ISCTE Business School
University Institute of Lisbon

ARC RATINGS

The Periphery Strikes Back

Rafael Almeida Soromenho

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Supervisor:
Prof. Rui Alpalhão, Visiting Associate Professor, ISCTE
Business School, Finance Department

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Resumo

A crise financeira de 2008 abalou não só os mercados financeiros como também a confiança da população em geral. Existiram vários responsáveis, que devido a decisões algo questionáveis, conduziram à quebra no mercado imobiliário e a toda a sua sucessão de eventos.

A Europa foi fortemente afetada pela crise. Devido ao papel que as Agências de Rating desempenharam no período pós-crise, com constantes "downgrades" no Rating dos países da União Europeia, que agravaram os impactos económicos, criou desconfiança referente às principais agências de rating (Standard & Poor's, Fitch e Moody's), todas elas americanas. Surgiram alternativas às mesmas, nas quais se destacam a DBRS e a Dagong Global, como forma de combater os ratings que se desconfiava não serem imparciais.
Isto criou uma oportunidade de penetração no mercado de ratings europeu, que até à altura era controlado pelas "Big Three".

Esta Tese foi desenvolvida segundo o método do caso. Uma empresa portuguesa (Companhia Portuguesa de Ratings) resolveu não desperdiçar a oportunidade, e estabelecendo uma aliança com empresas de rating líderes nos seus mercados, resolveu criar uma nova empresa, ARC Ratings, com sede em Lisboa, em 2013, com o intuito de se estabelecer no mercado europeu. Passados cinco anos da sua criação, a ARC Ratings decide perceber o impacto que a criação da mesma teve no mercado europeu, e também entender se a estratégia utilizada foi a mais indicada, bem como definir os futuros passos. Com a resolução do Caso os alunos serão chamados a formular as respostas a estas questões.

Palavras-chave: Mercados Financeiros, União Europeia, Agências de Rating, Estratégia

Summary

The 2008 Financial Crisis shook not only the financial markets but also the trust of the general population. There were several actors responsible, whom together, with questionable decisions led to the break of the real-estate market and the well-known succession of events.

Europe was strongly affected. The role of Rating Agencies during the post-crisis period, where they executed constants downgrades of EU's countries, aggravating the economic impacts, created a feeling of mistrust regarding the Credit Rating agencies, specially (Standard & Poor's, Fitch e Moody's), all American. Alternatives to those have emerged, from which we may highlight DBRS and Dagong Global, to contest the ratings issued by the American agencies, which were considered suspicious from being biased.
This created a opportunity for other agencies to penetrate the European market, which had been dominated by the "Big Three".

This thesis was developed according to the case study method. A Portuguese agency (Companhia Portuguesa de Ratings) didn't want to miss the opportunity and stablished a joint venture along with credit ratings agencies' leaders in their respective markets, creating a new agency based in Lisbon with the goal of focusing on the European market, ARC Ratings, on 2013. Five years past from its creation, ARC Ratings wants to evaluate the impact it had in the European market, assess if the strategy implemented could have been better and figure out what should be the next steps for the enterprise. By solving the Case, students will be requested to provide the answers to these questions.

Key words: Financial Markets, European Union, Credit Rating Agencies, Strategy

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Case Study

1. Introduction (Business Situation)

September 2008. The Federal intervention on the two most-known Government-Sponsored Enterprises (Freddie Mac and Fannie Mae), the collapse of Lehman Brothers, the forced acquisition of Merrill Lynch by Bank of America (for half the market valuation it had previously) and the AIG rescue agreement with the Federal Reserve Bank (due to a credit rating downgrade): this sequence of events was as unexpected as it was tragic. The Financial World was shaken. The quick rotation of capitals, high liquidity levels, the exaggerated expectations on price appreciation and the easiness on granting credits with low interest rates led to a market bubble. Almost all the financial players, including banks, insurers, enterprises, hedge funds, sovereign funds and families, had their positions shrunk due to a high depreciation of their assets. The majority of the western enterprises and institutions were close to bankruptcy due to inability to pay their debts. Financial markets suffered one of the worst catastrophes of its history, the kind of event that could reshape principles and mind-sets. The world demanded answers, everyone was asking how this was possible and who were the enablers for such disaster. Along with many others, one of the "guilty parties" was the Credit Rating Agencies and their "easiness" in grating prime rating (AAA+ - Low default probability) to Mortgage Securities, without performing a rigorous due diligence, that were actually packets of "AAA securities" mixed with "CCC securities" (High default risk), Mortgage-backed Securities ("MBS") owned by individuals with bad credit standing and unable to repay their loans. This led to a relevant and comprehensive mistrust of the investors and markets in the credit rating institutions.

In Portugal the situation was followed closely at Companhia Portuguesa de Ratings, SA (CPR), a company created in 1988 by Prof. Alfredo de Sousa, a highly reputed Portuguese academic. CPR was the first credit rating agency based in Portugal and focused on the Portuguese market. In 1995, CPR was acquired by its competitor, *Sociedade de Avaliação Estratégica e Risco, Lda. (SaeR, Lda.).* All the rating activities performed by SaeR, Lda. were then transferred to CPR, SA, which became (again) the only Portuguese CRA.

José Poças Esteves, a renowned Portuguese economist and a partner at SaeR, Lda. was promptly assigned to manage the future of CPR as its Chief Executive Officer. His strong background in the financial and economic fields, with focus on Strategic Consulting, Risk Assessment or even Competitiveness and Value Creation, aligned with years of professional experience on the sector and proven outstanding performances, made him the best fit to head this challenging project.

In the summer of 2012, while the economy was still recovering from the 2008 disaster, there was still evidence of the markets' mistrust relative to credit rating agencies, specially the Big Three. Investors started to fear CRA's judgement, not being completely sure of its methodologies, transparency and perhaps "personal agenda", losing its trusted guarantee seal. Other agencies worldwide, such as DBRS Ratings Limited, from Canada, or Dagong Global Credit Rating, from China, started to gain market share in the European and the Asian markets.

José Poças Esteves had a vision, this was the moment to take advantage of this mistrust, the opportunity for smaller agencies to improve their market share by regaining the markets' confidence. Why should CPR keep just operating in the small and limited Portuguese market? This was the question that moved José Poças Esteves to his next step. It was time for CPR to grow and explore the complexity of the global market, to offer a reliable alternative for those misleading CRA that were part of the biggest crisis on the recent financial history. However, a small company as CPR lacked the infrastructures, capital and international know-how to make such a giant step. This had to be overcome, therefore, he put in action a plan, using his vast network built in his years working as auditor and strategic consultant. The final result was revealed to the world on October 7th 2013, when CPR, SA was legally transformed in ARC Ratings, SA and officially registered with the European Securities and Market Authority (ESMA). This was the outcome of a joint venture between five CRA spread over four different continents. The founder partners, along with CPR, SA were: Credit Analysis and Research Limited (CARE), from India; Global Credit Rating Company Limited (GCR), from South Africa; Malaysian Rating Corporation Berhad (MARC), from Malaysia; and SR Ratings, LTDA., from Brazil and a CPR affiliate.

They knew that to generate competitiveness they had to frame a core strategy with an innovative approach to a dynamic and complex new economy, associating not only pioneering rating methods but also having strong global and local expertise referring to

markets and financial matters. These are the pillars that build ARC Ratings, SA, the ambition to provide investors a better outlook on where to invest their capital, through better, more efficient, more precise and adjusted ways to assess ratings both in a global and a local perspective.

ARC Ratings' challenge will be to acquire the trust of the markets and investors. This is its opportunity to strive in the hard and complex credit rating market, and there won't be a second one…

2. Chapter One – The Opportunity Arises

2.1. Credit Rating Agencies Industry

2.1.1. Role of Credit Rating Agencies

The actions of rating agencies could be represented as a cycle between four different players (bank, issuer, investor and borrower), the rating agencies being a fifth player that provides meaningful information to the market. The cycle is started by a borrower searching for a loan to finance some business activity (i.e. investment opportunity, buying a house, etc.). The borrower usually goes to institutions such as a bank or government agency, which will grant the loan carrying a certain interest, here happens the first direct transfer of funds. Later those institutions will establish a business relation with the issuer, banks that build securities packages, to whom they sell those loans into the form of debt (i.e. mortgages, corporate debt). Lastly there are the investors, willing to buy those securities' packages to receive the principal or interest paid on the debt by the borrowers. However, the investors need to know the likelihood of those particular debts being repaid, in total or in part, to understand if it is a viable investment or not. This is the moment in which rating agencies come into action, they provide a credit risk analysis of the assets, calculating the likelihood of a borrower to default. This process is made between the issuer and the rating agencies, through the payment of a fee from the former to the latter. Issuers are willing to initiate this business transaction in order to create value for their assets. A rated asset, with a rating issued by an independent agent, will make their financial instruments (securities' packages) more appealing to investors. Therefore, it's possible to verify several kind of transactions throughout the business cycle between the different players, both assets, payments or informational transactions and in direct or indirect relations. All of the interactions stated could be analyzed in the scheme presented in figure 1. This is the most used business model for rating agencies, where the primary clients are the issuers and their assets. Nevertheless, there is a different business model, where the primary clients are the investors. In this particular situation investors would pay rating agencies in order to rate a specific package. Both situations will be approached later in this case.

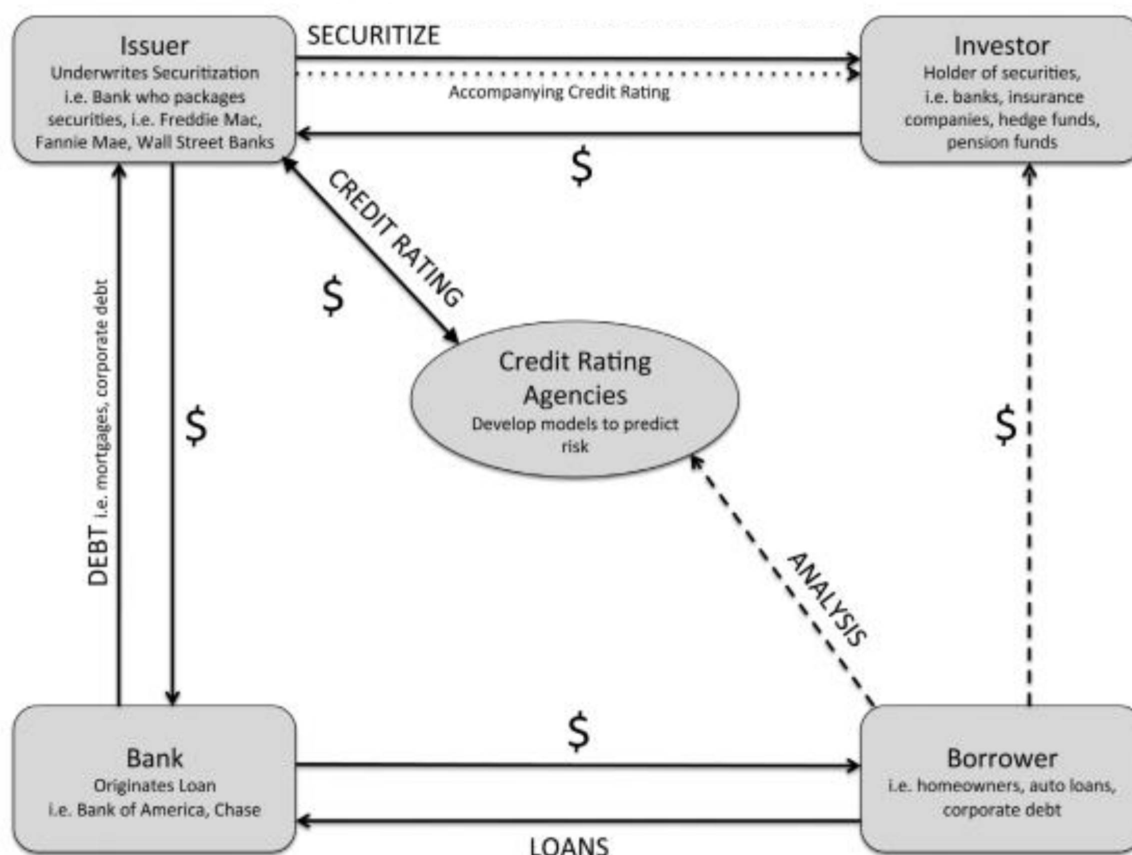

Figure 1 – The Role of Credit Rating Agencies (paper policy)
Source: Ekins, McClintock Emily; Calabria, A. Mark. "Regulation, Market Structure, and Role of the Credit Rating Agencies." Policy Analysis, No.704, 2012.

