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RATING AGENCIES AND THEIR ROLE IN THE PROCESS OF THE MULTI-LEVEL GOVERNANCE OF GLOBALIZED FINANCIAL MARKETS*

ABSTRACT

One of the biggest challenges of the modern world is the problem of new models of international system governance under the globalization processes. Given the multidimensional nature of globalization answers to this question have been sought through processes of international negotiations between nation states. However it is increasingly clear that nation-states are unable to effectively steer international system without an involvement of other actors operating on different levels. The article deals with the role played by credit rating agencies in the multilevel governance of financial markets under the globalization processes. There is no doubt that credit rating agencies became an important element of this new model of governance. The idea of multilevel governance has acquired unprecedented importance today. It not only suggests ways of dealing with new conditions of globalization, but is said to be an essential term for understanding the transnational processes and for identifying non-traditional actors involved in governance processes on different levels.

Keywords: multilevel governance, credit rating agencies, globalization processes

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INTRODUCTION

The idea of the "global civil society" is inextricably linked with actions aimed at the accomplishment of specific goals.[1] In a positive sense, transnational organizations of the civil society have developed in order to "promote" certain problems in the international arena; in a negative sense, in the opposition to unfavourable phenomena occurring in the global environment. Their activity has become particularly important in the face of globalization processes. There are two kinds of relations here. Firstly, the development of modern technologies has made it possible and easier for civil society organizations to go beyond national borders, influencing their mobilization and making them more effective. Thanks to the application of new technologies in the field of communication and information exchange, they can shape relations on the social, political, cultural and economic level through influencing the elements of the internal and external environment of countries. Secondly, the emergence of negative phenomena accompanying the globalization processes has significantly widened their scope of activity and quantitative development.[2] This effect is reflected in the involvement of transnational organizations of thecivil society in the process of managing/regulating global problems, including the challenges connected with the globalization of financial markets.[3]

This article discusses the role of rating agencies in managing problems connected with the globalization of financial markets, especially the role of the multi-level governance model. There is no doubt that rating agencies, as private organizations of thecivil society, have an enormous impact on their functioning and on the behaviour of the participants of financial transactions. It should be noted, however, that their role and importance in this respect are very often marginalized. Moreo-

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[1] *Global Civil Society Yearbooks 2001–2006.*

[2] M. Kaldor, H. Anheier, M. Glasius, *Global Civil Society in an Era of Regressive Globalization*, [in:] *Global Civil Society 2003*, Oxford 2003, p. 15.

[3] The research conducted by the Centre for Civil Society at the London School of Economics and Political Science indicates that there are four forms of such involvement. Firstly, activities aimed at maintaining current trends connected with the globalization of financial markets (supporters). Secondly, the involvement in order to reverse the process of the globalization of financial markets (isolationists). Thirdly, attempting to eliminate negative phenomena associated with the globalization of financial markets (reformists). Fourthly, the activities aimed at developing a model of international relations and lifestyle which would be an alternative to the "globalized market," M. Desai, Y. Said, *The New Anti-Capitalist Movement: Money and Global Society*, [in:] *Global Civil Society Yearbook 2001*, Oxford 2001, pp. 51–78.

ver, the fact that the multi-level governance model has been indicated as the mechanism of managing financial markets under the globalization processes stems from the conviction that as a result of the growing liberalization and integration of financial markets as well as of the privatization of risk involved, the efficiency of traditional forms of governance, which include exclusively state actors, may be questioned. Managing problems related to the globalization of financial markets requires a completely new approach – described by Thilo Marauhn as a "hybrid regulation,"[4] in which the applied solutions not only take into account the specific nature of these problems, but also show a high degree of flexibility, which is one of the reasons of their efficiency.

As it was mentioned before, rating agencies are one of the elements of the civil society. However, this thesis might be disputable for a few reasons. Can rating agencies be really considered to be part of a broadly defined civil society? If so, how is it reflected?

The theory of the global civil society, particularly developed in the publications of the Centre for Civil Society,[5] indicates that this notion encompasses a number of different organizations. It includes both large organizations of a complex structure, which have enormous budgets, and transnational networks operating in the Internet, which owe its existence exclusively to the commitment of individual people. Not only do they differ in size or a degree of formality, but also in the field of activity (organizations focused on single issues or those dealing with a variety of problems), a method of operation (organizations offering professional services or those trying to mobilize social support) and a management model (organizations managed in a democratic way or authoritatively governed sects).[6]

Researchers point out that it is none of the above criteria, but the functioning within the framework of the so-called "supranational sphere of social and political participation" that is an indicator of belonging to the global civil society.[7] What is particularly important in this respect is both the ability to initiate political processes and to influence the internal and external environment of countries in order

[4] T. Marauhn, *Introduction: the regulatory dilemma in international financial relations*, [in:] *The Regulation of International Financial Markets. Perspectives for Reform*, R. Grote, T. Marauhn (eds.), Cambridge 2006, p. 14.

