a crisis. This holds in particular when, like in Japan, debt is held by national residents and when the country enjoys a current account surplus. Recent analyses, however, suggest that debt ratios exceeding 100% can have negative effects on investment and consumption propensities as individuals (entrepreneurs and private households alike) equate today's debts with tomorrow's taxes and thus resort to precautionary savings behavior. Medium- and low-income countries often have problems even when this ratio is low, or below 60%.

17. **General Government Debt/General Government Revenue (%):** General government revenue/general government debt is a more significant ratio for assessing a government's creditworthiness than the more commonly used general government debt/GDP ratio discussed above. This indicator provides an assessment of the debt burden relative to a government's existing revenue stream. Even if the debt/GDP ratio is high, if the revenue/debt ratio is low, then the government might not be under fiscal stress. However, even if the debt/GDP ratio is low, if the revenue/debt ratio is high, then it means that if there is stress, it would be much more difficult for such a government to solve its fiscal problems, because any change in revenue would have to be proportionately significant, and as such, difficult to implement.

18. **General Government Interest/General Government Revenue (%):** The ratio of government interest to revenue is important because it provides an indication of how expensive it is for the government to finance its interest payments relative to its revenue. This will provide a good measure of how much pressure there might be on other government expenditures, given the existing debt stock.

Foreign Dependency

19. **Real Effective Exchange Rate (REER):** The real effective exchange rate attempts to adjust nominal exchange rate changes by either differences between domestic and international inflation (PPP approach) or by differences between changes in prices of non-tradables and tradables. The "effective" component accounts for the regional diversity in international trade patterns of a reporting country, based on exports and imports and measures exchange rate changes not against a single country but against all trading partners. An alternative older definition of "effective" exchange rates includes all domestic policy measures such as export and import taxes or subsidies that have an exchange rate equivalent. For instance, an export subsidy is equivalent to an exchange rate depreciation. As a result of the complexity of the exercise, the REER is not available for all countries. The two main sources for REER statistics are JP Morgan Chase and the IMF. Although international comparisons are somewhat problematic, changes in a country's REER over time might give a good indication of whether the country is becoming more or less competitive over time.

20. **Real Exports (% Change):** As with REER, there are deficiencies when trying to calculate the change in real exports, because establishing the appropriate deflator is not an exact science. In particular, separating volumes from values is difficult, given that exports are not simply goods (including very disparate products), but also services, such as tourism and financial services. These data are generally not available for most emerging market countries. As a result, emerging market exports are presented in nominal terms, but converted to US$ at the annual average exchange rate.

21. **Real Imports (% Change):** Calculating the change in real imports has all the same issues presented in indicator #18, with emerging market countries being handled in a similar fashion to real exports.

22. **External Debt/Exports ratio (%)*:** Although this is the normal terminology used, this ratio is more accurately described as the external debt/current account receipts ratio. In this case "exports" refers to all foreign exchange revenues included in the current account, not just to exports of goods and services but also revenues from investment income as well as private and public transfers. This is a powerful indicator of credit risk, since it shows a country's susceptibility to a host of external and/or internal shocks. However, a low ratio may mask significant risks if there is a bunching of amortization payments, high interest rates, or a sudden economic or political shock.

23. **Short-Term External Debt/Total External Debt (%)*:** This is a useful indicator in that the higher the ratio, the greater the rollover risk faced by the country. Also, a sudden build-up of short-term debt might indicate that investors believe that the overall risk is rising and that they are becoming less willing to lend medium-to-long term.

24. **External Debt/International Reserves (%)*:** This is a useful but somewhat crude measure of credit risk for emerging market countries.

25. **Reserves to Imports (months)*:** This measures the number of months a country's international reserves are sufficient to purchase imports if there were a sudden cut-off of foreign currency inflows. In the past, it was normal to expect a country to maintain this ratio at three months or more. Today this is viewed as less important, especially for countries with freely floating exchange rates. Yet, as many emerging market economies and developing countries either manage "dirty," floating," or exchange rate policies with implicit or explicit exchange rate targeting, this indicator may be meaningful in the short run.

26. **Foreign Exchange Reserves (US$)*:** This measures liquid foreign exchange assets of the government, usually held by the central bank. These reserves provide an important cushion in the event of an external or internal shock that might affect a country's access to international capital markets. This is a somewhat narrow measure of a country's foreign currency cushion because liquid foreign currency assets held by domestic banks are easily mobilized by a central bank if necessary.

27. **M2/Foreign Exchange Reserves (%)*:** This ratio measures the potential risk posed by residents or even non-residents attempting to flee the local currency. Such developments are usually associated with a foreign currency or banking crisis. Although other domestic assets might also be used, M2 represents the most highly liquid and is representative of the overall potential for such local currency flight.

28. **Debt Service Ratio (%)*:** The debt service ratio measures interest and current maturities on foreign debt (medium-to-long term debt maturing within one year) as a percent of total current account receipts. Historically, this was a key indicator, but since it doesn't take into account short-term debt and capital flows, it is no longer considered as useful as once thought. Although a low debt service ratio might mask risks, a high debt service ratio is clearly a cause of concern.

29. **External Short-Term Debt + Current Maturities Due on Medium-to-Long External Debt/FX Reserves (%)*:** This measures a country's vulnerability to economic shocks, which might result in a loss of market access. If the ratio is high, then a country poses a higher credit risk. If the ratio is less than 100%, then a country can withstand at least a temporary loss of market access.

30. **Contractual Obligations on Outstanding Long-Term External Debt (available now until 2017)*:** This measures amortization of external debt going forward. Although this measure may change significantly in the future, it can signal a bunching of debt repayments. Such bunching increases credit risk. For developing countries and emerging market economies, such contractual obligations can be disaggregated by the principal repayment and interest payment components. This is important as a rising share of interest payment in total obligations relative to the principal repayment signals a widening gap between the net resource flows on debt (loan disbursement minus the principal repayment) and the net transfers on debt (net resource flows on debt minus interest payments). While usually principal repayment is covered by fresh loan disbursement and should not pose a problem for the debt service, rising interest payments must be covered by the rate of return of projects or the country's growth rate. For illustration, very poor countries have low interest payments to principal repayments ratios and thus are relatively dependent on a continuous flow of fresh loans to cover the principal.

Debt Related

31. **Current Account Balance (US$) [disaggregated]:** investment income; net exports; and, transfers]: The current account is a measure of all international transactions between residents and non-residents. It includes exports and imports of goods and services, net dividends and interest on cross-border investments, plus official and private transfers. The former is often called "foreign aid", while the latter is usually referred to as "private" or "worker" remittances. A current account surplus implies that a country is lending to countries with a deficit, while a current account deficit implies that the country is a net borrower. A current account deficit is always financed, otherwise a deficit couldn't occur. Financing such deficits may pose a serious problem, especially for emerging market countries. Such deficits are less important for high-income countries in the near-to-medium term. A current account deficit for countries in a monetary union may be used as a medium-term indicator of a country's overall competitiveness, but does not have the same impact as it does for countries not in a monetary union. The reason is that in a monetary union the country at least partially can issue the currency in which it has to serve its debts. Since we compare current account balances using the US dollar, current account balances can often appear more volatile than they otherwise would be if measured in local currency.

32. **Current Account/GDP (%):** In order to put the current account balance into perspective, it is useful to compare the current account balance to GDP. As noted above, the current account approximately indicates a country's near-term net international borrowing or lending. Thus, if the country maintains a large current account deficit over time, that country will likely build up a sizable foreign debt. If the debt is financed by direct foreign investment or equity inflows, then the burden of financing that debt is less onerous. Therefore, to determine the net foreign position of a country, one has to compare the net debt position with the net equity position. However, if this position is consistently negative, such a debt may increase the country's credit risk even when the country issues an international currency like the US does. In general, the risk is smaller for large high-income countries with a sizable stock of equity abroad, but may pose a significant risk for emerging market countries and developing countries that do not have such cross-border equity. It may pose an extra burden for a country with a foreign currency regime based on a currency board (like Argentina before 2001) or one that uses a foreign currency as its local currency (i.e., legally dollarized countries such as Panama).