2.1.2. Rating Score

A rating score is the financial outcome from rating agencies' role. It states, by definition, the likelihood a borrower has to meet its financial obligations to a lender. This assessment of creditworthiness may be done relatively to individuals (credit score), corporations (corporate credit rating), national governments (sovereign credit rating) or financial instruments (i.e. RMBS[1], CDO[2], CMBS[3], etc.) as mentioned previously. The rating score system used by the majority of the rating agencies is based on a letter grade rating (see

[1] Residential Mortgage Backed Securities
[2] Collateralized Debt Obligations
[3] Collateralized Mortgage Backed Securities

table 1 and table 2). Each grade represents thus the likelihood of paying the debt within the loan agreement, higher credit rating (AAA), or the likelihood of default, poor credit rating (≤ BBB- or Baa3).

Long-Term Issuer Credit Ratings*

Category	Definition
AAA	An obligor rated 'AAA' has extremely strong capacity to meet its financial commitments. 'AAA' is the highest issuer credit rating assigned by S&P Global Ratings.
AA	An obligor rated 'AA' has very strong capacity to meet its financial commitments. It differs from the highest-rated obligors only to a small degree.
A	An obligor rated 'A' has strong capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligors in higher-rated categories.
BBB	An obligor rated 'BBB' has adequate capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments.
BB; B; CCC; and CC	Obligors rated 'BB', 'B', 'CCC', and 'CC' are regarded as having significant speculative characteristics. 'BB' indicates the least degree of speculation and 'CC' the highest. While such obligors will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposures to adverse conditions.
BB	An obligor rated 'BB' is less vulnerable in the near term than other lower-rated obligors. However, it faces major ongoing uncertainties and exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitments.
B	An obligor rated 'B' is more vulnerable than the obligors rated 'BB', but the obligor currently has the capacity to meet its financial commitments. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitments.
CCC	An obligor rated 'CCC' is currently vulnerable, and is dependent upon favorable business, financial, and economic conditions to meet its financial commitments.
CC	An obligor rated 'CC' is currently highly vulnerable. The 'CC' rating is used when a default has not yet occurred, but S&P Global Ratings expects default to be a virtual certainty, regardless of the anticipated time to default.
R	An obligor rated 'R' is under regulatory supervision owing to its financial condition. During the pendency of the regulatory supervision the regulators may have the power to favor one class of obligations over others or pay some obligations and not others.
SD and D	An obligor rated 'SD' (selective default) or 'D' is in default on one or more of its financial obligations including rated and unrated financial obligations but excluding hybrid instruments classified as regulatory capital or in non-payment according to terms. An obligor is considered in default unless S&P Global Ratings believes that such payments will be made within five business days of the due date in the absence of a stated grace period, or within the earlier of the stated grace period or 30 calendar days. A 'D' rating is assigned when S&P Global Ratings believes that the default will be a general default and that the obligor will fail to pay all or substantially all of its obligations as they come due. An 'SD' rating is assigned when S&P Global Ratings believes that the obligor has selectively defaulted on a specific issue or class of obligations but it will continue to meet its payment obligations on other issues or classes of obligations in a timely manner. An obligor's rating is lowered to 'D' or 'SD' if it is conducting a distressed exchange offer.
NR	An issuer designated 'NR' is not rated.

*The ratings from 'AA' to 'CCC' may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.

Table 1 – Letter Grading System used from Standard & Poor's in the rating score
Source: S&P Global Ratings Definitions 2016

Long-Term Rating Scales Comparison									
Standard & Poor's	AAA	AA+	AA	AA-	A+	A	A-		
Moody's	Aaa	Aa1	Aa2	Aa3	A1	A2	A3		
Fitch IBCA	AAA	AA+	AA	AA-	A+	A	A-		
Standard & Poor's	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-
Moody's	Baa1	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3
Fitch IBCA	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-
Standard & Poor's	CCC+	CCC	CCC-	CC	C	D			
Moody's	Caa1	Caa2	Caa3	Ca	C				
Fitch IBCA	CCC+	CCC	CCC-	CC	C	D			

Table 2 – Comparison between Moody's, S&P's and Fitch Ratings Scales Source: Bank for International Settlements, "Long-term Rating Scales Comparison," http://www.bis.org/bcbs/qis/qisrating.htm.

2.1.3. Role of Credit Rating Agencies in capital markets

2.1.3.1. Role of Credit Rating Agencies in the 2008 Eurozone crisis and their Criticism

Some published papers[4] argue that the way Credit Rating Agencies conducted the downgrading ratings for European countries was too hasty and intensified the negative repercussions of the financial crisis. Focusing on the downgrading that the PIGS (Portugal, Ireland, Greece and Spain) received by Standard & Poor's, which weakened the trust of investors and lending institutions, resulted on the unavoidable financial rescue of Greece, in 2010, by the IMF. Moreover this situation collapsed the entire financial sector of the country and brought instability to the European economy[5]. This started a snowball effect among the EU members, specially the PIGS, causing a shrinking of the

[4] Bayar, Yilmaz. 2014. "Recent Financial Crises and Regulations on the Credit Rating Agencies." Research in World Economy, Vol. 5, No. 1.

Utzig, Siegfried. 2010. "The Financial Crisis and the Regulation of Credit Rating Agencies: A European Banking Perspective." ABDInstitute, No. 188.

[5] CFR Backgrounders. 2015. [ONLINE] Available at: http://www.cfr.org/financial-crises/credit-rating-controversy/p22328.

European economy due to a lack of confidence of the markets. Besides the obvious economic impact, there was also the social aspect of living in uncertainty. This aspect also contributed to an acceleration of the crisis due to a lack of knowledge about the steps to follow. People, in general, were afraid of putting their money in the banks, which intensified the situation and created an even bigger hole in the financial system.
These events generated an environment of uncertainty surrounding CRAs, specially on the European markets. The reasons stated for such mistrust were:

- the fact that CRAs are not legally responsible for their ratings, they state that “they are merely issuing “opinions”[6];

- the oligopoly of the Big Three American agencies (Standard & Poor’s, Fitch and Moody’s), which creates a suspicion of preference for higher ratings in American enterprises;

- the model “issuer pays” that brings a conflict of interests, opening a door for a model “pay more, rate more”[7].

Moreover, the fact that is so easy for these agencies to avoid legal responsibilities and just hide behind the First Amendment[8], may let one think if it’s a good option to invest money on an “opinion” of agencies that do not want to be held responsible for it afterwards.
Secondly, but equally problematic, is the oligopoly in the credit rating industry where the so called Big Three control 94% of the global market. Many discussion papers argue[9] that

[6] SWP Berlin/John Ryan. 2012. The Negative Impacts of Credit Rating Agencies and proposals for better regulation. [ONLINE] Available at: https://www.swp-berlin.org/fileadmin/contents/products/arbeitspapiere/The_Negative_Impact_of_Credit_Rating_Agencies_KS.pdf.

[7] CFR Backgrounders. 2015. [ONLINE] Available at: http://www.cfr.org/financial-crises/credit-rating-controversy/p2232.

[8] Nagy, T, 2009. Credit Rating Agencies and the First Amendment. Minnesota Law Review, [ONLINE]. 94:140, 140-167. Available at: https://www.minessotalawreview.org/wp-content/uploads/2011/08/Nagy_MLR.pdf.

[9] SWP Berlin/John Ryan. 2012. The Negative Impacts of Credit Rating Agencies and proposals for better regulation.

the ratings may be biased due to the fact of all the agencies being incorporated in the American market. Therefore, an upgrading evaluation for that market would benefit them, generating a conflict of interest. "Some European leaders have blamed for aggravating the sovereign debt crisis with erratic and "subjective" ratings decisions…including rating agencies amplifying "contagious effects" though "subjective biases", and "arbitrary" downgrades that are poorly explained, triggering "significant investor over-reactions"[10]. In order to address these factors the EU decided to give ESMA (European Securities and Markets Authority) the power to regulate ratings. However ESMA doesn't have the capability to issue ratings, it can only vet ratings that appear not proper[11].
The problems and conflicts stated before arise an important question: why do credit rating agencies exist?

2.1.3.2. Why do Credit Rating Agencies exist?

In 1909, John Moody issued ratings for the U.S. railroad bonds, which originated Moody's Investors Service (1914). In 1941, Standard Statistics Company (1922) joined Poor's Publishing Company (1916), establishing Standard & Poor's Corporation. It published sovereign debt, corporate and municipal bonds ratings. Finally, in 1913, the Fitch Publishing Company was founded. It implemented the AAA through D rating system, in 1924, which is used nowadays throughout the industry as the rating basis. It was the birth of what are known today as the Credit Rating Agencies (CRA). These agencies specialized on assessing the ability that a given debtor has to pay back loans, which may be governments, companies or even sovereign nations, its creditworthiness. CRA's issue ratings depending on the likelihood of default by the debtor ("default risk"). The market analysis, performed by CRA's, allows investors to be aware of the investment risk meanwhile efficiently allocating their capital. Due to the U.S. market liquidity and strengthened regulatory requirements, which established strong entry barriers for

[10] SWP Berlin/John Ryan. 2012. The Negative Impacts of Credit Rating Agencies and proposals for better regulation. [ONLINE] Available at: https://www.swp-berlin.org/fileadmin/contents/products/arbeitspapiere/The_Negative_Impact_of_Credit_Rating_Agencies_KS.pdf.

[11] ESMA's supervision of credit rating agencies and trade repositories. 2015. www.esma.europa.eu. [ONLINE] Available at: https://www.esma.europa.eu/sites/default/files/library/2016-234_esma_2015_annual_report_on_supervision_and_2016_work_plan.pdf.

competitors, the three agencies stated previously (aka The Big Three) created an oligopoly controlling 90% of the global market share.
Credit Rating agencies' origins date back to the beginning of the 20th century, as stated previously in this case, when Moody's and Standard & Poor's were founded (Partnoy, 1999). According to literature, CRAs[12] were built to have two basic functions, that prevails as the reason for their existence:

i. Correction of the information asymmetry between issuers and investors (Boot et al., 2006; Listokin and Taibleson, 2010);

ii. Reduction of the costs of regulation (Partnoy, 1999; Macey, 2006; Listokin and Taibleson, 2010).

The first role is comparable to the "lemon" problem (Akerlof, 1970). This states that higher quality borrowers will be driven out of the market due to higher rates imposed by creditors, trying to protect themselves against lower quality borrowers ("lemon" borrowers). Rating agencies would solve this issue by acting as an independent intermediary, providing new information and verifying information on the borrowers' creditworthiness. However, some authors argue that the CRA role in this matter is not essential, since it doesn't add much new information to the market (Macey, 2006; Fitzpatrick and Sagers, 2009). If credit rating is just an output of financial analysis publicly available, this argument is valid. Furthermore, there is no evidence that information asymmetry would inevitably lead to a "lemon" market of borrowers, which could be prevented by due diligence, credit history or independent analysis from investors.

The second purpose for its existence is to regulate bond investments by financial institutions (Partnoy, 1999; Macey, 2006; Listokin and Taibleson, 2010). The US government gave the NRSRO (Nationally Recognized Statistical Rating Organization) status to some rating agencies in order to outsource some aspects of regulation, specifically in the area of investments and capital structure of financial institutions. This

[12] Credit Rating Agencies

action was intended to reduce the net costs of regulation, primarily the necessity of creating an analytical structure to evaluate bond investments, transferring it from investors to rating agencies.

Some authors argue that Credit Rating Agencies serves mostly as a public function, but not only as a regulator. The market rational reason for the existence of rating agencies could be explained by their role performing a sorting of information (Coffee, 2011; Rhee, 2013b; Rhee, 2015). The authors go further by arguing that rating agencies would exist as market players, even without its regulatory function.
The main evidence for this theory is the credit market volume and number of issuers, which would present a complication in the absent of an entity to sort, organize and make the information available.

	S&P	Moody's	Fitch	Others NRSROs	Total
Financial instructions	54,000	61,581	61,550	32,207	209,338
Insurance companies	8,200	4,540	1,657	5,391	19,788
Corporate issuers	44,500	30,285	13,385	11,116	99,286
Asset backed securities	117,900	101,546	64,535	18,480	302,461
Government Issuers	965,900	841,235	363,897	14,694	2,185,726
Total	1,190,500	1,039,187	505,024	81,888	2,816,599

Table 3 - Outstanding credit ratings reported by NRSROs to the Security Exchange Commission in 2011.
Source: U.S. Securities and Exchange Commission, 2011.

