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Credit Rating Agencies: A South African Perspective

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This research paper has not been published. It will also not be under consideration for publication elsewhere while being reviewed for the SAAA conference.

Kind regards,

David Rabinowitz

Research Paper

Credit Rating Agencies: A South African Perspective

Abstract

This paper provides a critical analysis of the Credit Rating Agencies (CRAs) from a South African perspective. CRAs seem to have gained notoriety for the role they played leading up to the 2008 financial crisis. This paper shows how CRAs became central to debt capital markets around the world. In the past, it seems that regulators placed undue reliance on CRAs which gave them immense power. Following the 2008 crisis, regulators worldwide are trying to reduce the power wielded by CRAs. Important topics such as the CRA business model, competition in the industry, CRA accountability and the South African Credit Rating Services Act (among others) are addressed in this paper.

1. Introduction and Background

Credit rating agencies (CRAs) have been subject to criticism for many years. Partnoy (1999) questions whether formal securities credit ratings (since their introduction in 1909 by John Moody) have ever provided valuable information to investors. CRAs had had to shoulder some of the blame for some of the biggest financial meltdowns over the past decade, including the collapse of Enron and WorldCom (Hill, 2009) as well as the financial crisis in 2008 (Partnoy, 2009a; Rafailov, 2011).

CRAs have been thrust into the limelight as a result of their failures leading up to the 2008 financial crisis, however it is important to note that literature questioning the credibility of CRAs and the value of their ratings extends well before the banking crisis of 2008 (for example, Partnoy (1999 and 2002) and White (2006)). CRAs play a central role in debt capital markets (White, 2010a) and it is important to understand how these institutions operate (Sinclair, 2005). The objective of this paper is to gain an understanding of CRAs from a South African perspective.

The main concern of a lender when advancing money to a borrower is around the creditworthiness of that borrower – that is: will the borrower be able to repay the money advanced as agreed upfront between the lender and borrower. A bond is similar to a loan, in that the lender (investor) is concerned that the amount lent will be repaid. Corporations issue bonds in order to raise much-needed capital to expand (and even maintain) their operations. Issuing bonds is an alternative financing mechanism, as opposed to traditional financing sources (such as bank loans or share issues). Like a conventional loan, bond issuers agree to pay back the capital portion of the bond at a specified date, as well as interest (at an agreed rate) on the capital amount over that time (White, 2010a).

Investors expend a great deal of effort to obtain sufficient reassurance that they are lending money to creditworthy borrowers. Investors gather their own information about borrowers and where the borrower's credit risk is high but still acceptable, restrictions – known as loan covenants – are often imposed on the borrower. Credit ratings, which are in effect opinions around creditworthiness, are issued by CRAs and tend to form another very important benchmark which investors rely upon to assess the credit risk of a bond issuer (White, 2010a:212).

Despite the negative view held by industry experts around CRAs, this view did not seem to be shared by the public until very recently, as little was known about CRAs. It seems that CRAs have only come under the public spotlight over the past decade following the business failures (such as Enron and WorldCom) and market collapses (i.e. the 2008 financial crisis) that have been linked (whether rightfully so or not) to the CRAs. Many blame CRAs as a central reason for the 2008 crisis (Partnoy, 2009a; White, 2010c).

In South Africa, Members of Parliament drafted the Credit Rating Services Bill. The Bill was adopted in November 2012. This is an attempt to regulate CRAs. The CRAs seem to oppose several clauses contained in the Act. According to the Act, several institutions such as municipalities will be required to obtain credit ratings, as they are not allowed to invest in investments that are not investment grade. The CRAs are opposed to this, as they insist that they (CRAs) merely offer a credit opinion. The CRAs contend that investors should obtain further information before relying solely on one of their ratings to make investment decisions (Maake & Lefifi, 2012:1). The Act also exposes CRAs to civil liability lawsuits (Donnelly, 2012:1).

This research is relevant since there may be a strong case for reform in the credit rating agency industry. Following the 2008 financial crisis it does not seem that industry will be able to continue operating along the same lines. It seems that the financial regulators' decision to delegate the important role of making creditworthiness judgements to a select few may be flawed. A reassessment of the current position may be required.