33. **External Debt (US$)*:** In the past, to assess credit risk, analysts concentrated on foreign currency debt. However, with the growth of financial innovation in the last 15-20 years, investors are now not only interested in foreign currency cross-border investments, but are also significantly involved in local currency cross-border investments. As such, it is more useful today to examine all external debt, regardless of currency. This proved especially important in the Mexican crisis of 1994-95 and the Russian crisis and default of 1998, which centered on local currency-denominated debt held by non-residents.

34. **External Debt/GDP (%)*:** This ratio allows us to put the size of the external debt in perspective relative to the size of the overall economy. If the ratio is high, then it implies that the cost of servicing the debt may prove burdensome over time. At the same time we need to take into account how closed the economy is. If we are analyzing a large, closed economy, then this ratio may not prove effective as a credit risk indicator.

Liquidity Factors

35. **Liabilities Owed to BIS Banks Due Within One Year/Total Assets Held in BIS Banks (%)*:** Commonly called the liquidity ratio, this proved to be a significant indicator of risk for countries facing a currency and/or financial crisis, including Korea, Indonesia, Thailand, and Russia. Although useful, it may occasionally produce a false positive such as was the case with South Africa. One explanation of this fluke may be that South Africa's financial system more closely resembles a high-income country, while the rest of the economy is more similar to middle-income countries.

36. **Total Liabilities Owed to BIS Banks/Total Assets Held in BIS Bank (%)*:** This is just a broader measure than indicator #35. Since it includes medium- and long-term liabilities due to non-resident BIS banks, it provides an indication of how much domestic banks have utilized medium- and long-term financing from non-resident BIS banks. Analyzing the difference between the two ratios may prove helpful in providing insight into a country's debt structure, and therefore is helpful in assessing credit risk.

** Middle and Low Income Countries: For all developing countries almost all these ratios are generally available from the World Bank Global Development Finance website.*

CODEBOOK - FORWARD LOOKING INDICATORS

I. POLITICAL, ECONOMIC AND SOCIAL STABILITY – FACTORS FOR FUTURE GROWTH AND FINANCIAL RELIABILITY

Political and Institutional Stability

1. Rule of Law

To what extent do government and administration act on the basis of and in accordance with legal provisions or culturally accepted norms to provide legal or practical certainty?

This question assesses the extent to which executive actions are predictable (i.e., can be expected to be guided by law).

Description	Score
Government and administration act predictably, on the basis of and in accordance with legal provisions. Legal regulations are consistent and transparent, ensuring legal certainty.	10, 9
Government and administration rarely make unpredictable decisions. Legal regulations are consistent, but leave a large scope of discretion to the government or administration.	8, 7, 6
Government and administration sometimes make unpredictable decisions that go beyond given legal bases or do not conform to existing legal regulations. Some legal regulations are inconsistent and contradictory.	5, 4, 3
Government and administration often make unpredictable decisions that lack a legal basis or ignore existing legal regulations. Legal regulations are inconsistent, full of loopholes and contradict each other.	2, 1

To what extent do independent courts control whether government and administration act in conformity with the law?

This question examines how well the courts can review actions taken and norms adopted by the executive branch. To provide effective control, courts need to pursue their own reasoning free from the influence of incumbent governments, powerful groups, or individuals. This requires a differentiated organization of the legal system, including legal education, jurisprudence, regulated appointment of the judiciary, rational proceedings, professionalism, channels of appeal, and court administration.

Description	Score
Independent courts effectively review executive action and ensure that the government and administration act in conformity with the law.	10, 9
Independent courts usually manage to control whether the government and administration act in conformity with the law.	8, 7, 6
Courts are independent, but often fail to ensure legal compliance.	5, 4, 3
Courts are biased for or against the incumbent government and lack effective control.	2, 1

To what extent is there a working separation of powers (checks and balances)?

This question refers to the basic configuration and operation of the separation of powers (institutional differentiation, division of labor according to functions and, most significantly, checks and balances).

Description	Score
There is a clear separation of powers with mutual checks and balances.	10, 9
The separation of powers generally is in place and functioning. Partial or temporary restrictions of checks and balances occur, but a restoration of balance is sought.	8, 7, 6
One branch, generally the executive, has an ongoing and either informally or formally confirmed monopoly on power, which may include the colonization of other powers, even though they are institutionally differentiated.	5, 4, 3
There is no separation of powers, neither de jure nor de facto.	2, 1

To what extent do government authorities ensure well-defined property rights and regulate the acquisition, benefits, use, and sale of property?

Description	Score
Property rights and regulations on acquisition, benefits, use, and sale are well defined and enforced. Property rights are limited, solely and rarely, by overriding rights of constitutionally defined public interest.	10, 9
Property rights and regulations on acquisition, benefits, use, and sale are well defined, but occasionally there are problems with implementation and enforcement under the rule of law.	8, 7, 6
Property rights and regulations on acquisition, benefits, use, and sale are defined formally in law, but they are not implemented and enforced consistently nor safeguarded adequately by law against arbitrary state intervention or illegal infringements.	5, 4, 3
Property rights and regulations on acquisition, benefits, use, and sale are not defined in law. Private property is not protected.	2, 1

2. Transparency / Accountability

Corruption prevention: To what extent are public officials prevented from abusing their position for private interests?
This question addresses how the state and society prevent public servants and politicians from accepting bribes by applying mechanisms to guarantee the integrity of officeholders: auditing of state spending; regulation of party financing; citizen and media access to information; accountability of officeholders (asset declarations, conflict of interest rules, codes of conduct); transparent public procurement systems; effective prosecution of corruption.

To what extent are the media independent from government?
This question asks to what extent the media are subject to government influence and the influence of actors associated with the government. The question focuses both on media regulation and government intervention. The rules and practice of supervision should guarantee sufficient independence for publicly owned media. Privately owned media should be subject to licensing and regulatory regimes that ensure independence from government.

To what extent does the government enable the participation of civil society in the political process?
This question asks whether the political leadership involves civil society actors in agenda setting, policy formulation, deliberation, decision-making, policy implementation, and performance monitoring. Civil society actors include civic, economic, and professional interest associations, religious, charity and community-based organizations, intellectuals, scientists, and journalists.

3. Social Cohesion

To what extent is exclusion and decoupling from society effectively prevented?

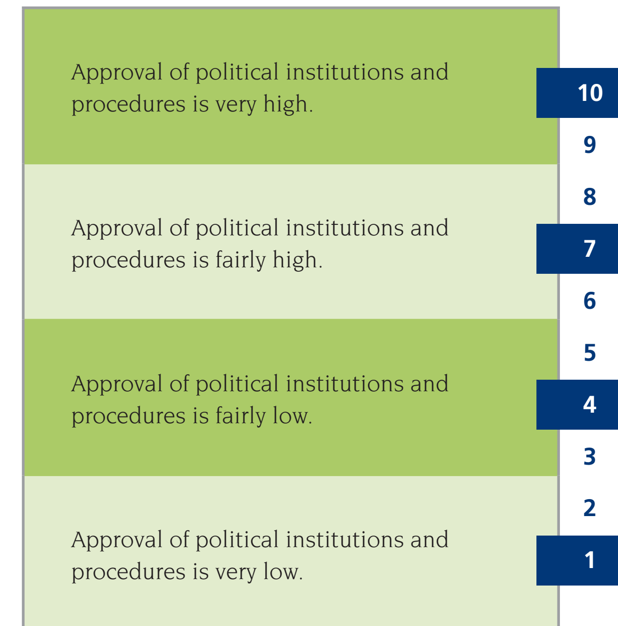
Reducing the various risks of social exclusion is a fundamental precondition for social cohesion and stability. The country assessment should focus on the following key questions: 1) To what extent is poverty effectively prevented? 2) To what extent are there enabling conditions for equal opportunity in society? In addition to poverty, please also take into account additional dimensions of exclusion like the experience of marginalization and the desire to be appreciated when evaluating socioeconomic disparities.