The data in table 2, shows the enormous number of issues rated by several NRSROs. Even considering that it has to be adjusted, due to the fact that is a common practice to be rated by at least two different rating agencies, the number is overwhelming. This fact aligns with the authors theory, that CRA are needed due to the enormous amount of information to be processed, the larger scale of the fixed income securities requires an efficient allocation of research resources that would be difficult to obtain by individual investors. Moreover, associating the data from table 2 with the data from table 3, which shows the number of credit analysts and supervisors employed by several NRSROs, we may find an even stronger evidence for this matter. Analyzing the data, it's possible to conclude that it would be unbearable, in terms of cost allocation, for investors to compete with ratings agencies, whom have more than 3500 credit analysts at their disposal. This cost would translate on a lower budget to allocate resources into equity analysis and new investment opportunities assessment, for investors and firms, an essential tool for players in the equity market.

	Credit Analysts	Credit Analysts Supervisors	Total
Moody's	1.088	116	1,204
S&P	1.109	236	1,345
Fitch	712	337	1,049
Other NRSROs	281	111	392
Total	3,190	800	3,990

Table 4 - Number of credit analysts employed by NRSROs as reported to the Security Exchange Commission in 2011
Source: U.S. Securities and Exchange Commission, 2011.

An unrealistic alternative would to pursue cooperation among investors. This solution would raise few problems, such as the amount of research and resources each one should deliver or loosing competitive advantage towards competitors. The first aspect leads to the possibility of free-riders, meanwhile the second carries problems related to sharing market intelligence or receiving misleading information from competitors deliberately. The rational conclusion is that the rating agencies are the most cost-effective solution for the credit market sorting of information problem.

2.1.3.3. "Issuer pays" Model vs Alternative models

Nowadays, the business model most used by NRSROs, is the "issuer pays" model. As stated previous, this presents a clear conflict of interests that generates suspicion and mistrust in the markets. However, the question is if there are better alternatives and if those are adequate to be put in action.

I. "Issuer pay" Model

Firstly, is important to understand the model, which is fairly simple and is explained in the figure 2. This model relies on the issuers' willingness to pay, in order to increase their value through the perception of being a desirable investment asset and to access public debt markets. However, it triggered the discussion whether rating agencies weren't receiving incentives in order to inflate the ratings for their clients, in order to retain or even charge higher fees. This question is usually addressed with the nature of the credit rating agencies market, which is relatively closed but is built on the grounds of reputation. Therefore, the argument is that rating agencies would not be willing to lose their market position by accepting to overstated rates for issuers. It is an arguable assumption, once if all the agencies would agree to do it, the reputation damaged would not affect a single agency alone, thus opening a gray area.

Figure 2 – "Issuer pays" Model

II. “Subscriber pay” Model:

An alternative model is the “subscriber pay” Model, which is depicted in figure 3. Nevertheless, for the reasons stated in the previous section, it is not a valid option.

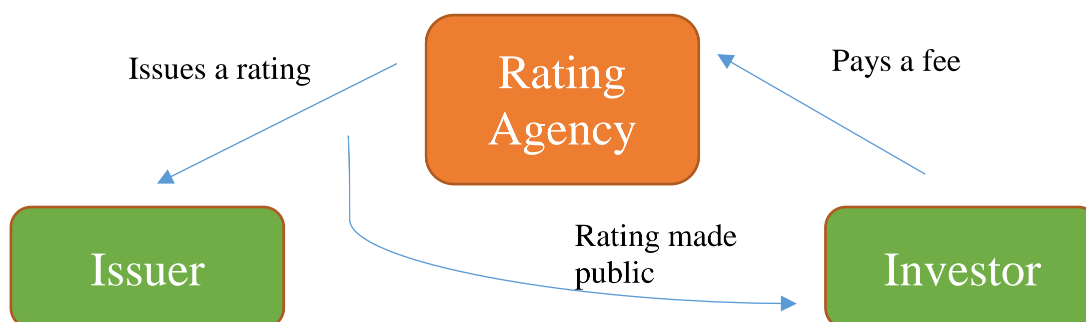

Figure 3 – “Subscriber pays” Model

III. Government as Hiring Agent Model

This is a more complex model, which states that the selection of the rating agency, to be used by an issuer, would be given to an independent agency. This basically means that the issuer would not be able to choose which rating agency would rate it, preventing thus a possible agreement between issuer and agency. It states that the initial rater would be chosen by a Board (Credit Agency Review Board), being afterwards the issuer free to not disclose the rate publicly or to hire additional rating agencies. The Board would be established under the Security Exchange Commission, being also responsible to set a “ceiling fee” in order to avoid overcharging or bribery. This Model was suggested in 2010[13], adding to the Dodd-Frank Act[14], under the Franken Amendment. This model remains a possibility for the future, but still has to overcome some studies about its feasibility.

The Model is, in a simple version, depicted in figure 4.

[13] OECD, 2010. “Competition and Credit Rating Agencies.”.

[14] The Dodd-Frank Act will be discussed later on the section Regulation of Credit Rating Industry.

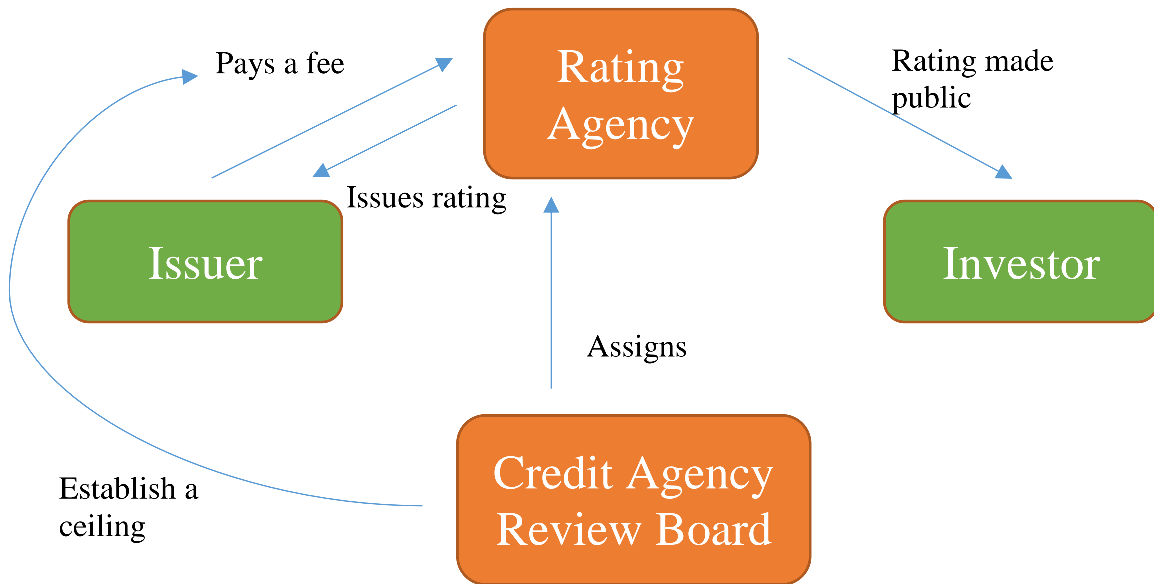

Figure 4 – Government as Hiring Agent Model

IV. Government Utility Model

This model sustain that a Governmental rating agency should be created in order to allow a term of comparison against the traditional rating agencies. This option is unrealistic in the sense that it would be an insupportable cost for the governments to sustain such an entity, that would most likely not be used in the private market.

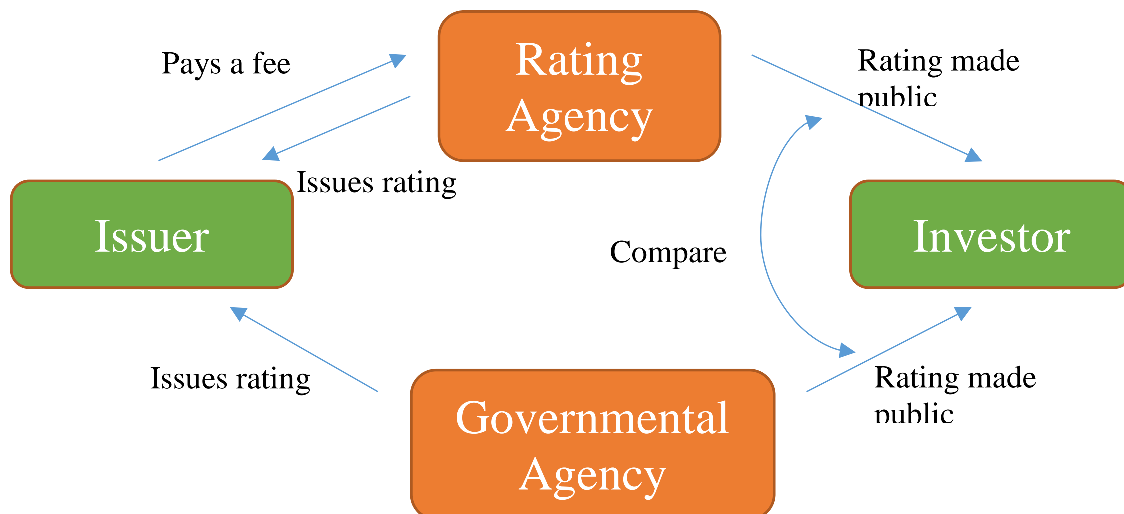

Figure 5 – Government Utility Model

Thus, throughout the analysis of the several alternatives, it’s possible to reach the conclusion that the current used model (“issuer pay” model) is the most suited option for the rating agencies market. However, it should be revised, in order to implement improvements and regulations, playing an active part in the prevention of future complications on the financial markets, such as the tragic events in 2008.

2.1.3.4. Competition among Credit Rating Agencies

There are evidences, not only in the literature but also empirical ones, that credit rating agencies operate in an oligopolistic market. This designation is given to an industry where few firms detain the majority of the market share, with high entry barriers for new firms, which can be natural or artificial impediments. An oligopolistic market differs from a competitive market in the sense that in the last, new firms will enter the market and compete with existing firms to gain/capture economic profits. However, in an oligopoly this is prevented through the barriers to entry. The outcome from the former is a market that strives with few firms, experiencing an increase in prices, being though less interested on finding or improving new tools on the credit risk assessment, which ultimately may reduce the quality of the information accessible by investors.

The natural barriers appear throughout reputational factors, that influence issuers and investors while choosing an agency to issue their rating. This moves the market towards a natural concentration, not only because of the reputational references already stated but also resulting from network effects. Lawrence White explains this phenomenon, where the same rating agency is used in order to achieve consistency across rating categories[15]. The reputational factor is explained by Langohr and Langohr[16], who argue that “a small number of CRAs with the highest reputation for quality and independence will always dominate”. Still, the dominant agencies failing on issuing accurate ratings, shown by the 2008 crisis, aligned with the suspected conflict of interests, due to the business model

[15] White, Lawrence J., 2010. "Markets: The Credit Rating Agencies." Journal of Economic Perspectives,24(2): 211-26.

16 Langohr, Herwig, and Patricia Langohr. 2008.“The Rating Agencies and Their Credit Ratings: What They Are, How They Work, and Why They Are Relevant.” Chichester Wiley.

used in the industry ("issuer-pays"), without losing its market dominance, reveals that beside the natural barriers, there must also be regulatory barriers.

The greater barrier to new entrants was the NRSRO designation. This regulation, that will be further observed in more detail on the Regulations chapter, conceded privileges to several rating agencies by giving them a "regulatory license" status. It was a "seal of guarantee" from the SEC, stating that a particular rating agency was complying with a minimum quality standard. This became a major advantage for NRSRO's rating agencies since some investors were legally obliged to invest in NRSRO's CRAs rated products. This created a core market advantage for NRSRO's rating agencies, once both issuers and investors were incentivized to invest their money in order to achieve a regulatory privilege. It stands as a government regulatory barrier because the process to achieve a NRSRO designation is long and unclear. Some rating agencies, such as Egan-Jones, DBRS or AM Best, state the extensive and shady process they have been through in order to obtain their "place" in the market[17]. On figure 6 is possible to see the timeframe comparison between their existence and the NRSRO designation of different rating agencies.

[17] Sean Egan, Managing Director, Egan-Jones Rating Company, 2005."The Role of Credit Rating Agencies in the Capital Markets," Testimony before the Senate Committee on Banking, Housing and Urban Affairs (Washington: 2005), 1–12.

Langohr and Langohr, 2008. "The Rating Agencies and their Credit Ratings."