[5] See: *Global Civil Society Yearbooks 2001–2006*.

[6] H. Anheier, N. Themudo, *Organisational forms of Global Civil Society: Implications of Going Global*, [in:] *Global Civil Society 2002*, Oxford 2002, p. 191.

[7] H. Anheier, M. Glasius, M. Kaldor, *Introducing Global Civil Society*, [in:] *Global Civil Society Yearbook 2001*, Oxford 2001, p. 3.

to shape their policy. Rating agencies have become part of this model. As they are private entities of a commercial character, operatingat the meeting point of politics and economy, their decisions concerning credit rating have specific political effects. The belonging of rating agencies to a group of transnational organizations of the civil society must be considered in the same context. What is of the key importance here is, first, the object and method of their activity and, second, their specificity as private regulatory institutions.

Rating agencies were established in response to the information gap existing in the first stage of the development of capitalism in the United States. The history of these institutions dates back to the end of the 19th century and is strictly connected with the development of the American economy.[8] Companies such as Poor's Railroad Manual Company (founded in 1867) or John Moody & Company (founded in 1900) focused on gathering and publishing data concerning American enterprises, combining the informative function with statistics. In the 1920s, they extended their business by starting to deal with credit rating issues. T.J. Sinclair noted that this decision was of a random character, being a response to the fast-growing market of securities.[9] Raising capital through debt involved information pressure from investors who wanted to know the financial condition of borrowers. This pressure was noticed and channeled by rating agencies, for which the assessment of credit worthiness became a new source of income. The agencies claimed to make judgments on "the future ability and willingness of an issuer to make timely payments of principal and interest on a security over the life of the instrument,"[10] although it was not a recommendation that it should be bought, but the information on the basis of which investors made decisions, depending on their willingness to take a risk. In this way rating agencies became a*de facto* intermediary in transactions in a financial market.

For many decades the activity of rating agencies was confined to the U.S. economy, being its characteristic feature. As the Bretton Woods system collapsed and financial markets liberalized, the demand for services provided by rating agencies increased and their operations were gradually internationalized (table 1).

[8] T.J. Sinclair, *The New Master of Capital. American Bond Rating Agencies and the Politics of Creditworthiness*, London 2005, pp. 22–27.

[9] T.J. Sinclair, *The New Master of Capital*…, p. 24.

[10] *Moody's Investors Service: Consistency, Reliability, Integrity*, New York, as cited in T.J. Sinclair, *The New Master of Capital*…, p. 7.

Table 1. International branches of Moody's and Standard & Poor agencies

REGION / OFFICE	MOODY'S INVESTOR SERVICE	STANDARD & POOR
USA and Canada		
• Toronto	• 1994	• 1993
• Boston		• 1994
• Chicago		• 1994
• Dallas	• 1993	• 1996
• New York	• 1909	• 1941
• San Francisco	• 1989	• 1989
• Washington		• 1994
Europe		
• France	• 1988	• 1990
• Germany	• 1991	• 1992
• Italy	• 1999	• 1999
• Spain	• 1993	• 1992
• Ireland	• 2000	
• Czech Republic	• 2000	
• Sweden		• 1988
• United Kingdom	• 1986	• 1984
Other		
• Israel		• 1998
• Cyprus	• 1995	
• Russia		• 1998
• RSA		• 1997
Asia Pacific		
• China	• 2001	
• Australia	• 1988	• 1990
• Hong – Kong	• 1994	• 1994
• India	• 1998	• 1996
• Indonesia		• 1996
• Japan	• 1985	• 1985
• Philippines		• 1999
• Singapore	• 1995	• 1996
• Korea	• 1998	
• Taiwan		• 1997
Latin America		
• Argentina	• 1999	• 1995
• Brazil	• 1997	• 1998
• Chile	• 1999	• 1996
• Mexico	• 2000	• 1993

Source: T.J. Sinclair, *The New Masters of Capital. American Bond Rating Agencies and the Politics of Creditworthiness*, London 2005, p. 28.

Rating agencies are presently an inseparable element of economic life on a global scale. They are concerned with assessing credit worthiness not only of corporations, but also of financial institutions, public utility companies and countries. Costs of evaluation are borne by investors, who receive information about the risk that a given loan involves.

The process of the evaluation of credit worthiness looks the same both for countries and enterprises. It involves gathering and processing information, and then making the results available. This information (both qualitative and quantitative) refers to the subject itself and its environment. It includes data concerning the relation between the subject's financial condition and the obligations resulting from debt service. What plays a significant role here is the time in which a borrower defaults on its payment, combined with its cash flow. Other information that a rating agency takes into account includes, among other things, financial forecasts for the following years (profit and loss account, balance sheet), a cost analysis, financial alternatives, a strategy and so called contingency plans. This information, which is secret, is complemented with widely available data. As part of the process of the assessment of credit worthiness agencies also use legal information, such as: a status of issued securities (type, size of offering) and their guarantees (potential pledge, protective clause). An important element of the process of evaluating credit risk is gathering and analysing data concerning the political and economic environment of the subject, such as the information about the market, competition, technological advancement, business legislation or labour market.[11]

On the basis of collected data, as a result of a complicated process of analysis,[12] the agency evaluates credit worthiness, which is formally described with a letter symbol, beginning with triple A, meaning the lowest degree of risk, and ending with D, meaning insolvency (table 2).