Reference Indicators: *Poverty rates | Gini Coefficient*

How strong is the citizens' approval of political institutions and procedures?

Please base your assessment on public opinion survey data, addressing the following factors:

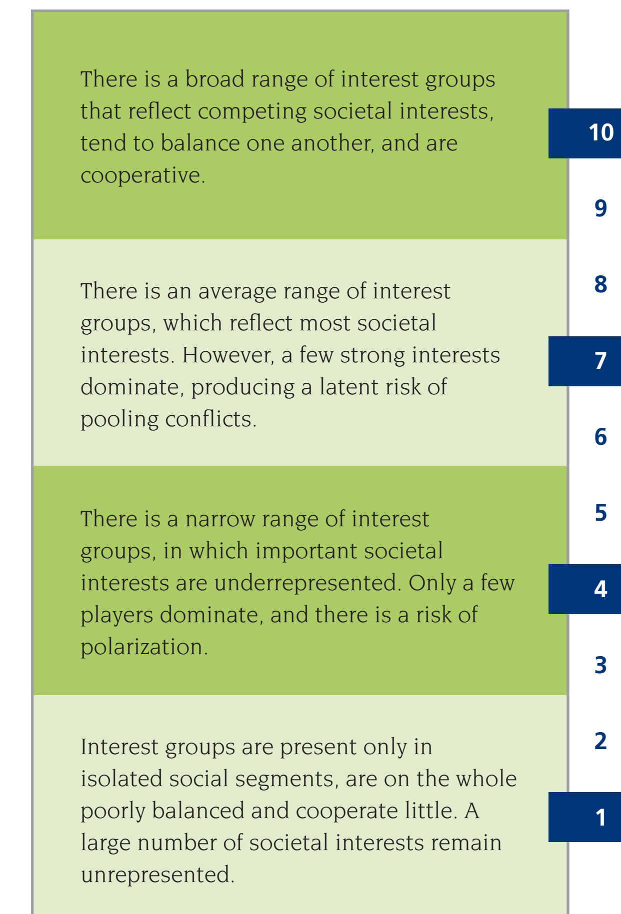
- approval of the political system
- approval of performance (measured by how the political institutions function in practice or the satisfaction with the working of the institutions)
- approval of political institutions (often measured by the level of trust in institutions such as government, the legal system and police, state bureaucracy, political parties, and the military)



To what extent is there a network of cooperative associations to mediate between society and the political system?

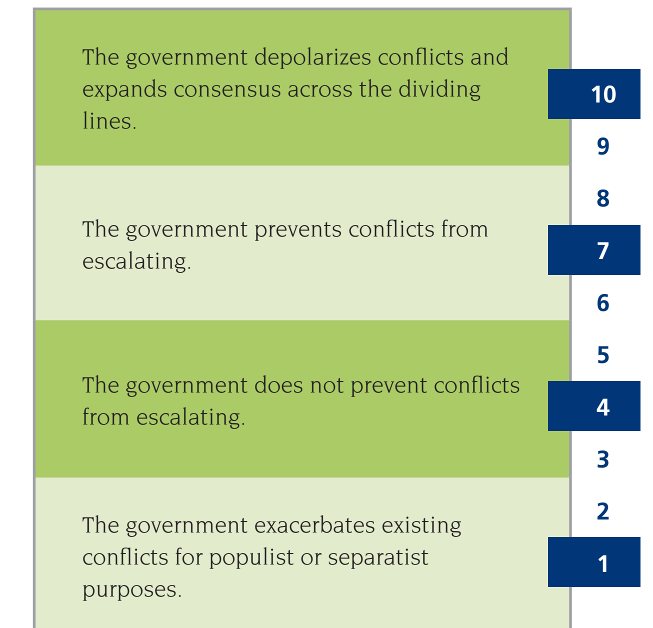
This question addresses the representation of societal interests in the political system. In evaluating the systemic nature and the quality of representative patterns, please consider:

- the spectrum of interest groups, ranging from social movements and community organizations to unions and professional associations
- the capacity to incorporate all (competing) societal interests and to avoid the dominance of a few strong interests
- the degree of cooperation between different interest groups



To what extent is the government able to moderate domestic economic, political, and social conflicts?

Please assess the extent to which the government is able to depolarize structural conflicts, to prevent society from falling apart, and establish as broad a consensus as possible across the dividing lines.



4. Future Resources

To what extent does education policy deliver high-quality, efficient, and equitable education and training?

This question assesses the extent to which a government's education policy facilitates high-quality learning that contributes to personal development, sustainable economic growth, and social cohesion. Your response should focus on the following, irrespective of the education system's organization: the contribution of education policy towards providing a skilled labor force, the graduate output of upper secondary and tertiary education, and (equitable) access to education. While the latter pertains to issues of fairness and distributive justice, it also has implications for a country's international competitiveness as unequal education implies a waste of human potential.

Reference Indicators: *PISA results | education spending | attainment levels*

To what extent does research and innovation policy support technological innovations that foster the creation and introduction of new products and services?

This question comprises subsidies and incentives for research institutions conducting basic and applied research, as well as subsidies and incentives for establishing start-up companies that transfer scientific output into products and enhanced productivity. Bureaucratic impediments to research and innovation should also be taken into account.

Reference Indicators: *R&D spending | Science and Technology Degrees | Patents | R&D Personnel*

How successful is a government in reducing unemployment and in increasing employment?

This question addresses a government's strategies to reconcile the following objectives: unemployment reduction and job security, and balancing supply and demand on the labor market by providing sufficient mobility of the labor force according to the needs of potential employers in order to increase the level of employment. To assess labor market and employment policy comprehensively, special emphasis should be placed on the positive or detrimental effects resulting from labor market regulation (e.g., dismissal protection, minimum wages, collective agreements) and from the modus operandi of unemployment insurance).

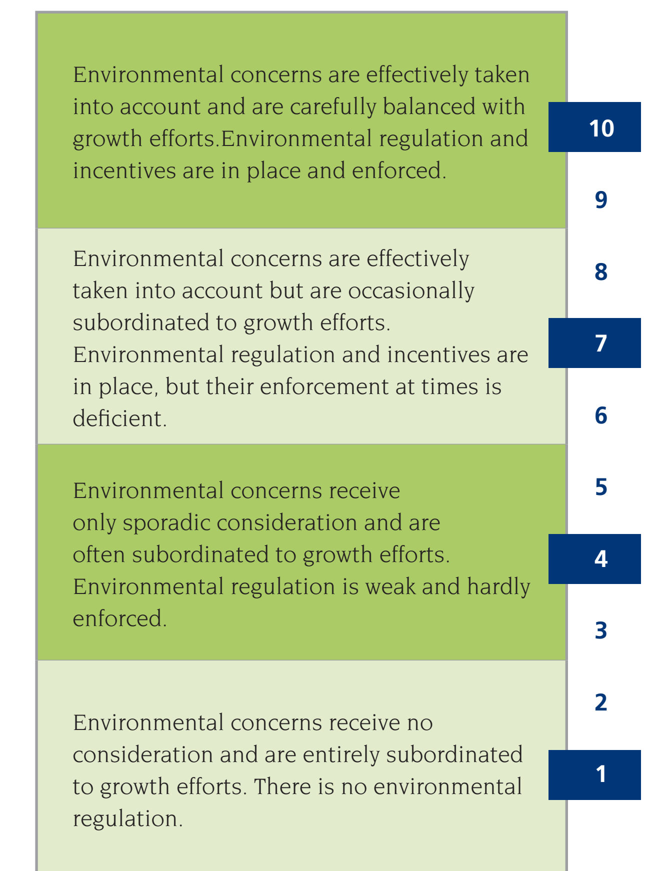
To what extent are social security schemes based on principles of fiscal sustainability?

This question seeks to assess the extent to which social security schemes (e.g. pension systems, health care insurance, unemployment insurance etc.) are fiscally sustainable. This question is essential for assessing a government's room to maneuver in paying its current financial obligations without shifting the cost to future generations.

To what extent are environmental concerns effectively taken into account in both macro- and microeconomic terms?