J. Wiggins, 2002. "A Chance to Step into the Light," Financial Times (London).

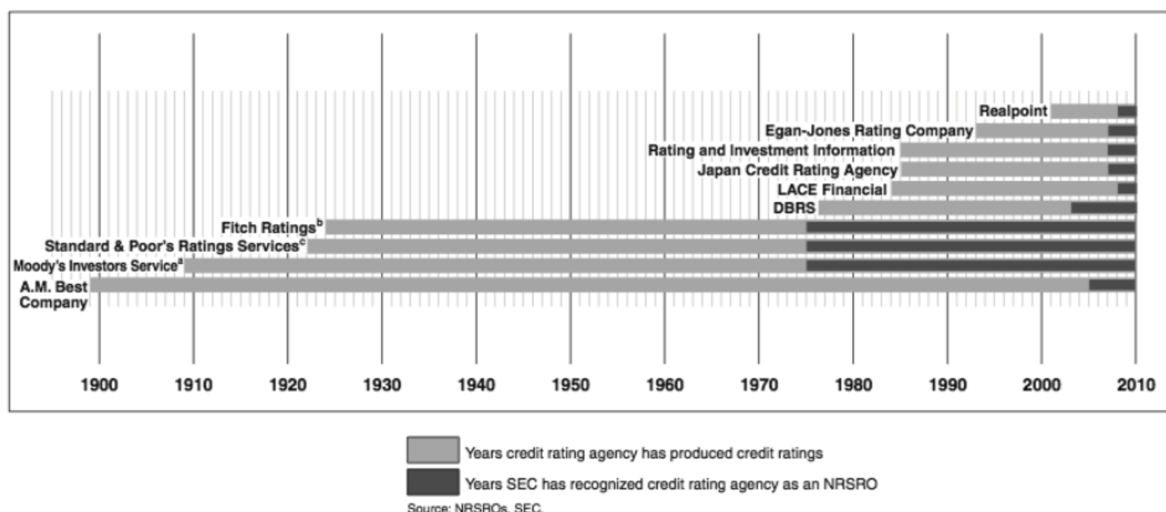

Figure 6 – Credit Rating History of Current Nationally Recognized Statistical Rating Organizations (NRSRO)
Source: Securities and Exchange Commission, *Action Needed to Improve Rating Agencies Registration Program and Performance-Related Disclosures* (Washington: United States Government Accountability Office, 2010).

Thus, resulting from a lower competitive threat and a high demand, NRSRO CRAs may have most likely reduced the quantity and quality of information supplying the market. The primary focus was to work for higher rates instead of innovation and following the market needs for better credit risk assessment due to more complex financial instruments. It finally ended up in an industry incentivized to be more complacent with its methodologies and looking up for market share retain instead of quality information.

Therefore, we may argue that opening access to the NRSRO designation would be beneficial and improve the credit risk assessment quality. However, Becker and Milbourn[18] explains that it still reduce the methodology efficiency within the regulatory framework. Their findings are in accordance with the conflict of interest stated previously on the case, where CRAs seeking to meet their clients' needs, tend to inflate their ratings[19]. This matter is observed in figure 7, which shows that investment rating grades was higher with high competition than with low competition. Moreover, opening the market without overcoming this issue would not be enough to create new methodologies

[18] Becker, Bo, and Todd Milbourn. How Did Increased Competition Affect Credit Ratings?, Harvard Business School, 2010.

[19] Becker, Bo, and Todd Milbourn. How Did Increased Competition Affect Credit Ratings?, Harvard Business School, 2010.

by CRAs. This problem needs to be addressed in order to build a framework that will incentivize rating agencies to comply with a constant innovation in their processes.
Thus, resulting from a lower competitive threat and a highly demand, NRSRO CRAs are most likely to have reduced the quantity and quality of information supplied to the market.

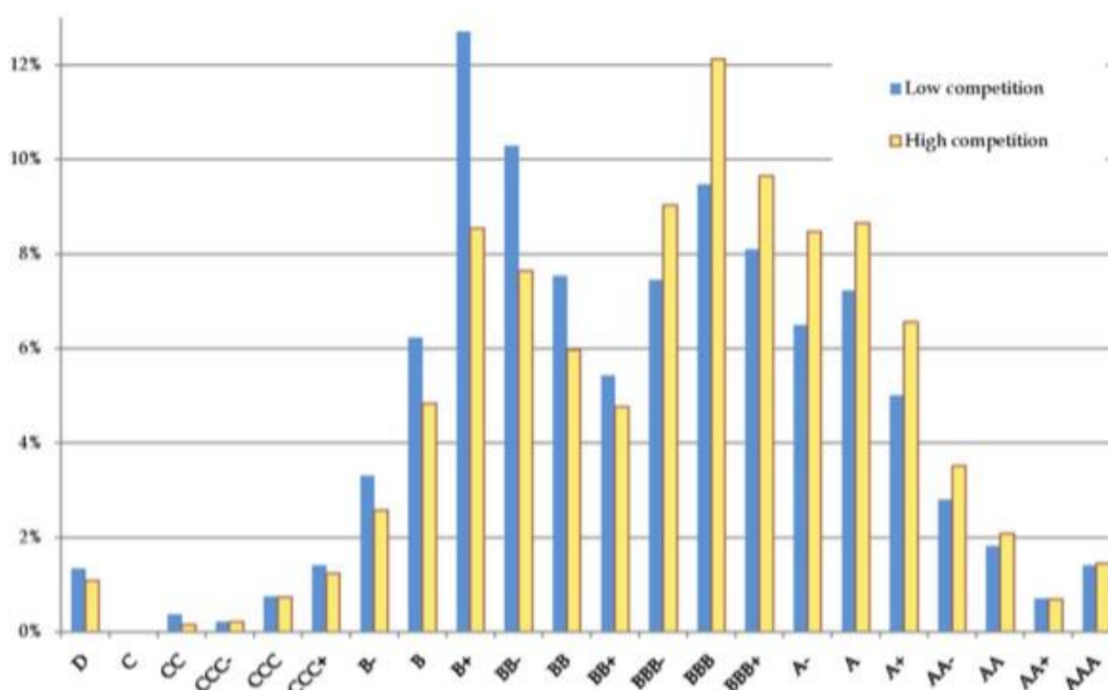

Figure 7 – Firm credit ratings distribution differences dependency to high and low competition on the credit rating industry
Source: OECD, 2010. "Competition and Credit Rating Agencies.".

2.1.4. Regulation of Credit Rating Industry

As a consequence of several events, such as the bankruptcy of Enron Corporation in 2001 or the collapse of Lehman Brothers in 2008, which were followed by the financial crisis, the CRA industry has been subjected to regulation procedures trying to prevent this kind of incidents in the future. Regarding this concern, both the US and the EU agreed on a series of principles that CRAs should implement as a code of conduct in order to commit to a more accurate and transparent process, offering a better service to the public. In the

US this was “accomplished” by the IOSCO[20] CRA Code of Conduct and the SEC, meanwhile in the EU was formed the ESMA[21], whose role was to supervise the rating grades and assure that they were proper.

2.1.4.1. IOSCO CRA Code of Conduct

It was firstly drawn and enforced in December 2004, after the Enron Corporation collapse in 2001. It was later revised in 2008, when the financial crisis occurred. The US government was urged to devise a more precise method for the industry due to the fact that Enron and Lehman were still on an investment grade level one day before their collapse, which showed the industry’s weakness. In this sense the IOSCO Code of Conduct raised the following regulatory issues:

1. CRA transparency in the rating process;
2. Independence and conflict of interest;
3. CRA industry and competition.

To address these issues the Code of Conduct, reformed in 2008, stated the following principles that CRAs should comply with:

i. The decision-making process should be objective on the reviewing of current ratings, which could be obtained by using separated teams to assess an initial rating and further to monitor that rating;
ii. A rating should be periodically reviewed, taking into consideration new methodologies and approaches that may be significant for the business;

iii. The measures and procedures used to assess a rating should contain sufficient quality to have a credible support. If this point is not complied with, then the CRA must state its limitations;

[20] International Organization of Securities Commissions
[21] European Securities and Market Authority

iv. CRAs should allocate adequate resources to the monitoring of significant changes in the business behind a particular rating, in order to be able to procced for an appropriate update, both in information and time, of that rating;

v. A CRA should monitor its employees and establish procedures to prevent an analyst involved in a rating process to leave the CRA and join the issuer of the financial instrument he was working on;

vi. A CRA should disclose if any client represents more than 10% of the CRA's annual revenue;

vii. CRA's should encourage a public disclosure of all the relevant information regarding a structured financial instrument, in order to allow investors to perform their own due diligence if they find it suitable;

viii. A CRA should publish verifiable historical information of their performances that allow investors to perform a comparison between different CRA's;

ix. A CRA should states its symbology across different structures of financial products and clearly identify and apply it in the same manner for similar products;

x. A CRA should disclose the methodology used to determine a rating for a specific financial product.

In addition to the IOSCO Code of Conduct, there is also the SEC designation of NRSRO as we explained previously in this case. The role of the SEC is to supervise CRAs, and one of its mainly requirements to obtain the so desired nomination of NRSRO is the compliance with the IOSCO Code of Conduct.

Furthermore, in 2010, the US Congress passed the Dodd-Frank Act. The Act aimed to empower the principles of the IOSCO Code of Conduct, by introducing rules for internal monitoring, managing conflicts of interest, improving rating quality and incentivizing periodical reviews of ratings. Under the Dodd-Frank Act, the SEC received higher

responsibilities on the overseeing of CRAs, being now responsible for conducting an annual examination of each NRSRO, issuing a public report stating its performance. If a NRSRO fails on providing reliable ratings, accordant with the IOSCO Code of Conduct, its NRSRO license may be suspended or revoked. Moreover, under the Act, CRA's started to be accountable for their ratings, if its provable that they failed on verifying the basis of the rating.

2.1.4.2. European Securities and Markets Authority (ESMA)

The global crisis, in 2008, that affected the sovereign debt ratings in Europe, made the European Union move towards a CRA regulatory framework. In 2009, the Regulation (EC) No 1060/2009, was approved by the European Parliament and the European Council. It was not only to reinforce the IOSCO Code of Conduct, but also to move from a self-regulatory system to a government-regulated framework. However, this Regulation suffered an Amendment, in 2010, proposed by the European Commission. This new proposal created the ESMA (European Securities and Markets Authority), which is nowadays responsible for the registration and supervision of CRA in the EU. Therefore, ESMA works as a regulatory "third-party" that has the role to supervise, approve and endorse the rating methods and the rating grades, both coming from CRA outside and inside the EU. Moreover, ESMA will only accept rating agency grades from regions with similar legal requirements. These actions have strengthened the European financial system, nevertheless the European Commission stresses that ratings should always be supervised thoroughly by investors.

3. Restatement of the Case's issue

In conclusion, José Poças Esteves identified a unique business opportunity that could generate a comeback to Companhia Portuguesa de Ratings. In order to undertake this bold vision, he negotiated with several rating agencies all across the world, establishing a joint venture that could allow a newly created rating agency (ARC Ratings) to penetrate a fragile European Market.

As stated, this is a unique opportunity that won't appear twice, therefore it is crucial to have a strong and well planned strategy. ARC Ratings put into motion its strategy and started operating on the European Markets on 2013. The Board of Directors decided to evaluate the enterprise performance since its launching, and to do so they decided to hire a financial/strategic consultant to evaluate the actions they took for the past 5 years and to measure the impact that the expansion strategy had on their value.

As ARC Ratings' consultant, your job will be to evaluate if its strategy was the best one taking into consideration the rating European rating market in 2013, measure its performance since then and finally propose a path to go in the future.

In order to support your decision, prepare a presentation where you will deliver your findings to ARC Ratings' Board of Directors.

4. Teaching Note

Chapter Two - The decision making for ARC Ratings, SA

4.1. Target Audience

Bachelor and Master students on the fields of Financial Markets and Strategical and Operational Management.

4.2. Learning Objectives

The learning objectives aimed at for this Case could be stated as:

a) Familiarize the addressees of the Case with the Credit Rating Agencies Business Model/Market and the role Rating Agencies played on the 2008 financial crisis and remember that besides the scrutiny they underwent on that time; the rating remains one of the major (if not the major) economic indicator of the "financial health" of a country (sovereign) or an enterprise (private);

b) Alert for the importance of the design a well-structured and informed strategy in order to succeed, which could be on an international or market based expansion, as well as highlight the factors enterprises need to take into consideration to build their growth strategy;

c) Finally provide an understanding that the financial and business world, in general, is not a steady environment, things may change in a fraction of a second, and it's a trait of a good manager to be able to adapt to these changes. As stated, Companhia Portuguesa de Ratings was no a prosperous business, however José Poças Esteves took advantage of an adverse situation to strengthen his company. Therefore, one of the objectives is to emphasize this

kind of mindset that addresses can benefit from in their future professional life.