[11] For more details see: T.J. Sinclair, *The New Masters of Capital…* , pp. 31–33.

[12] For more details see: D. Dziawgo, *Agencje credit-ratingu w procesie pozyskiwania kapitału na międzynarodowym rynku finansowym. Implementacja credit-ratingu w regulacjach ostrożnościowych dotyczących sektora bankowego*, [in:] *Nowa Umowa Kapitałowa Bazylejskiego Komitetu Nadzoru Bankowego – konsekwencje dla gospodarki i sektora bankowego w Polsce*, R. Wierzba, M. Iwanicz-Drozdowska, B. Lepczyński (eds.), Gdańsk 2004, pp. 171–200.

Table 2. Symbols and definitions of credit ratings

GRADE	S&P SYMBOL	S&P DEFINITION	MOODY'S SYMBOL	MOODY'S DEFINITION
Investment	**AAA**	Extremely strong capacity to meet financial commitments. Highest rating.	**Aaa**	Obligations rated Aaa are judged to be of the highest quality, with minimal credit risk.
Investment	**AA+** **AA** **AA-**	Very strong capacity to meet financial commitments.	**Aa1** **Aa2** **Aa3**	Obligations rated Aa are judged to be of high quality and are subject to very low credit risk.
Investment	**A+** **A** **A-**	Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances.	**A1** **A2** **A3**	Obligations rated A are considered upper-medium grade and are subject to low credit risk.
Investment	**BBB+** **BBB** **BBB-**	Adequate capacity to meet financial commitments, but more subject to adverse economic conditions. 'BBB-' – considered lowest investment grade by market participants	**Baa1** **Baa2** **Baa3**	Obligations rated Baa are subject to moderate credit risk. They are considered medium-grade and as such may possess certain speculative characteristics.
Non-investment	**BB+** **BB** **BB-**	'BB+' – considered highest speculative grade by market participants. 'BB' – Less vulnerable in the near-term but faces major on-going uncertainties to adverse business, financial and economic conditions	**Ba1** **Ba2** **Ba3**	Obligations rated Ba are judged to have speculative elements and are subject to substantial credit risk.
Non-investment	**B+** **B** **B-**	More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments.	**B1** **B2** **B3**	Obligations rated B are considered speculative and are subject to high credit risk.
Non-investment	**CCC+** **CCC** **CCC-**	Currently vulnerable and dependent on favourable business, financial and economic conditions to meet financial commitments.	**Caa**	Obligations rated Caa are judged to be of poor standing and are subject to very high credit risk.

GRADE	S&P SYMBOL	S&P DEFINITION	MOODY'S SYMBOL	MOODY'S DEFINITION
Non-investment	**CC** **C**	Currently highly vulnerable A bankruptcy petition has been filed or similar action taken, but payments of financial commitments are continued	**Ca** **C**	Obligations rated Ca are highly speculative and are likely in, or very near, default, with some prospect of recovery of principal and interest. Obligations rated C are the lowest rated class of bonds and are typically in default, with little prospect for recovery of principal or interest.
	D	Payments default on financial commitments		

Source: T.J. Sinclair, *The New Masters of Capital. American Bond Rating Agencies and the Politics of Creditworthiness*, London 2005, pp. 36–39.

The area of activity of rating agencies is also connected with their regulatory function. It has an unintentional character and is in fact the consequence of their commercial operations. Agencies, as profit-oriented entities, do not include an element of coercion – e.g. they do not establish legal rules which are binding for borrowers.[13] Two phenomena are fundamental to the current state of affairs. Firstly, broadening the scope of operations of rating agencies, combined with the increase in demand for their services and common trust to the objectivity and reliability of assessments made by them. Secondly, the increased level of transactional risk associated with the globalization of financial markets as there is an increasing number of transactions and participants of the market game. These two phenomena cause that agencies are beginning to play a central role in organizing financial markets, thanks to which they may significantly influence the behavior of their participants.

The literature on the subject indicates three dimensions of the regulatory activity of rating agencies:

1) knowledge dissemination;
2) standard setting;

[13] For more details see: D. Kerwer, *Holding Global Regulators Accountable: The Case of Credit Rating Agencies,* "Governance: An International Journal of Policy, Administration, and Institutions" 2005, vol. 18, no. 3, p. 455.