This question seeks to assess the extent to which externalization of costs or inadequate time horizons are avoided or restrained by environmental regulation. In macroeconomic terms, please determine whether tax and energy policies take ecological goals and measures into account (e.g. promotion of renewable energies, CO^2 reduction goals). In microeconomic terms, please establish whether the government sets incentives for environmentally sound consumption and investments to households and companies. Please take into account that a deeply engrained awareness of the environment or nature in society may serve as a functional equivalent.

Reference Indicators: *CO^2 emissions | Environmental Performance Index*



II. STEERING CAPABILITY AND REFORM CAPACITIES

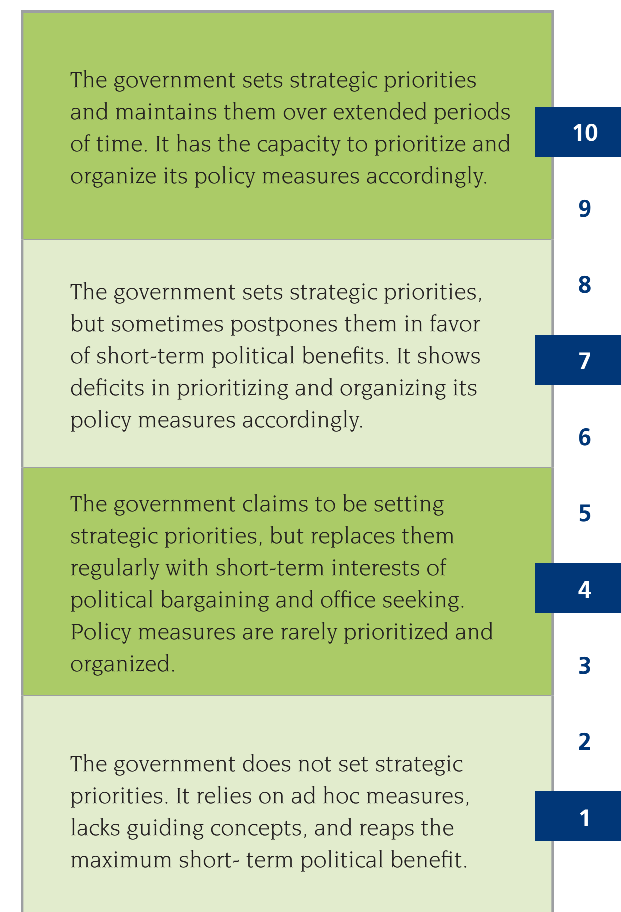
5. Strategic Capacity

Prioritization: To what extent does the government set and maintain strategic priorities?
This question seeks to assess:

- the political capability to take on a longer-term perspective going beyond immediate concerns of electoral competition, to maintain strategic priorities over periods of crisis and stalemate

- the strategic capacity of the government to prioritize and organize its policy measures (gaining and organizing expertise, evidence-based policy-making, regulatory impact assessment, strategic planning units)

Make sure to identify reform drivers and defenders of the status quo, as political determination and institutional capacity may vary among different departments and ministries. Please also comment on how setting and maintaining strategic priorities might be constrained by government composition and by actors outside the government (e. g. powerful economic interests, lobbies, foreign governments, foreign donors).



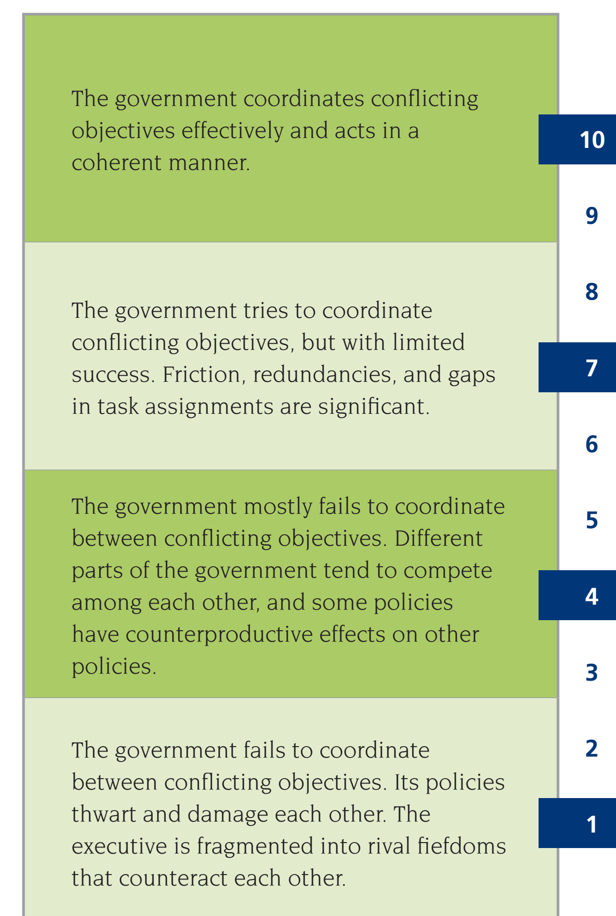
Policy coordination: To what extent can the government coordinate conflicting objectives into a coherent policy?
As many policies have conflicting objectives, reflect competing political interests and affect other policies, the government has to ensure that its overall policy is coherent. Successful coordination should:

- assure that trade-offs between policy goals are well balanced

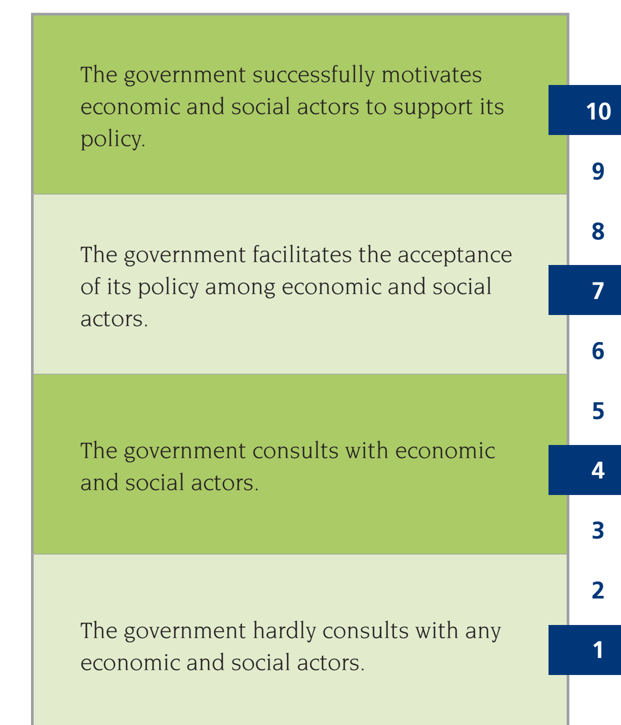
- introduce horizontal forms of coordination to mediate between different departments of the state administration

- ascribe responsibilities in a transparent manner to avoid the negligence of tasks, redundancies, or friction between different government branches.