4.3. Literature Review addressing the Case's Issue

4.3.1. Strategic Planning

As stated in the case, defining a well-structured strategy is a key success factor. In order to achieve an informative and defined approach, today's companies need to understand not only their internal strengths and limitations, but also the business environment surrounding them. "Strategy is the direction and scope of an organization over the long term, which achieves advantage in a changing environment through its configuration of resources and competences" (Johnson et al. 2009). In this sense, a strong strategic planning is constituted by an internal (SWOT Analysis and Ansoff's Matrix) and an external analysis (PESTLE Analysis and Porter's 5 Forces) analysis:

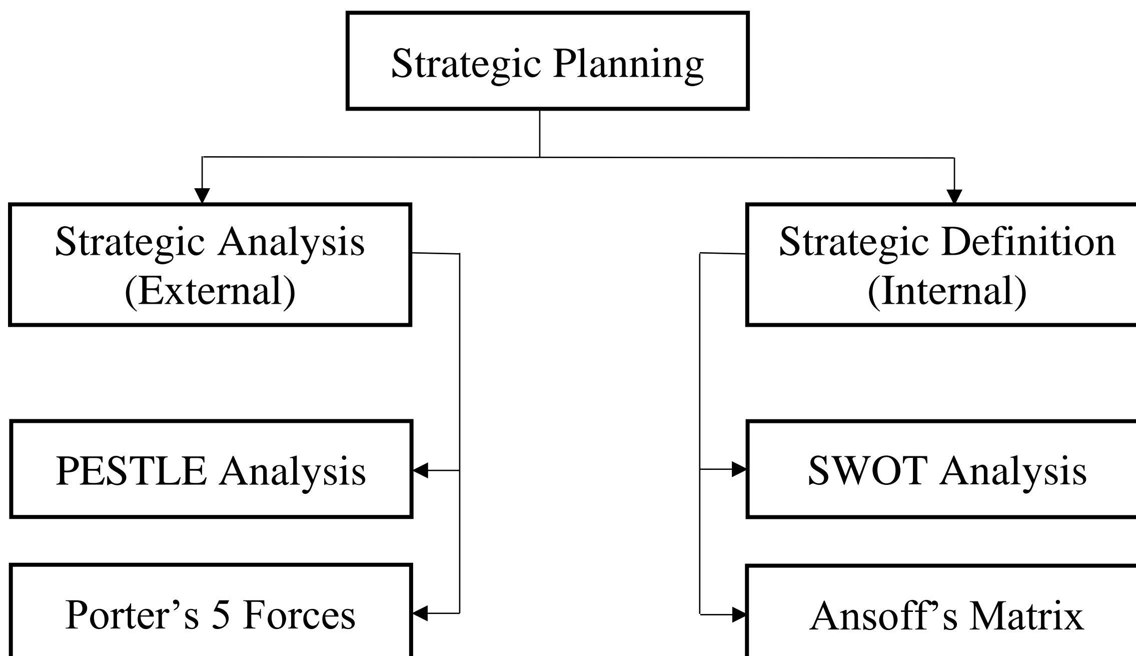

Figure 8 – Strategic Planning Diagram
Source: Adapted from Team FME; PESTEL Analysis: Strategy Skills; ISBN 978-1-62620-998-5

4.3.1.1. PESTLE Analysis

When performing an external analysis, it is critical to understand the environment factors that could affect the enterprise's operations. These factors could be Political, Economic, Social, Technological, Legal and Environmental (PESTLE):

- Political: It is advisable to be cautious about policies and governments in the geographical area an enterprise is willing to operate, because an unstable government may have a significant impact on day-to-day operations. For instance, operating in the European Union area, with few trade restrictions won't be the same as trading in the Middle East, where operations may be much more regulated and costly;

- Economic: It is crucial to have a macro-economic understanding of the geographical region an enterprise is operating in. Factors such as unemployment, employees' education, wages and working practices or labor trends have a significant impact on day-to-day operations and profitability. It is therefore important to have a deep knowledge, which can be obtained by research, in financial news on the region and use of official economic indicators, such as GDP;

- Social: From the Social point of view, it is important to have a good knowledge about the demographics and level of education in the geographical areas a company is targeting, which will produce a better cross-cultural communication in order to promote its business;

- Technological: In this field it is important to be aware of technological breakthroughs that may impact companies' business models. For instance, if there will be an innovative way to achieve the outcome your enterprise is delivering with significantly less costs or even a completely new manner that could make your services obsolete;

- Legal: In terms of Legal issues, is important to understand if there are laws that could be an impediment for the companies' operations, or even if there is the

possibility of new laws to be implemented in the near future. For instance, in the European financial market, the European Central Bank ("ECB") is a major regulator which imposes certain regulations to companies in order to operate on the EU;

- Environmental: Environmental issues have gained a preponderant role in today's society. Therefore, companies' must be attentive and sensitive to this kind of issues, especially specific local regulations, in order to avoid either environmental fines as well as local boycotts of their goods and services.

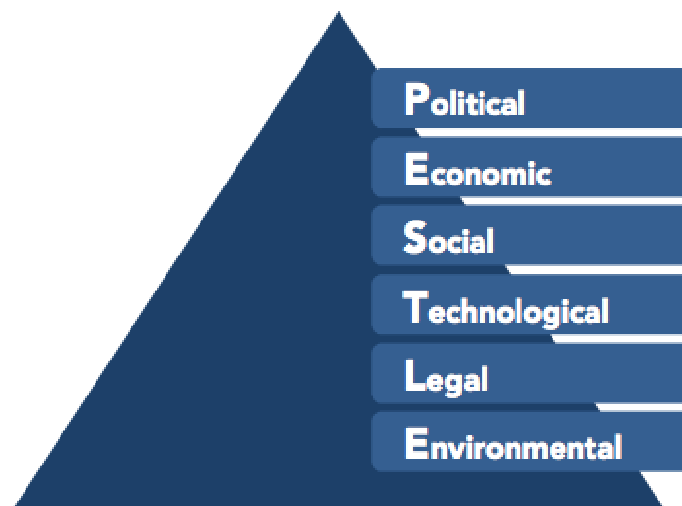

Figure 9 – PESTLE Analysis elements
Source: Team FME; PESTLE Analysis: Strategy Skills; ISBN 978-1-62620-998-5

4.3.1.2. Porter's 5 Forces

Just as a PESTLE analysis, Porter's 5 Forces are also an external analysis. However, PESTLE is an analysis of the external environment, meanwhile this analysis is specific for obtaining an understanding of the attractiveness of an industry. It's important to fully understand that on this analysis we start narrowing our information, we already know the environment we're facing, now we need to understand the attractiveness of the specific

market we want to get into. In this sense, Porter identified five elements, that combined can give companies an outlook of the costs and profitability of entering in a new market[22]:

- Competition among competitors: This includes different types of competition, such as price discounting, services improvements, etc. Basically it means to analyze if the market is already saturated with too many players or if demand will still stimulate the growth rate of the industry. One example is to analyze the market share of the competitors and understand if the market is monopolized or if its shared among the players;

- Bargaining Power of Suppliers: This element is related to the risk of suppliers threatening the companies with higher costs for goods and services. For instance, an industry with fewer suppliers may be more susceptible to increasing demands from suppliers, since there are no alternatives;

- Bargaining Power of Buyers: Is very similar to the previous point, however in the other side of the coin. If buyers have a wider range of choice (several suppliers of that good or service) between which they may switch easily, looking for the better offer, this will decrease prices and therefore decrease the revenue;

- Threat of Substitutes: This element addresses the possibility of creating new products that will fulfill the same needs of the company's product, with less costs or in a new way that could be more appealing to consumers, which would turn the current offers obsolete to the market. An example of this was MP3 that turned CD Players obsolete and eliminated then from the market;

- Threat of New Entrants: Is related to the possible market entry barriers for new companies. Those entry barriers limit the number of competitors, which will also reduce the competition among them. These barriers could be affected by product differentiation, capital requirements, access to distribution channels, economies of scale or even government policies.

[22] Porter, M. E. (1979). How competitive forces shape strategy. Harvard Business Review

Figure 10 – Porter's 5 Forces
Source: https://www.business-to-you.com/porters-five-forces/, accessed on September 19th, 2018

4.3.1.3. SWOT Analysis

On this point we start to evaluate the internal aspects that will be relevant to stablish a strategy. A SWOT Analysis correspond to an understanding of the Strengths, Weaknesses, Opportunities and Threats of the enterprise. By combining them into a four entries matrix, management is able to identify the points to be improved, as well the opportunities and threats the company will face when pursuing a course of action.

	Strengths	Weaknesses
Opportunities	How do I use these strengths to take advantage of these opportunities?	How do I overcome the weaknesses that prevent me from taking advantage of these opportunities?
Threats	How do I use my strengths to reduce the impact of threats?	How do I address the weaknesses that will make these threats a reality?

Figure 11 – SWOT Analysis Matrix
Source: https://academicjournals.org/article/article1380639652_Ommani.pdf, accessed on September 19th, 2018

4.3.1.4. Ansoff's Matrix

For further information regarding this topic address point 5.1 of the note.

5. Chapter Three – The Time has Come

After identifying a market opportunity, there is the phase of selecting the adequate strategy to make the most out of it. In order to stablished the better path to grow it's extremely important to have internal and external factors into consideration, such as capital/personal/in-house limitations or macro-environment factors, etc. All of those components will merge on a "formula", that is not a guarantee of success but a better chance on the pursuit of it.

5.1. Growth/Expansion Strategies

According to Penrose (2006) any enterprise has an expansion limit, which means that there is a growing point from where it starts decreasing its profits. Nevertheless, Penrose also states that this limit point could be overcome through an internal adaptation and development of new products or new opportunities.
Thus, taking in consideration Penrose's conclusions, we may conclude that the limits of an enterprise are set from market opportunities and/or management decisions.
We may therefore argue that the growth strategy of an enterprise is correlated with both new market opportunities identified and the decision of upper management on how to react to them, which may be influenced by the market sector analysis, new products or services to explore and even prospects of increasing market share.
Taking all of the previous points stated into consideration, management has to decide a best outcome strategy to follow, which can be divided in four paths to undertake, Chandler (1962):

i. Volume Expansion: An increase on the sale's volume of the enterprise on the market;
ii. Geographic Dispersion: An increase on the locations that the enterprise offers its services or goods;
iii. Vertical Integration: Consists on the integration of new services that complement the present offer of the enterprise, which will increase the supply chain valor. It could be done by adding a supplier of goods (backwards) or acquiring a retailer of its goods (forward);

iv. Goods or Services Diversification: Consists on the development of new products or services to be offered by the enterprise.

As stated previously in this note, the market and internal analysis (which together may show new potential opportunities) are essential to define the growth strategy (Ansoff, 1957).

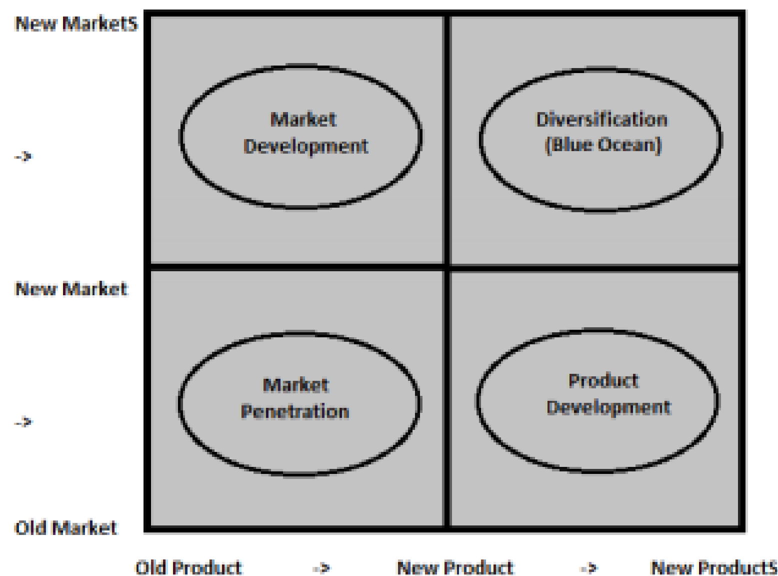

Figure 12 – Ansoff's Matrix
Source: Adapted from Ansoff, 1957

According to Ansoff's matrix, we may argue that depending on the position of the enterprise on the market segment, it should focus on a specific strategy, which could be one of the following[23]:

v. Market Development: penetration of new markets with existing goods or services;

vi. Market Penetration: obtaining market share on an already stablished market;

vii. Diversification: penetrating on new markets with innovative goods or services:

viii. Product Development: developing new goods or services in an already established market.