3) using *rating* in financial regulations at the country level and on the international ground.[14]

Knowledge dissemination is the most characteristic form of the regulatory activity of agencies. It mainly stems from the role of *rating* itself. Opinions about credit worthiness given by agencies unintentionally become a factor which reduces the element of uncertainty dominating in financial markets and clears the information clutter. The knowledge made available by rating agencies is relevant from the point of view of investment decisions. As the number of transactions and market participants has considerably grown, the evaluations made by rating agencies become an important guideline for investors bombarded with excessive information. In this way this knowledge significantly influences financial markets and the behavior of their participants.

The role of rating agencies in disseminating knowledge may also be viewed in the context of the functioning of the so-called "epistemological communities." T.J. Sinclair noted that bydefining epistemological communities as " networks of knowledge-based experts" we also indicate their competences concerning knowledge dissemination.[15] It means that through dealing with gathering and processing some types of knowledge, rating agencies become experts in the field of their activity. As they control knowledge they have access to, they gain a significant advantage over other market players. As a result, they also have the right to create their own image as entities offering the only reliable expert knowledge. The fact that other market players acknowledge the professionalism and expertise of rating agencies in the area of their operations results in the growing number of entities that are interested in the knowledge they offer, which, consequently, leads to its spreading.

Another dimension of the regulatory function of rating agencies is standard setting Agencies define rating as models of operation which are conducive to obtaining the highest grade. Thus, they establish specific operational standards, the accomplishment of which may result in raising rating of debt securities, which in

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[14] T.J. Sinclair, *The New Masters of Capital. American Bond Rating Agencies and the Politics of Creditworthiness*, London 2005; D. Kerwer, *Holding Global Regulators Accountable: The Case of Credit Rating Agencies*, "Governance: An International Journal of Policy, Administration, and Institutions" 2005, vol. 18, no. 3, pp. 453–75; idem, *Governing Financial Markets by International Standards*, [in:] *New Modes of Governance in the Global System*, M. Koenig-Archibugi, M. Zürn (eds.), London–New York 2006, pp. 77–100; idem, *Standardising as Governance: The Case of Credit Ratings Agencies*, http://www.coll.mpg.de/pdf_dat/001_3.pdf.

[15] T.J. Sinclair, *The New Masters of Capital*…, p. 14.

turn will lead to the increase of its investment attractiveness.[16] They do it by issuing criteria, according to which they estimate a level of risk. These criteria include two major kinds of information. First, they indicate the value of a loan; secondly, they show how to increase this value (if there is a need). This is particularly important because low rating significantly increases the costs of loans taken out both by states and enterprises, and raises a level of risk involved in financial transactions.

In this context, the standardization activity of rating agencies is mostly defined as establishing certain rules, the purpose of which is to promote specific "organizational procedures and structures."[17] What is important, the dissemination of these standards does not involve any coercion. As it was mentioned before, agencies, as private institutions of a commercial character, do not have this attribute. However, the freedom and expert character of their activity, combined with the invariability of the criteria they use for rating and the tendency of the participants of market transactions to optimize their decisions and minimize risk, are all conducive to their universalization. In other words, standards developed by agencies become widespread as it brings benefit to all subjects using their opinions. It should also be emphasized here that in this way agencies gain significant control over the participants of market transactions and influence the functioning of the market, including cash flow channels.

The regulatory character of the activity of rating agencies is also reflected in the fact that rating is has become part of financial regulations at the country level and on the international ground. This practice particularly concerns the obligation of financial institutions, including banks, to obtain the opinion of an independent rating agency. This opinion describes the real financial condition of an institution and its ability to repay its debts, which is important in the context of its involvement in financial markets and undertaking investment activities.[18] This dimension

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[16] T.J. Sinclair, *The New Masters of Capital. American Bond Rating Agencies and the Politics of Creditworthiness*, London 2005; D. Kerwer, *Holding Global Regulators Accountable: The Case of Credit Rating Agencies*, "Governance: An International Journal of Policy, Administration, and Institutions" 2005, vol. 18, no. 3, pp. 453–475; idem, *Governing Financial Markets by International Standards*, [in:] *New Modes of Governance in the Global System*, M. Koenig-Archibugi, M. Zürn (eds.), London–New York 2006, pp. 77–100; idem, *Standardising as Governance: The Case of Credit Ratings Agencies*, http://www.coll.mpg.de/pdf_dat/001_3.pdf.

[17] D. Kerwer, *Standardising as Governance: The Case of Credit Ratings Agencies*, http://www.coll.mpg.de/pdf_dat/001_3.pdf, p. 8.