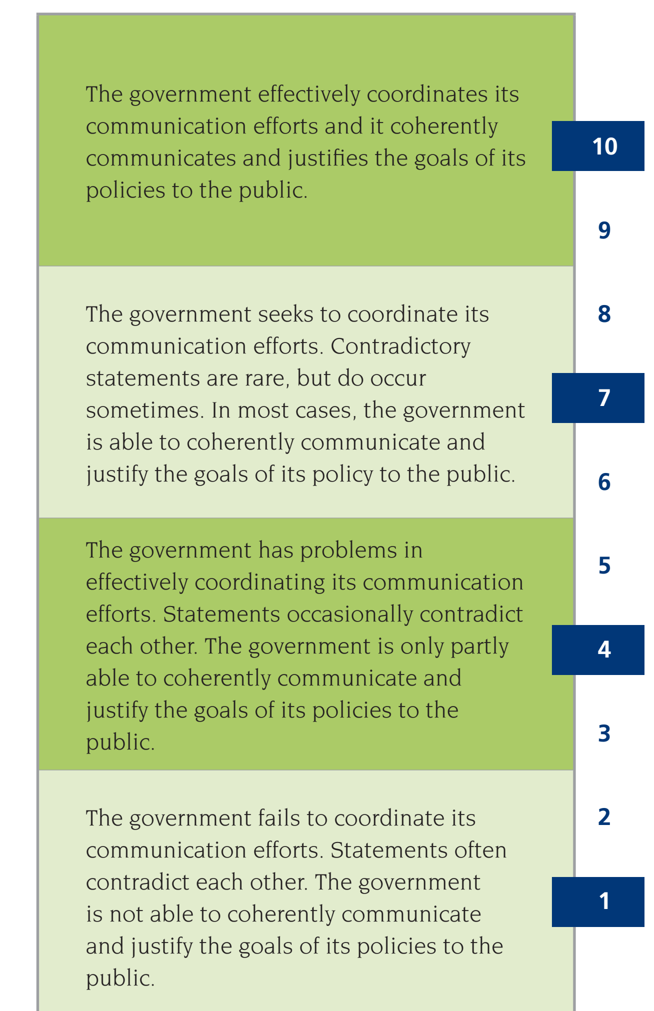
Various coordination styles (hierarchic-bureaucratic, informal-network, personalist, centralized, decentralized etc.) are possible and may be functionally equivalent. What matters is their impact on policy coherence.



Stakeholder Involvement: To what extent does the government consult with major economic and social interest groups to support its policy?
This question assesses how successfully the government consults with economic and social actors in preparing its policy. Successful consultation is conceived here as an exchange of views and information that increases the quality of government policies and induces economic and social actors to support them.



Political Communication: To what extent does the government actively and coherently communicate and justify the rationale for and goals of its policies to the public?
A coherent communication policy is an important aspect of strategic governance, and ultimately in winning public acceptance for governmental policies. This question assesses governments' public communication efforts, and the extent to which policy-makers are able to coherently describe and justify goals and programs to the public.



6. Implementation and Efficiency

To what extent can the government achieve its own policy objectives?

This question seeks to evaluate a government's implementation performance against the performance benchmarks set by the government for its own work. The assessment should therefore focus on the major policy priorities identified by a government and examine whether declared objectives could be realized.

To what extent does the government make efficient use of available human, financial, and organizational resources?

In assessing the government's resource efficiency, please focus on the executive, including the administration and the cabinet.

Reference Indicators: *Personnel expenses relative to the services offered by the state | low number of politically motivated dismissals and new appointments of public servants | competitive recruiting procedures protected against political influence | transparent budget planning and implementation | low deviation of actual budget expenditures from the associated planned expenditures | effective and independent auditing | public administration that enables effective management under criteria of professional rationality | procedures and institutions to reform and modernize public administration.*

7. Adaptability

Policy Learning: How innovative and flexible is the government?

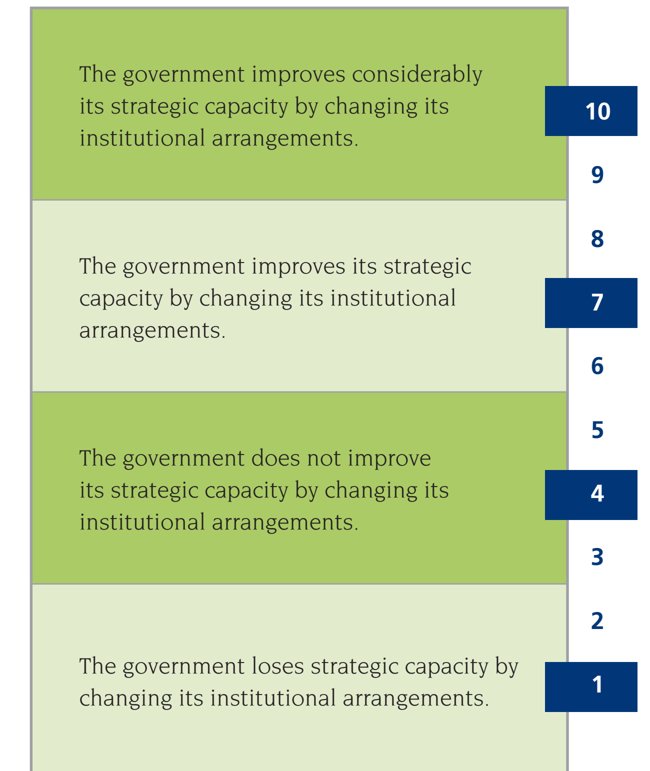
Innovation in policy-making often comes from learning. This learning goes beyond changes in policy outputs to include changes in the basic beliefs in guiding policy formulation. Learning opportunities are provided by:

- learning from past experience (effective internal monitoring and evaluation)
- observation and knowledge exchange (good practices, international cooperation)
- consultancy (academic experts and practitioners)

Flexibility refers to a government's ability to adapt to and take advantage of development opportunities inherent to a given political situation. Flexibility and learning allow governments to replace failed policies with innovative ones. If possible, provide empirical evidence on whether policy learning happens coincidentally or if there are institutionalized mechanisms that facilitate innovation and flexibility in policy-making.

Institutional Learning: To what extent does the government improve its strategic capacity by changing the institutional arrangements of governing?

Strategic capacity is the capacity to take and implement political decisions that take into account the externalities and interdependencies of policies, are based on scientific knowledge, promote the common goods and represent a long-term orientation. Institutional arrangements include the rules of procedure and the work formats defined there, in particular the cabinet, the office of the head of government, the center of government, the portfolio of ministries, the advisory staffs of ministers, and the head of government as well as the management of relations with parliament, governing parties, ministerial administration, and public communication.



III. TRACK RECORD OF PAST CRISIS MANAGEMENT (IF APPLICABLE)

- Is there evidence from historical events that the country and its society have already mastered economic and political shocks in the past?
- Does the political system facilitate crisis remediation in a timely manner?
- Is the signaling process between decision makers (government, central bank, employers, employee representatives) so well established that confusion about (and resistance to) the expected outcome of decisions by one decision maker on the others can be avoided or at least minimized?
- Are there constitutionally anchored and politically accepted procedures for sequencing and timing of countermeasures in a crisis?
- Are precautionary measures (e.g., deposit insurance, foreclosure procedures) in place that can protect the most vulnerable groups against the full effect of a crisis?
- Are automatic stabilizers in fiscal policies sufficiently strong to contain surges of massive unemployment?

COUNTRY LIST

On average the big three CRAs, Moody's, Standard & Poor's and Fitch, each rate just over 100 sovereigns. The following table lists the countries rated by these agencies, divided into three groups according to the World Bank's Income Group classification.[1] The World Bank divides countries into three categories: low income, $1,005 or less; lower middle income, $1,006 - $3,975; upper middle income, $3,976 - $12,275; and high income, $12,276 or more. There are 162 countries on this list: 53 high income countries, 52 upper middle income countries and 57 lower middle income countries. Low income countries have not been included in this preliminary list because they are less likely to have data collecting agencies and to engage in cross-border trading. INCRA would start to produce approximately 100 sovereign ratings in the first year of operations.