[23] Navarra, Daniela and Scaini, Luca; Improvements In The Strategic Use Of The Marketing Matrices Applying Dynamics Parameters Based On Time: A Better Analysis Of Prospect; European Scientific Journal April 2016 edition vol.12, No.10 ISSN: 1857 – 7881 (Print) e ISSN 1857 - 7431

However, a paper written in 2016[24], suggest some improvements that could be made to Ansoff's classic Matrix, due to it being a two axis basic matrix, by adding for instance the kind of strategy that the enterprise may be aiming.

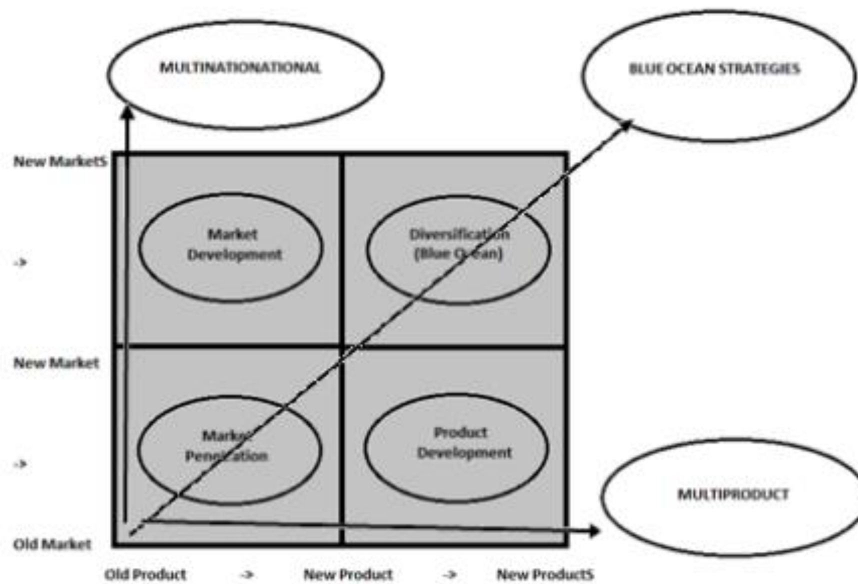

Figure 13 – Ansoff's Matrix with strategic positions goals
Source: Paper Improvements In The Strategic Use Of The Marketing Matrices Applying Dynamics Parameters Based On Time: A Better Analysis Of Prospect

Therefore, this new approach may add relevant information for the future position of an enterprise taking into consideration the strategy it wants to put in action. According to the paper, there are three macroeconomic environments that can be achieved[25]:

ix. Multinational: focusing on approaching and developing new markets, leaving innovation as a secondary roll;
x. Blue Ocean Strategies: Main focus on developing new goods and services and entering new markets;
xi. Multiproduct: focusing on acquiring innovative goods or services as a competitive strategy on stablished markets.

[24,24] Navarra, Daniela and Scaini, Luca; Improvements In The Strategic Use Of The Marketing Matrices Applying Dynamics Parameters Based On Time: A Better Analysis Of Prospect; European Scientific Journal April 2016 edition vol.12, No.10 ISSN: 1857 – 7881 (Print) e ISSN 1857 - 7431

This "internal introspection" of the position of the enterprise on the market, aligned with the market analysis done previously, permits to understand and predict in which direction the market is moving, allows upper management to take a more robust and sustained decision about with strategy they are going towards.

The next step to go through is how will the enterprise raise the necessary capital, both monetary and human, to undertake this new path?

There are two different approaches to face this issue, Internal or Organic Growth and External or Inorganic Growth. There isn't a right one "per say", the implementation of one rather the other will depend on the financial assets that the enterprise has access to, the time-setting for the strategy to work and finally the extensive research done previously in order to locate the enterprise on the market segment. Both of them have advantages and disadvantages that are needed to take into consideration when taking the decision. We will analyze the differences between the two of the in the next paragraph[26]:

a. Organic Growth

Organic or Internal Growth is often the most used model by enterprises. This strategy consists of expanding the business's volume or entering new markets using only the company financial assets (e.g. revenue from previous periods), new funding from shareholders and unused debt capacity. This organic growth may be achieved through pursuing new markets, developing new technologies, trying to approach new segments of customers (niches segments) or just by increasing production and building an economy of scale (Bruner, 2004). Therefore, this approach is more suited for companies that aim to growth with a controlled risk. It has advantages and disadvantages regarding inorganic growth[27,28]:

[26,26] Berg, Jean; Three growth models; http://www.estin.com/pdf/publications/ThreeGrowthModels.pdf, accessed on September 13th, 2018

[27] http://www.iisjaipur.org/iiim-current-09/OORJA-May-August-2009/03Infocus.pdf, accessed on September 14th, 2018

a.1. Advantages

The most relevant is the ability to maintain the processes in-house, which provides the opportunity to growth without losing the company's "identity". By focusing on their own assets, the management is aligned with the company's mission and values, which allows a more centric point of view on the value proposition meant to be delivered to customers. Moreover, there is a clear view from everyone on the company about what they aim to achieve, which may allow a higher efficiency in pursuing the objective.

a.2. Disadvantages

The main disadvantage of this model is a possible overinvestment when compared to competitors. The cost of growth is likely to be higher than the returns it brings, on the short run, therefore an ineffective allocation of resources may result on an absorption of all the benefits, making the growth obsolete.

b. Inorganic Growth

On the other hand, Inorganic or External Growth consists on acquiring or entering into strategic alliances with other companies, in order to obtain more human capital, new production facilities or even access to innovative technologies that support the desired expansion. As advantages, this strategy allows to reduce competition on the market through the merging of two or more competitors, in the long run builds economies of scale, may bring new ideas to upper management, allows to enter new markets in different geographies and also reduces the time-to-market factor, which could be relevant in the market segment. As disadvantage, one finds the loss of company's identity and the possibility of the two firms not having their values and mission aligned, which could bring problems in the long term and how the customers relate with the new enterprise.

We may argue that an Inorganic Growth may be subdivided into two different categories[29]:

[29] Chari, Latha; Inorganic growth strategies: Na empirical analysis of who benefits from them?; https://www.researchgate.net/publication/237229177, accessed on September 14th, 2018

b.1. Mergers & Acquisitions (M&A)

There are different forms of merger and acquisitions. A merger could relate to an absorption, when the acquiring enterprise maintains its identify and the acquired enterprise is terminated, or to a consolidation where both enterprises cease to exist, and a new firm is created (Damodaran, 2002). There are different types of mergers[30]:

- Horizontal Merger: Between two firms in the same line of business, usually occurs to add a new technology or to reduce the competitors and gain market share;
- Vertical Merger: Between two firms in different stages of the supply chain, usually occurs in order to add value to the customer;
- Conglomerate Merger: Between firms on different lines of business, usually occurs when a company wants to penetrate on new markets.

Regarding acquisitions, there could an acquisition of assets, where all the assets of an enterprise is acquired gaining control over it, or acquisition of stocks, which implies purchase enough shares to gain board seats and power of control on the management decisions of the acquired enterprise (Damodaran, 2002).

b.2. Joint Venture

A joint venture corresponds to a strategic consolidation between two or more enterprises in order to share resources, risk and profits. As advantages, this model allows a faster and less costly access to foreign markets (which may also have regulatory factors attached), access to distribution channels and know-how from a local perspective that may be critical to enhance the success of the venture and also a possible complementarity between enterprise's business that could allow a maximization of the services provided. In the downside, if the strategies are not correctly aligned it may create a certain resistance that could drive the venture to an unsuccessful path[31].

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[30] Chari, Latha; Inorganic growth strategies: Na empirical analysis of who benefits from them?; https://www.researchgate.net/publication/237229177, accessed on September 14th, 2018

[31] D. Maugh, Ryan and R. Stewart, Milton; International Joint Ventures, a practical approach; https://www.dwt.com/files/Publication/1b841dbe-3453-4983-97cd-d6f5b44e5b2f/Presentation/PublicationAttachment/47d38fc0-1cc3-4c3e-b91f-d8aacd2ce6d1/International%20Joint%20Ventures%20Article_Stewart.pdf, accessed on September 14th, 2018

We may find examples in the literature[32] of the most successful enterprises on the world pursuing different strategies. For instance, Apple is a good example of organic growth, throughout product innovation, the company build its own success by investing its sales' revenues in innovation and repeating the process over and over. On the other hand, Microsoft is a good example of inorganic growth, since it has been successfully acquiring more than 100 enterprises since 1986, in order to add value to its value chain and also having access to new technologies then implemented on its products. We may also find examples of joint ventures, such as the joint venture between General Motors and Toyota, in order to share resources and knowledge, decreasing the cost on R&D that both companies would incur to produce a new car. In conclusion, as stated previously on this note, there isn't a right or a wrong answer, there is a more suitable strategy that depends on where the enterprise is positioned on the market, on its resources and most importantly on the goal it proposes to aim.

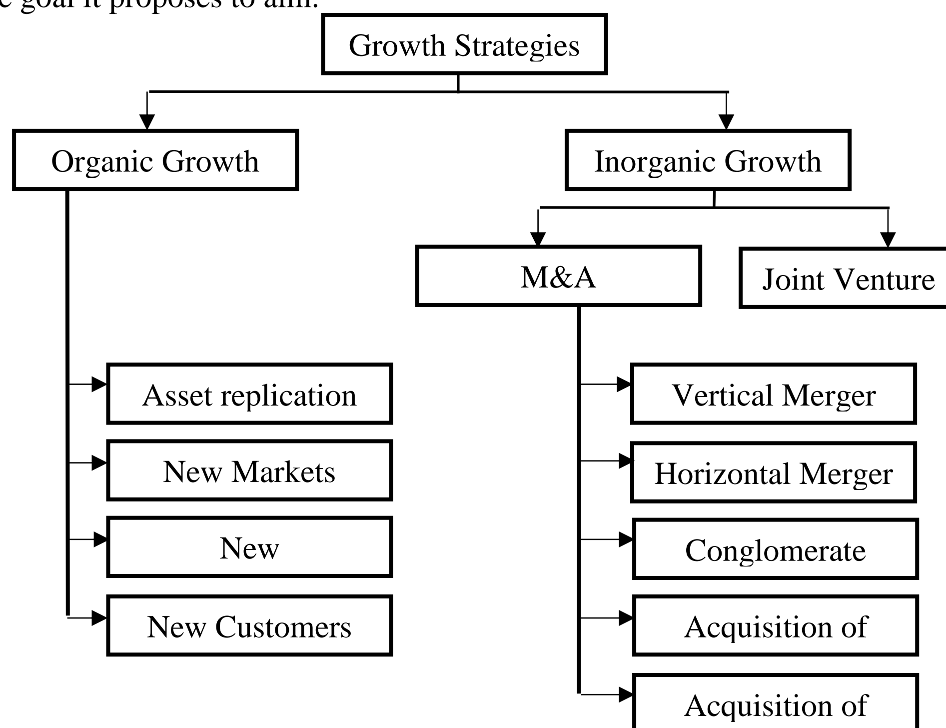


Figure 14 – Growth Strategies
Source: Adapted from article: Inorganic growth strategies: An empirical analysis of who benefits from them?

[32] Jacob, Miriam; 2006; "Organic vs Inorganic Growth: A Case Study", https://www.academia.edu/1996738/Organic_Vs_Inorganic_Growth_A_Case_Study, accessed on June 21st, 2019
Meierkord, Tim; 2016; "Analysis of growth strategies. Organic vs, inorganic growth", Munich, GRIN Verlag

5.2. Bottom-up vs Top-down Structure

Finally, after deciding how to finance its strategy, the enterprise has to go throughout a restructuring of its own organization hierarchy in order to guarantee that the vision and the final goal is obtained. It's, in other words, a "chain of command" on how the company will approach the market and put its ideas on motion.
There are two different theoretical approaches to this issue, that will be explained in the following paragraphs:

5.2.1. Top-down Approach

This approach goes in direction of a more authoritarian model, where the upper management is responsible for taking all the implementation process decisions, "the starting point is the authoritative decision; as the name implies, centrally located actors are seen as most relevant to producing the desired effect" (Matland, 1995). This model of hierarchical organization brings advantages and disadvantages[33]:

5.2.1.1 Advantages:

- There is a decrease in risk from operations, since upper management is generally better informed and have more knowledge of the business environment than lower level employees;
- A more efficient organization, once the tasks to be executed are determined by the higher ranks and have to be followed, not allowing space to inefficient assignments.