[18] T.J. Sinclair, *The New Masters of Capital…*, pp. 42–49; L.J. White, *The Credit Rating Industry: An Industrial Organization Analysis*, [in:] *Ratings, Rating Agencies and the Global Financial System*, R.M. Levich, G. Majnoni, C.N. Reinhart (eds.), New York 2002, pp. 41–63.

of the regulatory function of rating agencies also refers to laws which oblige investment funds to avoid investing in low-rated debt securities (speculative), which particularly concerns pension funds. The aim of such efforts is to reduce the number of those funds' risky investments, which, in the worst scenario, could even lead to the loss of money entrusted to them. Rating has become part of international financial regulations, which is reflected in the New Capital Accord issued by the Basel Committee on Banking Supervision – so called Basel II – the purpose of which wasto formulate an international standard used when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks they face.[19] It should be pointed out that the requirement of a positive rating grade included in financial regulations both at the country level and on the international ground is meant to stabilize financial markets and reduce the negative behaviour of market players.[20]

2. THE GLOBALIZATION OF FINANCIAL MARKETS – THE ESSENCE OF THE PHENOMENON

In order to recognize the role and importance of rating agencies, we need to understand the essence of the phenomenon which made them so important in modern financial transactions. It must be noted that the globalization of financial markets led to the increased interest in the area of activity of rating agencies. As a result, they have become subjects in the field of managing problems associated with the globalization of financial markets. Thus, it is necessary to present the essence of this process as well as to identify the main problems it entails.

There is no doubt that the globalization of financial markets is one of the most evident paths of globalization processes occurring in the contemporary world. The fact that financial markets are interconnected is obvious not only to investors, especially when the major stock markets collapse, but also to specific countries, for

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[19] S. Emmenegger, *The Basel Committee on Banking Supervision – a secretive club of giants?*, [in:] *The Regulation of International Financial Markets. Perspectives for Reform*, R. Grote, T. Marauhn (eds.), Cambridge 2006, pp. 224–236; M.R. King, T, J. Sinclair, *Private Actors and Public Policy: A Requiem for the New Basel Capital Accord*, "International Political Science Review" 2003, vol. 24, no. 3, pp. 345–362.

[20] For more details see: L. Oręziak, *Globalizacja rynków finansowych*, [in:] *Globalizacja od A do Z*, E. Czarny (ed.), Warszawa 2004, p. 163.

instance in the context of unfavourable data concerning their economic condition, which usually directly translates into negative reactions of financial markets.

This phenomenon dates back to the 1970s.[21] It was the time when the deregulation of financial markets, after abandoning the Bretton Woods system of monetary management, originated the new quality of their functioning. Giving up the key principles of the system, especially the rules of exchange rate determination, was a catalyst of deep changes, both in the internal policy of countries, as regards eliminating barriers to capital flow, and with respect to the possibility of performing financial operations at a global scale.[22] Those phenomena were enhanced by unprecedented technological development, especially from the beginning of the 1990s, as a result of which a flow of capital became more efficient. Thanks to the advancement of telecommunications or information technology, a lot of new instruments appeared, some of which were completely unconnected with real trade transactions.[23]

The creeping abolition of barriers and control in international capital flows, combined with the privatization of risk involved in global financial transactions and the deregulation of financial markets, meant a qualitative change in their functioning. Financial markets became more interconnected and integrated. Having no barriers and control, capital could flow freely from one place to another. In the face of the fact that states withdrew from the regulatory function with regard to financial markets or were unable to exercise it, it was market mechanisms that started to fulfil the function of a regulator. It corresponded with the economic philosophy of the time, stemming from the classical ideas of liberalism, according to which the privatization of risk is an element of the market game and brings benefits to its participants.[24]

The lack of barriers to capital flows has significantly increased their mobility on a global scale. However, a real breakthrough in the functioning of financial markets

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[21] L. Oręziak distinguishes four conditions ("driving forces") of the process of the globalization of financial markets: the globalization of national economies, the liberalization of financial markets, increasingly tough competition among financial institutions and technological advancement in information technology and telecommunications, L. Oręziak, *Globalizacja rynków finansowych*…, pp. 153–162.

[22] See: K. Marzęda, *Proces globalizacji korporacyjnej*, Warszawa–Bydgoszcz–Lublin 2007, pp. 135–136.

[23] For more details see: A. Sopoćko, *Rynkowe instrumenty finansowe*, Warszawa 2005.

[24] See: M. Friedman, *Capitalism and Freedom*, Chicago 1962; idem, *Tyranny of the Status Quo*, New York 1985; F.A. Hayek, *The Road to Serfdom*, Chicago 1944; idem, *The Constitution of Liberty*, Chicago 1960; J. Gray, *Liberalism*, Minneapolis 1986.

came with the progress of science and technology. The information revolution, which started in the 1990s, led to deep changes in the functioning of financial markets, providing new opportunities for their participants. However, it was not the only qualitative change which occurred in the field of finance under globalization processes. Having a lot of leeway at a global scale, participants of financial transactions gained double benefit. Firstly, owing to great mobility they became "immune" to any negative, in their opinion, deregulatory decisions of countries. Secondly, they gained significant influence on the shape of national economic policies, because even if state governments considered themselves to be independent in the implementation of their own economic policies, they made decisions and undertook actions which would be well-received by foreign investors.[25] Therefore, the process of the globalization of financial markets has considerably undermined the effectiveness of traditional tools of economic policy used by countries, such as interest rates, the size of budget expenses or taxes. The new model of international financial markets not only reduced the state's real influence on its own economic policy, including inflow and outflow of capital, but also increased the risk of a financial crisis (capital outflow) as a result of unpredictable, often hysteric behaviour of the participants of the financial market.[26]

Under the new circumstances in financial markets the level of risk associated with financial transactions has also changed. On the one hand, the globalization of financial markets provided new opportunities for raising and accumulating capital to their participants, including countries. On the other hand, it also increased the risk involved. Two factors are responsible for this state of affairs.