World Bank Classification According to Income — HIGH

	Moody's	S & P	Fitch	Not Rated
Andorra	X	X		
Aruba		X	X	
Australia	X	X	X	
Austria	X	X	X	
Bahamas	X	X		
Bahrain	X	X	X	
Barbados	X	X		
Belgium	X	X	X	
Bermuda	X	X	X	
Brunei				X
Canada	X	X	X	
Croatia	X	X	X	
Cyprus	X	X	X	
Czech Republic	X	X	X	
Denmark	X	X	X	
Equatorial Guinea				X
Estonia	X	X	X	
Finland	X	X	X	
France	X	X	X	
Germany	X	X	X	
Greece	X	X	X	
Hungary	X	X	X	
Iceland	X	X	X	
Ireland	X	X	X	
Israel	X	X	X	
Italy	X	X	X	
Japan	X	X	X	
Korea	X	X	X	
Kuwait	X	X	X	
Liechtenstein	X	X		
Luxembourg	X	X	X	
Malta	X	X	X	
Monaco	X			
Netherlands	X	X	X	
New Zealand	X	X	X	
Norway	X	X	X	
Oman	X	X		
Poland	X	X	X	
Portugal	X	X	X	
Qatar	X	X		
San Marino	X		X	
Saudi Arabia	X	X	X	
Singapore	X	X	X	
Slovak Republic	X	X	X	
Slovakia	X	X	X	
Slovenia	X	X	X	
Spain	X	X	X	
Sweden	X	X	X	
Switzerland	X	X	X	
Trinidad and Tobago	X	X		
United Arab Emirates	X			
United Kingdom	X	X	X	
United States	X	X	X	

World Bank Classification According to Income — UPPER MIDDLE

	Moody's	S & P	Fitch	Not Rated
Albania	X	X		
Algeria				X
Antigua & Barbuda				X
Argentina	X	X	X	
Azerbaijan	X	X	X	
Belarus	X	X		
Bosnia and Herze.	X	X		
Botswana	X	X		
Brazil	X	X	X	
Bulgaria	X	X	X	
Chile	X	X	X	
China	X	X	X	
Colombia	X	X	X	
Costa Rica	X	X	X	
Cuba	X			
Dominica				X
Dominican Republic	X	X	X	
Ecuador	X	X	X	
Gabon		X	X	
Grenada		X		
Iran, Islamic Republic			X	
Jamaica	X	X	X	
Jordan	X	X		
Kazakhstan	X	X	X	
Latvia	X	X	X	
Lebanon	X	X	X	
Libya		X		
Lithuania	X	X	X	
Macedonia, FYR		X	X	
Malaysia	X	X	X	
Maldives				X
Mauritius	X			
Mexico	X	X	X	
Montenegro	X	X		
Namibia	X		X	
Palau				X
Panama	X	X	X	
Peru	X	X	X	
Romania	X	X	X	
Russian Federation	X	X	X	
Serbia		X	X	
Seychelles			X	
South Africa	X	X	X	
St. Kitts and Nevis				X
St. Lucia				X
St. Vincent and Gren.	X			
Suriname	X	X	X	
Thailand	X	X	X	
Tunisia	X	X	X	
Turkey	X	X	X	
Uruguay	X	X	X	
Venezuela, RB	X	X	X	

World Bank Classification According to Income				LOWER MIDDLE
	Moody's	S & P	Fitch	Not Rated
Angola	X	X	X	
Armenia	X		X	
Belize	X	X		
Bhutan				X
Bolivia	X	X	X	
Cameroon		X	X	
Cape Verde		X	X	
Congo				X
Cote D'Ivoire				X
Djibouti				X
Egypt	X	X	X	
El Salvador	X	X	X	
Fiji	X	X		
Georgia	X	X	X	
Ghana		X	X	
Guatemala	X	X	X	
Guyana				X
Honduras	X	X		
India	X	X	X	
Indonesia	X	X	X	
Iraq				X
Kiribati				X
Kosovo				X
Laos				X
Lesotho			X	
Marshall Islands				X
Mauritania				X
Micronesia				X
Moldova	X			
Mongolia	X	X	X	
Morocco	X	X	X	
Nicaragua	X			
Nigeria		X	X	
Pakistan	X	X		
Papua New Guinea	X	X		
Paraguay	X	X		
Philippines	X	X	X	
Samoa				X
São Tomé & Principe				X
Senegal	X	X		
Solomon Islands				X
Sri Lanka	X	X	X	
Sudan				X
Swaziland				X
Syria				X
Timor-Leste				X
Tonga				X
Turkmenistan				X
Tuvalu				X
Ukraine	X	X	X	
Uzbekistan				X
Vanuatu				X
Vietnam	X	X	X	
West Bank & Gaza				X
Yemen, Republic				X
Zambia		X	X	

CORE TEAM CONDUCTING THIS REPORT:

Overall conceptual idea and lead:
Annette Heuser,
Executive Director, Bertelsmann Foundation

Legal and organizational contributors
Thomas von Hippel,
Judge and Freelance Researcher

A. Christopher Sega,
Partner, Venable LLC

Peter Walkenhorst,
Senior Project Manager, Bertelsmann Stiftung

Civil society conceptual input:
Helmut K. Anheier,
Professor of Sociology and Dean,
Hertie School of Governance

Methodology and criteria contributors:
Najim Azahaf,
Project Manager, Bertelsmann Stiftung

Sabine Donner,
Senior Project Manger, Bertelsmann Stiftung

Rolf Langhammer,
Vice President, Kiel Institute for the World Economy;
Professor, Kiel Institute

Daniel Schraad-Tischler,
Project Manager, Bertelsmann Stiftung

Vincent Truglia,
Principal and Managing Director, Granite Springs LLC;
Former Managing Director and Head of Sovereign Risk Unit, Moody's Investors Service

Rainer Voss,
Former Banker, Deutsche Bank

Business plan outline:
David Moniz,
Marketing Consultant
Former Managing Director, Head of Europe Mideast Africa Marketing, Moody's
Former Managing Director, Head of Latin America, Moody's

Overall coordination and analysis:
Anneliese Guess,
Project Manager, Bertelsmann Foundation

Research support:
Stefan de Geus

Editorial team:
Joel Kolko
Katherine Lewis

BIOGRAPHIES

Helmut K. Anheier

Helmut K. Anheier, PhD, is Professor of Sociology and Dean at the Hertie of Governance. He also holds a chair of sociology at Heidelberg University and serves as Academic Director of the Center for Social Investment. He received his PhD from Yale University in 1982. From 2001 to 2009, he was Professor of Public Policy and Social Welfare at UCLA's School of Public Affairs and Centennial Professor at the London School of Economics. Professor Anheier founded and directed the Centre for Civil Society at LSE and the Center for Civil Society at UCLA. Before embarking on an academic career, he served as social affairs officer to the United Nations. He is currently researching the role of foundations in civil society and focuses on concepts and methods in civil society and globalization studies. Prof. Anheier is the editor of the annual *Global Civil Society Yearbook* (with Mary Kaldor and Marlies Glasius) and the *Cultures and Globalization Series* (with Raj Isar). His recent publications include *Foundations and American Society* (with David Hammack, 2009, Brookings Institution Press) and *Nonprofit Organizations: Theory, Management and Policy* (2005, Routledge).

Najim Azahaf

As a graduate in Social Science, Najim Azahaf has worked as project manager with the Sustainable Governance Indicators project (SGI) at the Bertelsmann Stiftung in Gütersloh, Germany since 2010. Currently, he is responsible for two special SGI studies assessing and comparing policy performance and governance capacities in the so-called BRICS countries as well in eminent economic powers in Asia.

Before joining the SGI project, he had the opportunity to pursue his long-standing interest in good governance solutions on different levels and regions in the framework of the foundation's Young Professional Program. Most pertinent to his commitment to international efforts for good governance and sustainable development was his engagement at the Institute for Development and Peace (INEF). At this think tank founded by the former German chancellor Willy Brandt, he worked as the assistant to the director for many years. In addition, he gathered practical experience in Germany and abroad by working with several organizations for international cooperation such as the German Agency for Technical Cooperation (GTZ, Nairobi), Capacity Building International (InWEnt), and the German NGO Welthungerhilfe.

Sabine Donner

Sabine Donner, PhD, is Senior Project Manager at the Bertelsmann Stiftung in Gütersloh, Germany and responsible for the project "Shaping Change – Strategies of Development and Transformation" and the Bertelsmann Transformation Index. She has been involved in conceptualizing and developing the BTI, a global survey on the quality of democracy, economic development and governance in 128 developing and transition countries. She holds a master's degree in Political Science, German Literature, and Russian Language and Literature from the University of Freiburg. Prior to joining the Bertelsmann Stiftung, Sabine worked as a freelance journalist for German newspapers and radio stations. Her main areas of research are good governance and democratization as well as political and economic developments in the Former Soviet Union countries.

Stefan de Geus

Stefan de Geus completed his bachelor's degree in 2011 at the University of Utrecht with a concentration in Economics. He authored a thesis that examined the underlying reasons for discrepancies in the prevalence of management consultancies and advanced producer service firms in European metropolitan areas.