5.2.1.2 Disadvantages:

- A dictatorial approach may cause lack of motivation in lower level employees, by undertaking tasks that sometimes may seem irrelevant, and limits their contribution to the final goal of the enterprise;

[33] Matland, 1995

- A slower response to eventual challenges that may arise on the process, since it has to go through the chain of command, once lower level employees are not “empowered to find solutions”.

5.2.2. Bottom-up Approach

In opposition to a top-down structure, a bottom-up approach complements the business insights of upper management with the lower level employees, which are the actual implementers of the enterprise’s vision, “at the macro-implementation level, centrally located actors devise a government program; at the micro-implementation level, local organizations react to the macro-level plans, develop their own programs, and implement then” (Berman, 1978). This allows to address probably the biggest issue with a top-down structure, the inability to overcome challenges that may arise on the day-to-day operations in a time-effective manner, which may be crucial to the enterprise’s success, “if local level implementers are not given the freedom to adapt the program to local conditions it is likely to fail” (Palumbo, Maynard-Moody, & Wright, 1984). This model supports that lower level employees are actually involved on their tasks and rationalizing about a better way to implement the enterprise’s vision, having into consideration that personal on the physical locations may have access to relevant information that upper management doesn’t have. As occurs with the previous approach, the bottom-up approach also presents its advantages and disadvantages[34]:

5.2.2.1 Advantages:

- By including lower level employees in the decision making process, it builds morale and creates a feeling of added value that will improve the communication among the enterprise that will contribute to a successful strategy;
- It increases collaboration and sharing of solutions, which may build trust across departments and benefit with quicker and more effective problem solving solutions.

[34] Matland, 1995

5.2.2.2 Disadvantages:

- On the other hand, if it may create quicker solutions for the day-to-day operational problems, having several people with different mindsets contributing to the long term enterprise's vision may create conflicts that could delay the implementation of the strategy;
- Additionally, having several employees looking into the same problem may consume time that could be spent on achieving other tasks and could even lead to bias results or inaccurate decisions.

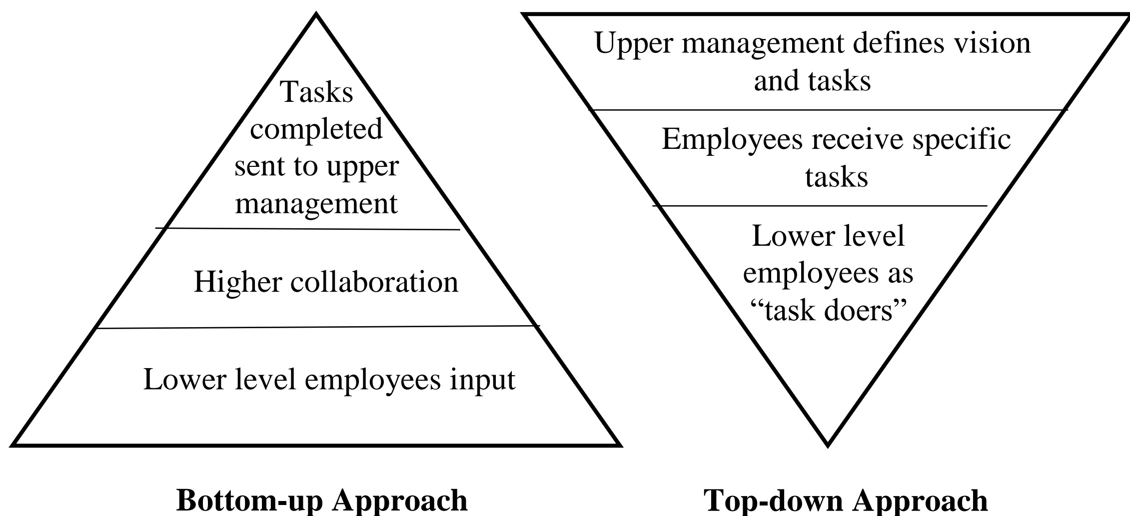


Figure 15 – Bottom-up vs Top-down Approach
Source: Adapted from https://www.smartsheet.com/top-down-bottom-up-approach, accessed on September 17th, 2018

5.3. ARC Ratings Overview

ARC Ratings is an international credit rating agency, founded as a joint venture between five different CRAs from four continents, which has its headquarters in Portugal. The CRA's represented in this partnership are the following:

i. ARC Ratings, SA (former Companhia Portuguesa de Rating, SA): as stated previously in this case, this was the only CRA based in Portugal and has more than 25 years of working experience in the business, being one of the oldest CRA operating in Europe. ARC Ratings was the builder of this adventure, pursuing the market opportunity. The headquarters is located in Lisbon, at ARC's offices, due to its ESMA license which allows them to operate on the European market. This subsidiary is the responsible for the European operations;

ii. Credit Analysis and Research Limited (CARE): CARE was founded in April 1993, having two decades of business experience in the Indian market. It's, in the moment, the second largest CRA in India, regarding rating revenues, being the leader in segments such as banks, sub-sovereigns and IPO grading ratings. By having its headquarters in Mumbai, and several subsidiaries around India, it's naturally focused in the Indian market;

iii. Global Credit Rating Company Limited (GCR): GCR started in 1996, and has its headquarters in Johannesburg (South Africa) as well as offices in Nigeria, Kenya or Zimbabwe. GCR is established as a market leader in Africa, representing 60% of the total ratings given in the region. Its strength is also shown by its key shareholders Carlyle Group (one of the largest international Private Equity groups) and DEG/KfW Group (which is owned by the German Government). Its operational strength and know-how makes it the perfect fit for the African continent;

iv. Malaysian Rating Corporation Berhad (MARC): MARC was founded in 1995 and started its business operations in 1996. It provides securities ratings for a wide array of sectors, such as real state or financial institutions. Having insurance companies, stockbrokers and Malaysian investment banks as its major

shareholders, it is also recognized by the Securities Commission and approved as an External Credit Assessment Institution by the Bank Negara Malaysia;

v. SR Rating, Ltd.: operating in the South-American market there is SR, which is based in Brazil, having its headquarters in São Paulo. It provides a wide spectrum of ratings services for public and private corporations. Along with the company know-how, one of its strongest aspects is that they offer both international and local scale ratings, depending on the best possible practice.

5.4. Set of Analytical tools

There was developed a set of analytical tools, added to the teaching note of this Case, in order to give support to the students for the resolution of the proposed questions. This tools' objective is to give guidance, therefore the final presentation of results will be harmonized, avoiding dispersion from the required subjects and facilitating the debating of the solutions presented.

The first part of those tools, added as AA1, provides templates for the students in order to allow them to focus and perform a qualified analysis of the credit ratings' market environment and its attractiveness for investment (PESTLE Analysis, 5 forces of Porter) as well as a template for ARC Ratings' internal position (Strategic Groups, SWOT Analysis). This support should be given to students during the resolution of the case.

As support for the evaluation of the organizational structure that ARC Ratings' underwent throughout its creation, there is a template with the various decisions of the enterprise that the students should comment and evaluate, these aspects are present on appendix AA2. There is also a suggestion, containing supporting comments for the lecturer, of the points that students should focus meanwhile conducting this evaluation (as points 5.5.1 and 5.5.2 – Resolution's suggestion). The objective of this assessment is to develop a critical thinking of the decisions performed by an enterprise's expansion in the economic markets, and evaluate them according to the assets detained.

5.5 Case Study Resolution

5.5.1 Using the analytical tools give to you, that you may find on the appendixes of this case, develop a conclusion regarding the attractiveness of the ratings' industry in the European market. You must take into consideration all the factors stated during the case.

Resolution's suggestion

On this topic, students are expected to fill the appendix regarding a PESTLE Analysis and Porter's 5 Forces in order to perform an external analysis of the European ratings' market, and then perform a SWOT analysis to understand the strengths and weakness that the company will face. Additionally, they should explore Ansoff's Matrix, to comprehend which strategy will fit better with the market understanding and company's options.

External Analysis – regarding this point, students must understand that the major issue in this industry is legal compliance (since to operate on the European market a company must have an ESMA recognition to do so). Additionally, they must evaluate that this is a mature market, with high barriers for new entrants (due to legal compliance), a very low threat of substitutes as stated during the case and finally a very concentrated market, since the big players (Standard&Poors, Moody's, Fitch and DBRS) control over 85% of the market segment. As a conclusion, students should conclude that this industry reveals a very low attractiveness index, however they should also state the particular economic and fragile situation at the moment, in order to comprehend why ARC made this bold move on a mature market.

Internal Analysis – regarding this topic, students should complete the SWOT analysis template on the appendix, where they should find that the strength/opportunity of ARC is its new formula of ratings' calculation (supported by expertise of renowned rating agencies all over the world) that would offer better transparency and trust to an unreliable market at the time. In the other hand, ARC's weakness/threat may have been the difficulty to convince companies to change and obtain market share to become a relevant player and therefore be accepted by the ECB as issuer of sovereign ratings. Lastly, by using the Ansoff's Matrix, students should perceive that ARC's creation is clearly a market penetration strategy. This last part will be very important in order to perform an understanding of ARC's goals and the steps the company followed to achieve them.

5.5.2 Taking into consideration your conclusions on point 5.5.1, conclude on the primary goals that ARC had defined vs the overall result of the joint venture (you may find a table stating ARC's goals vs ARC's goals achieved on appendix AA3) and comment the strategy implemented by ARC.

Resolution's suggestion

Students should start by state the conclusions they reached on the previous discussion point, which should have been that according with ARC's goals it pursued a market penetration strategy for the European ratings' market.

In this sense, students should approach every individual strategy topic, such as organizational structure, business strategy or cooperation made in order to enhance and optimize ARC's path.

Furthermore, students should explore ARC's initial goals with what it has actually accomplished, stating what they think about the success of the joint venture. Note that in this point, just because the goals weren't fully achieved, it doesn't mean that it was not a successful approach or implementation of the strategy. This topic doesn't have a wrong answer meanwhile it is well explained and justified.

Finally, students should expose their own opinion on the case and address topics such as:

- Was it the right move for Companhia Portuguesa de Ratings?;
- Could a different strategy have been applied?;
- Could the outcome have been different?

A suggested set of answers follow.

6. Answers to Case Study Questions

Overall I believe that it was a successful business move that took action over a market opportunity that appeared through one of the biggest financial crisis of the modern times. We should not forget that ARC's joint venture was put in action by José Poças Esteves, the CEO of a small Portuguese rating company (Companhia Portuguesa de Ratings) that had a very small foothold in the minuscule Portuguese market. He was able to use his knowledge of the European ratings market to sell a, maybe utopian, idea that by unifying efforts the "smaller" players could rise against the bigger players that had controlled the market for so long and take a seat at the "Big 3 table". Consequently, he took action and, from a company that would probably fade out from existence (CPR), formed the ARC Ratings joint venture, that even not fulfilling his wish of becoming the new "big player in the playground", is now a strong and stable player on the geographical areas that it operates. In Europe ARC has a major expression in Portugal, as expected, but has potential to grow with the recovery of the economy. The segment of companies' ratings, specially SME's (small and medium enterprises), is growing due to the obligation/best practice of having a certified rating issued to pursue loans from banks and private investors.

Therefore, I believe that it was an intelligent and successful idea to turn a small Portuguese company that was failing into one of the most interesting players in the private company ratings' market that still has a strong potential to grow.

Regarding the strategy and steps that ARC implemented to achieve its goals, I strongly believe that it followed the path that could better serve its intentions.

ARC was trying to penetrate a mature market that was controlled by a few players, therefore it wasn't feasible to implement an organic growth of the company. It had to go for the market share of its competitors, and the best way to build a strong brand and get resources, without investing money that it didn't have, was by cooperating with renowned rating companies from other geographies. This was meant both to build trust and share expertise in order to create a better offer for its customers.

Furthermore, by going for a joint venture with a top-down approach, ARC guaranteed that every single member would maintain its independence and the different geographical

offices that better know and understand their markets would be the ones taking the decisions that made all of the joint venture partners' top players in their markets.

In sum, I strongly believe that it was a smart business idea, that the implementation of the strategy was done in a proper manner and that ARC achieved the best outcome possible. So the question is: Why wasn't ARC Ratings able to achieve a better market position and even move to a more relevant position in the European ratings' market?
I think that to answer that question we should take into consideration the contestability of the ratings market.
According to William J. Baumol (1982)[35], a contestable market should present three characteristics:

- Few or none barriers for new entrants;
- Access to technology on same level for all the players;
- No sunk costs for new players willing to entry or players willing to exit.