Firstly, the privatization of risk resulting from the deregulation of financial markets and the minimization of control and supervision over capital flows and market players' behaviour. Secondly, information asymmetry, connected with the qualitative and quantitative evolution of the subjective structure of international financial transactions and the new role of traditional actors, such as banks. In the face of the creeping integration of financial markets, supported by technological progress, financial transactions have acquired a new character as they often linked subjects which are thousands of kilometres apart and have no adequate knowledge about each other. This qualitative change led to the escalation of information asymmetry, which resulted in the increased uncertainty among market players.

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25 K. Marzęda, *Proces globalizacji korporacyjnej…*, pp. 197–202.

26 See: K. Marzęda, *Międzynarodowe problemy gospodarcze*, [in:] *Międzynarodowe stosunki polityczne*, M. Pietraś (ed.), Lublin 2006, pp. 481–489.

Another consequence of the globalization of financial markets is the evolution of the subjective structure of financial markets. Not only did globalization-related changes reduce the role of banks as traditional financial intermediaries, thus increasing their involvement in the investment field, but they also significantly increased the importance of institutional investors (insurance companies, investment funds, pension funds) in the international financial markets and enhanced the role of public offering as a means of raising capital by enterprises[27]

While these changes were originally positively received, especially in the context of the global growth of capital flows,[28] an increase in the mobility of short-term capital, often of a speculative character (as L. Oręziak pointed out, aiming at profit maximization, many investors are willing to invest in some highly risky markets[29]), combined with the lack of effective mechanisms of scrutiny over the activities of the participants of the financial market, started to be viewed as a threat to its stability. Two events revealed how serious this threat is. Firstly, a number of financial crises affecting the world economy in the 1990s; secondly, a series of scandals ended with bankruptcies of large multinational corporations, operating in financial markets, a disgraceful example of which was the case of Enron.

The above-mentioned qualitative changes, which incidentally may positively and negatively affect the functioning of financial markets, in the face of a threat of their destabilization resulting from a series of financial crises, gave rise to the increase of interest in the activity of rating agencies. Not only did they acquire a status of an intermediary in financial transactions, but they also revealed their potential in the field of managing problems associated with the functioning of financial markets.

THE MULTI-LEVEL GOVERNANCE OF GLOBALIZED FINANCIAL MARKETS– THE ROLE OF RATING AGENCIES

More and more evident threats to the stability of the international system provoked a debate on effective mechanisms of managing the problem of globalized financial markets. The experience of the monetary crises of the 1990s showed the

[27] L. Oręziak, *Globalizacja rynków finansowych*…, p. 159.

[28] For more details see: R. Kozul-Wright, P. Rayment, *Globalization Reloaded: An UNCTAD Perspective*, "UNCTAD Discussion Paper" 2004, no. 167, pp. 18–22.

[29] L. Oręziak, *Globalizacja rynków finansowych*…, p. 160.

ineffectiveness of the previous solutions, based mostly on the mechanisms existing within the framework of the International Monetary Fund. It became apparent that a new formula must be developed in order to ensure the real cooperation and coordination of actions of all actors influencing the functioning of international financial markets, including rating agencies. This formula would also take into consideration the characteristics of problems occurring at the financial level in the conditions of globalization.

The intensification of research on the mechanisms of managing problems created by globalization is connected with the fiasco of the IMF's efforts to fight the financial crises of the late 1990s. The inefficiency of the IMF as the key pillar of the global financial architecture, contrasted with new challenges posed by globalization processes, drew attention to the need for seeking new solutions, which would be more effective and adapted to the new reality. The central theme of this debate was the issue of the new financial architecture.

First proposals concerned deep reform of established institutions, such as the IMF.[30] It was indicated that the Fund was not properly prepared for crisis situations, it had no specific strategies and its actions were of a reactive character. It did not monitor crisis-prone situations, either, so it did not have an "early warning system." While the IMF's regulatory potential was appreciated, it was pointed out that this institution has no relevant attributes, which are indispensable for effective action, i.e. it is not able to intervene in time (to step in and solve problems before they become a serious crisis)), and for enforcing the fulfilment of its own recommendations or decisions.[31] That is why the demands for the reform of the IMF were accompanied by opinions which indicated the need for establishing some completely new institutions equipped with "super" competences regarding the stabilization of international financial markets. These proposals included: a demand that the World Financial Authority[32] and the World Central Bank[33] be established and a proposal to develop the so-called International Bankruptcy Procedures.[34]

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[30] See: K. Marzęda, *Międzynarodowe problem gospodarcze…*, pp. 481–489.