Currently, he is pursuing a master's in Economics and Geography at the University of Utrecht. In his studies, he uses his knowledge of economic theory and econometrics to analyze trends in micro-level entrepreneurship and regional economic convergence policies across the European Union.

Anneliese Guess

Anneliese Guess joined the Bertelsmann Foundation as a project manager in August 2011, shortly after completing a master's degree in German and European Studies at Georgetown University's Edmund A. Walsh School of Foreign Service. While studying at Georgetown, she held internships with the Embassy of Liechtenstein and Atlantic Partnership, and a part-time position at the German Historical Institute. Her work at the Bertelsmann Foundation includes supporting the Megatrends Meta-Analysis project and contributing to the project's blog on FutureChallenges.org.

Anneliese Guess holds a bachelor's degree in German and English literature with a minor in global and international studies from the University of California, Davis. During her time at UC Davis, she was the recipient of a German Academic Exchange Service (DAAD) undergraduate scholarship for one year's study at Georg-August University in Göttingen, Germany.

Annette Heuser

Annette Heuser established the Washington DC office of the Bertelsmann Foundation, a private, non-partisan operational foundation that promotes and strengthens trans-Atlantic cooperation, in 2008, and has led it since. She established the foundation's Brussels office and served as its executive director from 2000 to 2006. From 1995 to 2000, she was Director Europe/USA at the Bertelsmann Stiftung in Gütersloh, Germany. In this function, she managed European and trans-Atlantic projects, and developed European networking activities.

In the corporate sector, she served as vice president of international relations from 2006-2008 at Bertelsmann AG, Europe's largest media company. She was editor of the *Jahrbuch der Europäischen Integration*, an annual publication that covers the year's institutional and political developments in European integration.

Annette Heuser studied political science, law, and sociology at the University of Mainz in Germany. She is a member of the Atlantic Council Board of Directors and its Strategic Advisors Group and a member of the European Council on Foreign Relations. She previously served on the World Economic Forum's Global Agenda Council on the Future of the European Union and as the vice chair of the Council on Foundations' Global Philanthropy Committee in the United States.

Thomas von Hippel

Thomas von Hippel, PhD, is judge and freelance researcher in Hamburg, Germany. Previously he was for several years a senior research fellow at the Max Planck Institute for Comparative and International Private Law in Hamburg. He was project coordinator of several interdisciplinary and legal comparative research projects, especially on non-profit organizations, foundations, taxation, and philanthropy. He finished his legal education in Göttingen (First State Exam) and Hamburg (Second State Exam). He received his PhD and habilitation from the University of Hamburg and was Visiting Professor in Hamburg, Heidelberg, Dresden and Bochum.

Joel Kolko

Joel Kolko has had more than 30 years of experience as a copy editor and managing editor for U.S. and international publications dealing with such issues as business and finance, securities, telecommunications and the internet, commercial arbitration, and intellectual property. He obtained a bachelor's degree from Boston University; a JD from Boston University School of Law; and a master's in Journalism and Communications from American University in Washington DC.

Rolf J. Langhammer

Rolf J. Langhammer, PhD, is Vice President of the Kiel Institute for the World Economy since October 1997 and Professor at the Kiel Institute. From April 2003 to September 2004, he served as Acting President. From July 1995 to November 2005, he headed the Research Department "Development Economics and Global Integration" at the Kiel Institute. In addition, he has been honorary professor in international economic relations and development economics at the Faculty of Economics, Business Administration, and Social Sciences at Kiel University since November 1995. He was formerly research division chief at the Kiel Institute (since 1978) and research associate at Kiel University (1972-78) after graduating from the same university. He received his PhD in 1977 and was awarded several research fellowships and visiting professorships abroad.

Rolf Langhammer has served as consultant to a number of international institutions (EU, World Bank, OECD, UNIDO, ADB), as well as to the German ministries of economic affairs and economic co-operation. He is a member of the Scientific Advisory Council of the Federal Ministry of Economic Co-operation and Development. His research issues cover international trade patterns, trade policies, regional integration, and international capital flows. He has published in professional journals and contributed to many volumes of conference proceedings. He is co-author of "Regional Integration among Developing Countries" (1990), "The International Competitiveness of Developing Countries for Risk Capital" (1991), and "Regional Integration in Europe and its Effects on Developing Countries" (1994) as well as co-editor of "Monetary Policy and Macroeconomic Globalization in Latin America" (2005 with Lúcio Vinhas de Souza) and "Labor Mobility and the World Economy" (2006 with Federico Foders).

Katherine Lewis

Katherine Lewis is an independent journalist based in Washington DC with 18 years' experience writing for magazines, newspapers and online, in addition to radio and television appearances. A regular contributor to Fortune Magazine online, her expertise is finance, work and family. Her freelance articles have appeared in Money, New York Times, Fiscal Times, MSN Money, Parade, Slate, USA Today's magazines and Washington Post Magazine.

Katherine Lewis worked as a national correspondent covering money and work for Newhouse News Service from 2003 to 2008. Previously, she reported for Bloomberg News in Washington on everything from agriculture, finance, media and technology policy to Congress and the White House. She began her career in New York covering state and local debt markets for the Bond Buyer. Active in the Asian American Journalists Association, she serves as founding co-chair of the AAJA Digital Group. She received a bachelor's degree in physics from Harvard University.

David Moniz

David M. Moniz is a marketing consultant with 30 years' experience in marketing strategy, product development, and sales management in the US, Europe, and Latin America. He held a variety of positions with Moody's Investors Service for 14 years, including heading the firm's marketing activities in the Europe, Middle East, Africa, and Latin America regions. He began his career at Bankers Trust Company as a financial analyst and then managed a newly created product management unit in the global private banking unit. He has a master's of International Affairs degree with a specialization in International Economics from the School of International and Public Affairs at Columbia University, and a bachelor's degree in Political Science from Providence College. He has also studied at the Universite de Fribourg, in Fribourg, Switzerland.

A. Christopher Sega

An estate and business planning attorney and former international banker, A. Christopher Sega's practice involves advising closely held corporations and high net worth individuals on estate, gift, business succession and retirement planning issues. He assists U.S. and foreign clients in selecting tax-efficient estate planning techniques to coordinate charitable, wealth planning and testamentary objectives, as well as handling life insurance issues and negotiating on their behalf with the Internal Revenue Service. He has been quoted in the *Wall Street Journal* regarding his extensive experience with Cryonics and Personal Revival Trusts.

A. Christopher Sega served as the Chair of the Committee on Fiduciary Income Tax and currently serves as the Chairman of the Subcommittee on Grantor Trusts of the Committee on Estate and Gift Tax of the American Bar Association's Section on Taxation. He is a member of the Tax Section of the District of Columbia Bar. He is active in the D.C. Estate Planning Council, where he served as both Director and Past President. He taught International Taxation as an Adjunct Faculty Member of the Columbus School of Law from 1993-1995, and is currently a member of the Adjunct Faculty at Georgetown University Law School where he teaches Estate and Gift Taxes. In this capacity, he received the Charles Fahy Distinguished Adjunct Faculty Award for 2008-2009. He is a Fellow of the American College of Trust and Estate Counsel.

Daniel Schraad-Tischler

Daniel Schraad-Tischler joined the Bertelsmann Stiftung in Gütersloh, Germany in 2008. He heads the Stiftung's "Sustainable Governance Indicators" (SGI) project, a cross-national comparison of policy performance and governance capacities in the OECD.

Daniel Schraad-Tischler holds a PhD in Political Science from the University of Cologne (Faculty of Management, Economics, and Social Sciences) as well as a master's in Political Science, History, and German Literature (Cologne). His main areas of research are good governance, sustainable development, and EU politics, as well as cross-national comparisons of social justice and equality of opportunity.

Before joining the Bertelsmann Stiftung, he worked as a research associate at the Jean Monnet Chair for Political Science and European Affairs at the University of Cologne. Daniel Schraad-Tischler also gained project management experience at the European Parliament and at Bayer AG.