As stated in the case, the European rating industry fails the first, and probably most relevant, characteristic. Even in a mature market, as the rating market, if there was the possibility of new entrants the stronger players would invest in innovation due to the threat of being replaced.
In this sense, we may conclude that the ratings market exhibits very little of even no contestability due to governmental and legal regulations (such as ESMA and SEC certifications) that prevent the entrance of new players that could bring better working ways.
Concluding, we may argue that ARC Ratings is today what the market "allowed" it to be. However, I believe that it is a good example for medium size rating companies to follow and that ARC Ratings will lead by example the "uprising" of those firms in order to create a wider and more competitive market in the ratings industry. Furthermore, I believe that a "deregulation" from governmental and legal entities, or an easier path to new entrants

[35] William J. Baumol, John C. Panzar and Robert D. Willig; Contestable Markets: An Uprising in the Theory of Industry Structure: Reply; published on: *The American Economic Review*; Vol. 73, No. 3 (Jun., 1983), pp. 491-496

would also improve not just the competitiveness of the market but also transparency amongst the suppliers (rating companies) and the buyers (sovereign and private customers) creation a trust environment in a once not so trustworthy industry.

7. Looking into the future

Finally, as a suggestion or a prediction, I believe that the ratings industry should start to look to other industries, such as the audit industry, were the technology advances permitted to start using Big Data software to process information.

As stated in the case, to formulate a rating requires to capture, process, transform and customize big quantities of financial information which have then to be analyzed in order to achieve a final result. This takes a long time and there is always the possibility of human error along the process.
These kind of software could reduce the time spent on treating the information into 40% to 60% and reduce the human errors associated with it, which would create more useful time to accurately analyze the outcomes and produce higher quality conclusions.
Other industries are already taking this approach and nevertheless having a significant investment both of money and people (to understand what has to change to implement this new approach), I strongly believe that's the way to pursue for industries that have to deal with massive informational analysis.

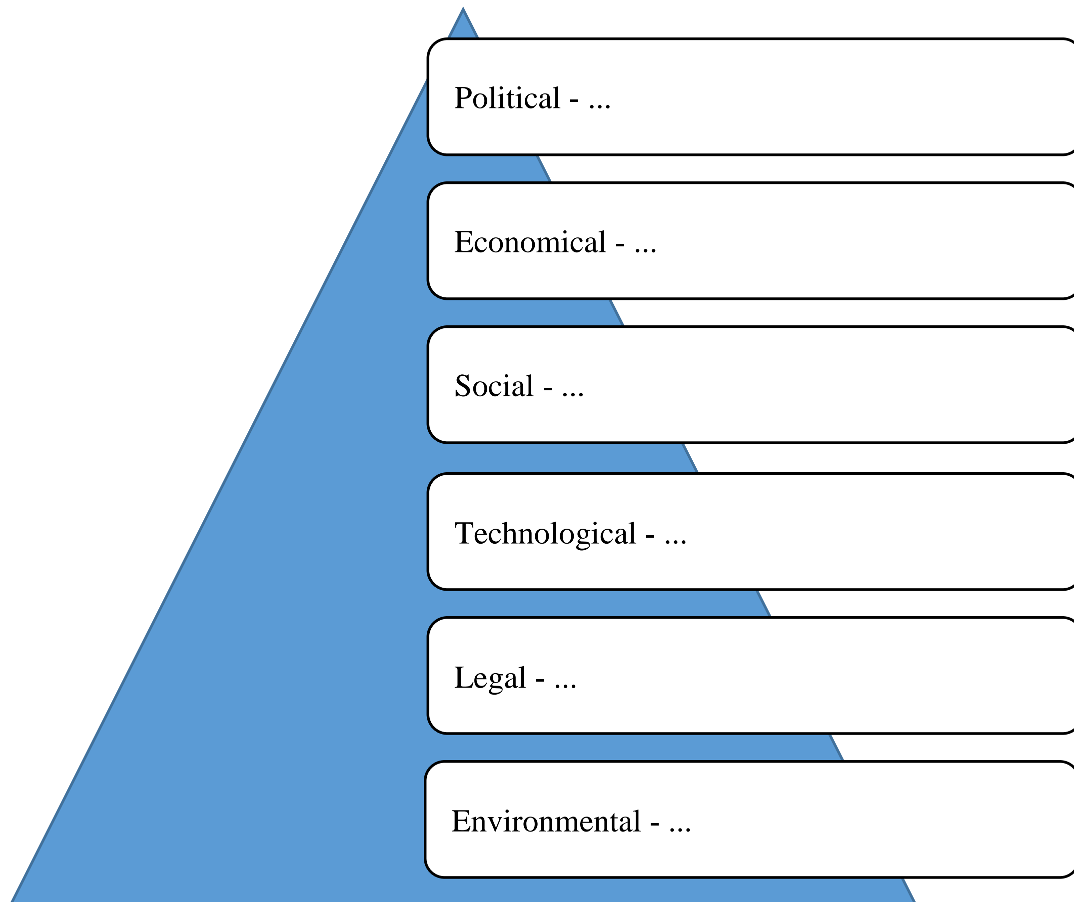
I really hope that rating companies will invest their time and resources on being one of the factors that prevent a financial crisis to happen in the future, like the one in 2008.

8. Appendix

Appendix AA1

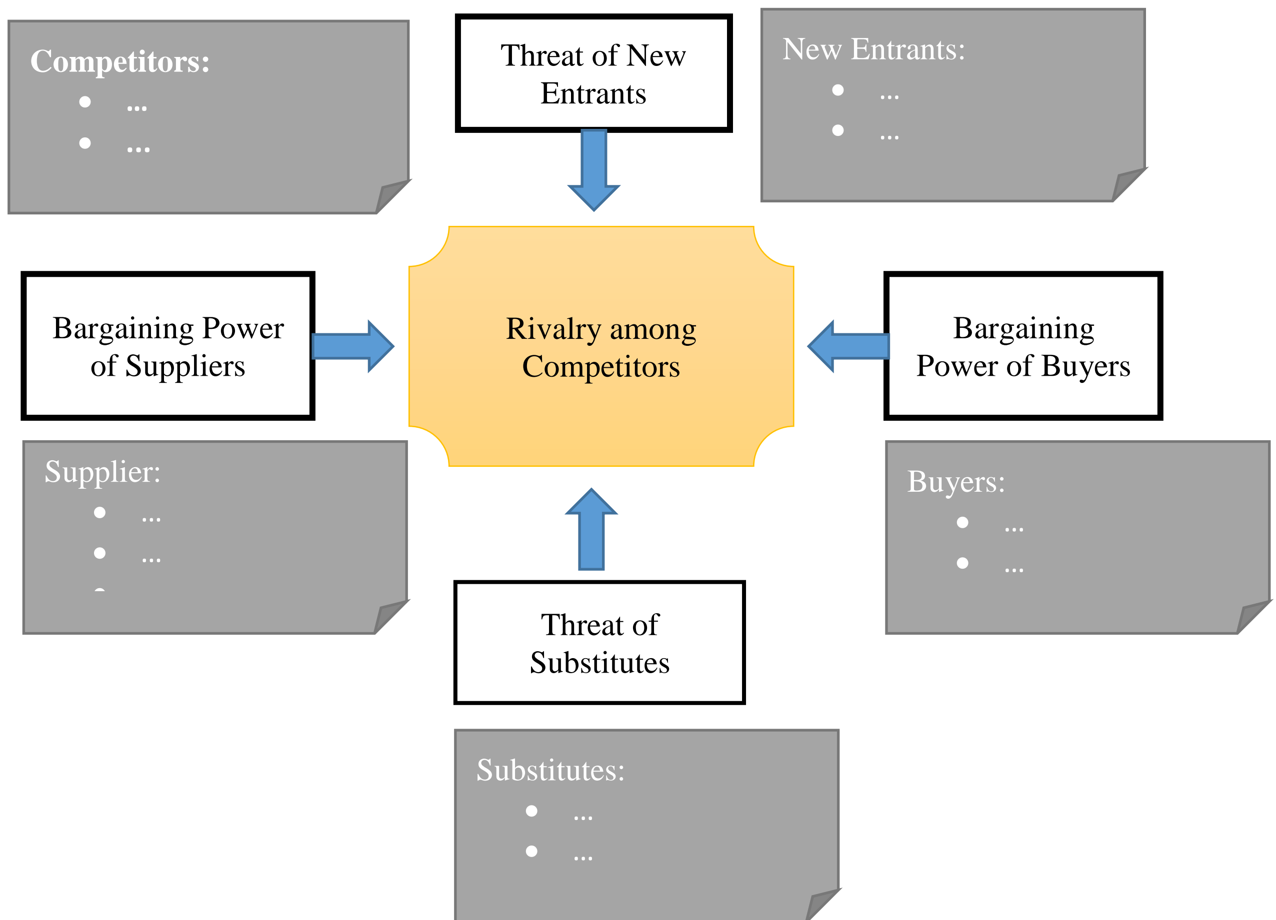
External Analysis

<u>PESTLE Analysis</u>



Porter's 5 Forces

Industry's Attractiveness' Index: ___________________________

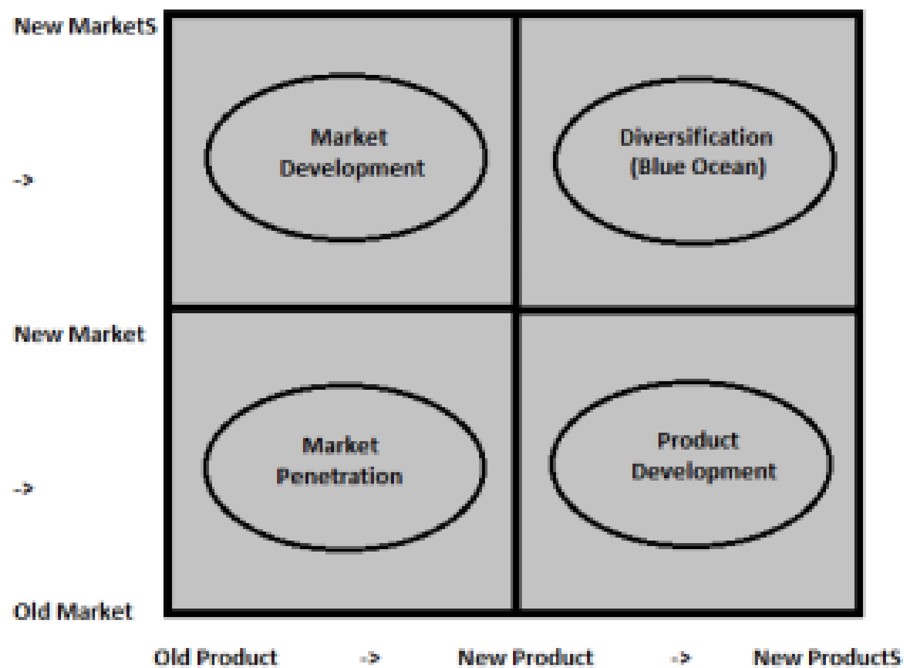


Internal Analysis

SWOT Analysis

	Strengths	**Weaknesses**
Opportunities		
Threats		

Ansoff's Matrix



Appendix AA2

ARC's Ratings Strategy

1. **Strategy: Market Penetration**
2. Organic Growth vs Inorganic Growth
3. Mergers & Acquisitions vs Joint Venture
4. Bottom-up Structure vs Top-down Structure

Appendix AA3

Note: Both me and my coordinator tried to achieve financial information from ARC Ratings, however they have said that due to confidentiality reasons they could not disclose that kind of information. Therefore, these goals and achievements are regarding my personal perspective of the case and may not correspond in 100% with ARC's goals and final positioning in the market to the date.

ARC'S GOALS	ARC'S TO DATE
1. ACHIEVE A RELEVANT MARKET SHARE IN THE EUROPEAN MARKET; 2. ACHIEVE ECB RECOGNITION, BEING ABLE TO ISSUE SOVEREIGN RATINGS; 3. BE CONSIDERED AS A VIABLE OPTION TO THE BIG 3 PLAYERS IN THE MARKET (STANDARD&POORS, FITCH AND MOODYS.	1. ACHIEVED AN STRONG MARKET SHARE IN THE PORTUGUESE SEGMENT OF PME (SMALL AND MEDIUM ENTERPRISES); 2. NOT COMPETING WITH THE BIG PLAYERS (ADDITION OF DBRS) IN TERMS OF SOVEREIGN RATINGS.

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