[31] D. Nayyar, *The Existing System and the Missing Institutions*, [w:] *Governing Globalization. Issues and Institutions*, D. Nyyar (ed.), Oxford 2002, p. 70.

[32] Ibidem.

[33] J. Smithin, B.M. Wolf, *A World Central Bank?*, [in:] *Global Instability. The Political Economy of World Economic Governance*, J. Michie, J. Grieve Smith (eds.), London–New York 1999, pp. 212–226.

[34] M.S. Kumar, M. Miller, *Bail-outs, bail-ins and bankruptcy: evolution of the new architecture*, [in:] *International Financial Governance under Stress*, G.R.D.Underhill, X. Zhang (eds.), Cambridge, 2003, pp. 343–359.

The new institutional architecture was also supported by a proposal to reform the principles of financial systems both at a country and international level. The reform consisted of five steps:

- firstly, to establish mechanisms facilitating supervision over the macroeconomic policy of states, which would help to coordinate global efforts in case of a crisis;
- secondly, to develop "emergency" finance mechanisms for countries, which would avert the risk of the depletion of currency reserves;
- thirdly, to adopt the standstill principle during a crisis in order to prevent the outflow of capital from the country in recession;
- fourthly, to allow countries latitude in choosing the principles of monetary policy and the scope of the liberalization of the capital market;
- fifthly, to strengthen the institutional framework of the financial market by spreading the principles of corporate governance and standards concerning regulation, supervision and accounting.[35]

The debate on new international environment governance models under globalization processes is an important part of the discussion about the effective management of global financial markets.[36] The idea of Global Governance, which aroused interest of many international circles in the 1990s, should be mentioned here.

This model involved the establishment of an additional platform for international decision-making among national governments, international organizations and representatives of the so-called civil society, thus undermining the priority role of state-based structures of international governance. However, this model was significantly limited by the lack of reference to internal processes in countries themselves, including the processes which concern the dispersal of power and competences of national governments, both upwards – to supranational organizations, and downwards – to the subnational level. In this situation the alternative to global governance was the multi-level governance model, which takes into account not only the number of management levels, but also a multitude of actors and institutions acting simultaneously through different levels of governance.

[35] D. Nayyar, *The Existing System and the Missing…*, pp. 369–370.

[36] K. Marzęda, *Zarządzanie wielopoziomowe jako mechanizm funkcjonowania późnowestfalskiego ładu międzynarodowego*, [in:] *Późnowestfalski ład międzynarodowy*, M. Pietraś, K. Marzęda (eds.), Lublin 2008, pp. 272–280.

It should be noted that the multi-level governance model has been actually developed in the margin of the above-mentioned debates. As under the pressure of globalization, financial markets function in a characteristic way, it has become very difficult to establish a universal, "new financial architecture." All the more so because this "architecture" should take into consideration the requirements which might be referred to as "market axiom." These axioms, which are connected with the new quality of the functioning of financial markets under globalization processes, include:

1. making a market more efficient rather than creating barriers to its development;
2. giving priority to self-regulating activity;
3. freedom and utilitarianism (profitability);
4. cooperation between subjects at different levels of management;
5. maintaining and promoting the policy of financial market liberalization and defending its achievements.

In the European context, the multi-level governance model was mainly used for explaining the evolution and specific nature of a decision-making process,[37] whereas with respect to the globalization of financial markets it focuses on institutions (actors) which make efforts to fight its negative effects. It stems from the characteristics of the issue under analysis. What plays the key role here is the relations between market participants and the subjects involved in regulatory activity, which are determined through balancing interests of all sides involved. Therefore, the multi-level governance is a kind of a game played by actors representing different, autonomous levels of management. In this game, it is those actors who specify links connecting different layers of governance, coordinate the management process through penetrating all its levels and indicate the need for undertaking specific political actions.[38]

Not only does the multi-level governance model involve the dispersal of decision capabilities (competence) among various actors at different decision levels, but it also puts emphasis on the overlapping of competences at various layers, implying that in relations between actors representing different management levels the representatives of national governments play an important, but not a dominant

[37] For more details see: N. Bernard, *Multilevel Governance in the European Union*, The Hague–London–New York 2002.

[38] G. Peters, J. Pierre, *Multi-level Governance and Democracy: A Faustian Bargain?*, [in:] *Multilevel Governance*, I. Bache, M. Flinders (eds.), Oxford 2004, pp. 77–78.

role. It also assumes that state authorities are not the only link between the national and supranational level. As far as the subject of our analysis is concerned, in case of managing problems connected with the globalization of financial markets we can distinguish the level of the participants of market transactions, the level of countries and the level of intergovernmental and non-government organizations. However, the activity of these subjects is not assigned to a single layer of governance. The activity of countries is not confined to the national level, but it also concerns the regional or supranational level, just like the activity of market participants or intergovernmental and non-government organizations.