Vincent J. Truglia

Vincent J. Truglia has more than 34 years experience as an economist. At present, he is a Principal and Managing Director of Global Economic Research at Granite Springs Asset Management, LLC. He also worked at Moody's Investors Service for 15 years in the Sovereign Risk Unit, which he headed for a number of years. Before that he worked for the Federal Reserve Bank of New York. For 13 years, Vincent J. Truglia was a Vice President and International Economist at the Bank of New York/Irving Trust. In 1977, he started the Country Risk Department at NCNB (the parent bank of Bank of America). He received a master's degree and ABD in International Economics from McGill University in Montreal. He received a BSFS from the School of Foreign Service, Georgetown University. He also did graduate research at Trinity College, Dublin, as well as studying at the Università per Stranieri in Perugia, Italy.

Rainer Voss

Rainer Voss has been active in various roles in the capital markets for over 25 years; he ran debt capital markets for Dresdner Kleinwort Benson, where he was Head of Syndicate and responsible for the financing of sovereigns and supranationals. In the early 2000s he worked at Deutsche Bank, where he oversaw debt capital market origination for the German corporate universe. Since 2007 he has been a consultant for political and financial institutions. His main fields of interest are the non-financial roots of the recent financial crises. He holds an economics degree from University of Cologne.

Peter Walkenhorst

Peter Walkenhorst is senior project manager at the Bertelsmann Stiftung in Gütersloh, Germany. His current responsibilities include the coordination of the "Salzburg Trilogue" conference as well as projects dealing with European-Asian relations. Previously, he was a member of the global governance team, which developed ideas and suggestions for political management of globalization processes. He also worked in the foundation's philanthropy and civil society division on enhancing the management quality, organizational effectiveness and innovation capacity of civil society organizations. He is the author and editor of several books and articles on the non-profit and philanthropic sectors as well as on German and European nationalism. Peter Walkenhorst was a visiting lecturer at the University of Bologna's Master in International Studies in Philanthropy in 2006 and 2008.

Before joining the Bertelsmann Stiftung, he studied history and public law in Germany and the United States. He received his PhD from the University of Bielefeld and holds a master's in History from the University of Massachusetts at Boston.

ACRONYM OVERVIEW

AIG – American International Group
BIS - Bank for International Settlements
BTI - Bertelsmann Transformation Index
CESR - Committee of European Securities Regulators
CPI - Consumer Price Index
CRA - Credit Rating Agency
ESMA - European Securities and Markets Authority
EU - European Union
Eurosif - European Sustainable Investment Forum
EWE - Early Warning Exercise
FLI - Forward-Looking Indicators
FSB - Financial Stability Board
FX - Foreign Exchange
GDP - Gross Domestic Product
HNWI - High Net Worth Individual
IMF - International Monetary Fund
INCRA - International Non-Profit Credit Rating Agency
INSEAD - Institut Européen d'Administration des Affaires
IOSCO - International Organization of Securities Commissions
M2 - Money Supply
NBER - National Bureau of Economic Research (US)
NGO - Non-Governmental Organization
NRSRO - Nationally Recognized Statistical Rating Organizations
PPP - Purchasing Power Parity
SEC - Securities and Exchange Commission
SGI - Sustainable Government Indicators
ST - Short Term
UN - United Nations
UNCTAD - United Nations Conference on Trade and Development
WTO - World Trade Organization

ENDNOTES

III. Introduction

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[2] See: Coffee 2011. The accusations were (1) that the CRAs did not discover the problem and (2) conflicts of interest because of the issuer-payment model, dominating "customers" and the oligopoly structure of CRAs.

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[5] See: De Grauwe, Paul. (2008) "Lessons from the Financial Crisis: New Rules for Central Banks and Credit Rating Agencies?" *Intereconomics*. Retrieved from: http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=5&ved=0CG4QFjAE&url=http%3A%2F%2Fwww.intereconomics.eu%2Fdownloads%2Fgetfile.php%3Fid%3D647&ei=DRFuT8W5ObHP4QSnkOzAAg&usg=AFQjCNGeXk1sQ_bYhyAIB4ilybacV4tjrA&sig2=0nHpe-Al6y9rlX2nl2v-Sg

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[8] The American firms Standard & Poor's (S&P) and Moody's jointly have approximately 80 percent of the market share; the British agency Fitch Ratings, a 100 percent subsidiary of the French Fimalac Group, holds a further 15 percent. See: Blaurock, U. (2007). "Control and responsibility of credit rating agencies." *Electronic journal of comparative law*, 11(3), 1-37; Rönsberg, A. (2011, July 5) and "S&P warning puts damper on Eurogroup plans." *Deutsche Welle*. Retrieved March 19, 2012, from http://www.dw.de/dw/article/0,,15212433,00.html

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Challenges with CRAs and Existing and Proposed Reforms

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IV. The Legal and Organizational Setup

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[2] A third example is the Stiftung Warentest, a consumer organization that investigates and compares consumer goods and services in Germany. This institution is partially supported by the government, but it maintains its reputation and independence from the government. The Stiftung Warentest is an example that German Foreign Minister Guido Westerwelle used as a potential model for a Credit Rating Agency (See: Westerwelle, Guido. "Stiftung Warentest als Vorbild für Ratingagentur." *Welt Online*. Retrieved from: http://www.welt.de/wirtschaft/article13818952/Stiftung-Warentest-als-Vorbild-fuer-Ratingagentur.html). It is important to note that the subjects of its ratings are not governments but companies and goods and services. Consequently, it is less problematic that the German government partially finances the Stiftung Warentest; possible conflicts of interest would be much more severe if this organization were funded by industry.

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V. Methodology and Indicators: A Wider View

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Reinhart, Carmen M. & Rogoff, Kenneth S. (2011_. "From Financial Crash to Debt Crisis," American Economic Review, American Economic Association, vol. 101(5), pages 1676-1706; and

Reinhart, Carmen M. (2010). "This Time is Different Chartbook: Country Histories on Debt, Default, and Financial Crises" NBER Working Paper No. 15815.

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[12] In this instance, we mean supranational in the broadest possible definition, including traditional supranational entities like the EU as well as entities like the World Bank and the World Trade Organization. "Supranational Organizations (SNOs), and supranationalism to refer to all organizations, institutions and political and social processes involving more than a single state or at least two non-state actors from different nation-states. Supranational will thus encompass formal organizations, institutions, and political and legal agreements related to transnational interaction."

Lucas, Michael R. (1999). "Nationalism, Sovereignty, and Supranational Organizations." *Heft* 114. Hamburg. Retrieved from: http://www.ifsh.de/pdf/publikationen/hb/hb114.pdf.

And also:

"The criteria of "supranationalism" in the European Communities are the following: independence of the executive from the member states; the ability of the law making institutions to bind the member states, in a number of significant cases by less than unanimous agreement of the membership; and, most important, the ability of the Community to make law which is directly binding and effective in the member states without requiring legislative implementation by the latter."

Hay, Peter. (2012). "Supranational Organizations and United States Constitutional Law." Retrieved from: http://heinonline.org/HOL/LandingPage?collection=journals&handle=hein.journals/vajint6&div=18&id=&page=.

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Country List

[1] The World Bank classification is based on the Gross National Income (GNI–formerly referred to as GNP) per capita. In calculating GNI per capita in U.S. dollars for certain operational purposes, the World Bank uses the Atlas conversion factor. The purpose of the Atlas conversion factor is to reduce the impact of exchange rate fluctuations in the cross-country comparison of national incomes. The Atlas conversion factor for any year is the average of a country's exchange rate (or alternative conversion factor) for that year and its exchange rates for the two preceding years, adjusted for the difference between the rate of inflation in the country.

Source: The World Bank. (2012). "How We Classify Countries." Retrieved from: http://data.worldbank.org/about/country-classifications.

Bertelsmann Foundation
1101 New York Avenue, NW, Suite 901
Washington, DC 20005
USA
main phone +1.202.384.1980
main fax +1.202.384.1984

www.bfna.org