Another important element of the multi-level governance model is the activity of private participants of market transactions. Their regulatory activities, which are conducive to the stabilization of financial markets, reflects the key principle of this model. As they enter specific management levels, they complement actions undertaken by other players without undermining the principles of market functioning. This is the role which rating agencies actually play. As private actors, they are participants of market transactions and regulators at the same time. This gives them an enormous advantage in the conditions of globalized financial markets, when the regulatory initiatives of countries encounter resistance or reluctance of other participants of market transactions. All the more so because the assumption that the regulation of such important spheres as the functioning of financial markets by definition falls within the competence of public actors (countries, international institutions) has become highly controversial under the pressure of globalization.

The practice of recent years indicates that the participation of private actors in regulation process, especially by delegating specific competences sanctioned in the national or international legislation, appears to be a lot more effective than initiatives launched by public participants. In the case of rating agencies it was the U.S. legislation of 1975 that was of the key importance in this respect. It introduced preferential treatment (the exemption from the requirement to have a specified reserve capital) of debtors whose securities have obtained an investment grade as estimated by at least two "nationally recognised statistical rating organizations.[39] The implementation of this law significantly influenced the scope of activity of agencies and changed the attitude of other participants of market transactions towards them. Rating became the indispensable element of investment activity as well as a channel for the dissemination of knowledge and standards determining

[39] M.R. King, T.J. Sinclair, *Private Actors and Public Policy: A Requiem for the New Basel Capital Accord*, "International Political Science Review" 2003, vol. 24, no. 3, p. 347.

the behaviour of market players. In this way agencies grew in importance as private regulatory institutions. Their operations entered the area originally reserved for national states, which benefited both the market (its participants) and countries (which, in the conditions of globalized financial markets, put increasingly difficult governance tasks into the scope of self-regulating activity).

The role of rating agencies in managing problems connected with the globalization of financial markets increased again after the New Capital Accord (so-called Basel II) issued by the Basel Committee on Banking Supervision came into force.[40] This agreement was a response to threats connected with the evolution of the traditional role of banks, which consisted in the reduction of their role as intermediaries in raising capital and their increased involvement in the international investment activity. This growth, however, did not correspond with an increase in efficiency of national institutions of banking supervision. This contrast in the functioning of financial markets and state institutions, whose task was to supervise banking operations, led to issuing the above-mentioned New Capital Accord.

From the point of view of rating agencies the key provision of the New Capital Accord concerns the fact that rating was recognized as an instrument of reducing the risk resulting from the international involvement of banks. Entering it in the Accord means a new approach to managing problems associated with the globalization of financial markets. Although it is (in a technical sense) only a "soft" international financial law, when adapted to national legal systems, the provisions of the Basel Committee become a "hard", commonly binding law.

Thanks to the New Capital Accord the activity of agencies enters the national level, affecting the functioning of the internal capital market. It means that, in accordance with the premises of Basel II, agencies are no longer investment counselling companies, but become an important element of the process of managing international financial markets. As Danuta Dziawgo points out, bearing no responsibility for the evaluations they produce, the proposed solutions result in the significant reinforcement of the influence of agencies on the financial market.[41]

[40] The Committee is composed of the representatives of the central banks of G10 countries. The committee's decisions are not binding for the central banks of the Group of Ten and other countries, but because of the specific nature of the issues the Committee's regulations concern, they are commonly respected.

[41] D. Dziawgo, *Agencje credit-ratingu w procesie pozyskiwania kapitału na międzynarodowym rynku finansowym*…, p. 193.

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To conclude, it must be emphasized that rating agencies have become an important element of the process of managing problems associated with the globalization of financial markets. The characteristics of their activity and regulatory functions also indicate the direction in which new ways of coping with challenges posed by globalization are sought. The dissemination of knowledge, setting standards or making rating part of regulations at the national and international level is clear confirmation of the new approach to the issue of managing problems of new quality and dynamics – the so-called hybrid regulation. Although it is difficult to unambiguously evaluate the activity of rating agencies,[42] there is no doubt that the enlargement of the area of regulatory initiatives by new actors and new forms, such as, for example, self-regulating activity, significantly increase the flexibility of the international system and its adaptation to new challenges. This, in turn, will lead to the development of a new model of managing problems associated with globalization processes – the multi-level governance model.

[42] Many authors are critical of the effects of making rating agencies part of the processes of managing international financial markets. The role of agencies in minimising investment risk specified in the provisions of the New Capital Accord is especially criticised; see: D. Dziawgo, *Agencje credit-ratingu w procesie pozyskiwania kapitału na międzynarodowym rynku finansowym*, pp. 171–200; M.R. King, T.J. Sinclair, *Private Actors and Public Policy: A Requiem for the New Basel Capital Accord*…, pp. 345–362.