This research paper is organised as follows: Section 2 presents a detailed review of relevant and important literature on CRAs. Section 3 states the research objective of this paper. Section 4 presents the scope and limitations of this research paper. Section 5 provides an explanation of the method used to perform this study. Section 6 presents the results of this research paper. Lastly, section 7 concludes this paper and offers possible avenues for future research.

2. Literature Review

The literature review will cover three main areas. First, the change in the business model adopted by CRAs will be discussed. Second, the role played by CRAs in recent financial crises will be assessed. Last, the issue of CRA regulation will be addressed.

2.1 The CRAs' Change in Business Model

Prior to the 1970s, CRAs earned their keep from selling agency reports to their subscribers – that is, investors and other users of the credit ratings issued by the CRA paid for that information (Sylla, 2002). However, in the 1970's there was a shift in the business model adopted by the CRAs. They moved from an 'investor-pays' model to an 'issuer-pays' model (White, 2010a:214). This shift in business model enhanced the profitability of CRAs and allowed them to expand the services they could offer (Cantor & Packer, 1994).

Coffee (2010:33) suggests that a 'government-created and managed rating agency' could be a possible alternative to the issuer-pays model and the lack of competition in the CRA industry. However, Coffee (2010) admits that introducing a government rating agency has advantages and disadvantages.

2.2 The CRAs' Role in Recent Financial Crises

Hill (2009) indicates that CRAs made many mistakes before Enron. Enron had an investment grade rating four days before it declared bankruptcy. She states that the 'rating agency hall of shame' includes several debacles including Executive Life, the Asian Flu, Orange County, and National Century Financial Enterprises (Hill, 2009:291).

Partnoy (2009a) claims that one of the causes of the financial crisis in 2008 was overdependence by the markets on credit ratings. This view seems to be mirrored by Mizen (2008), who states that the CRAs failed to obtain enough information to provide accurate ratings. While Acharya &

Richardson (2009) do not cite the CRAs as the ultimate reason for the financial crisis, they do highlight the fact that conflicts of interest might have arisen due to the CRAs prioritising their fees over accurate ratings. This further contests the reasons offered by the CRAs attempting to justify their shift in business models.

According to Rafailov (2011), the CRAs' principle mistake was that they had failed to correctly assess the underlying risk of mortgage-backed securities that were issued wholesale leading up to the 2008 financial crisis. The failure of the CRAs to rate the credit risk of structured financial instruments accurately was a major contributing factor to the financial crisis.

Hill (2010a:332) describes the CRAs as 'villains'. The CRAs rank second in her list of four main 'villains' that caused the financial crisis. Hill's (2010a) list of villains also includes 'mortgage brokers and originators' as first, 'lawyers and investment bankers' as third and 'buyers of subprime securities' as fourth. Hill (2010a:332) states that 'mortgage brokers and originators' committed blatantly illegal acts. The CRAs come second as they 'lied and/or exaggerated' when it came to rating complex repackaged securities.

Manns (2009) is of the opinion that CRAs should be accountable for their actions. Manns (2009:1022) claims that CRAs have 'responsibility without accountability'. He further states:

> *'Rating agencies not only appear culpable for facilitating the crisis but also may be grossly negligent, if not wilfully complicit, in papering over its magnitude and allowing the bubble market to grow even more.'*

According to White (2010a), in the past, CRAs have referred to their ratings as opinions because this supports their claim that they are publishers. The implication of this is that they have enjoyed protection from liability under the First Amendment of the US Constitution.

2.3 The Need for CRA Regulation

While the aim of the SEC in establishing the NRSRO category was to force issuers to obtain ratings from reliable sources, it seems that the establishment of the NRSRO category has presented its own set of unintended consequences – namely, that its establishment has become a barrier to entry for new entrants and it has given huge power to the incumbent players.. Delegating the 'safety-and-soundness judgements' to the CRAs has also had its flaws; the CRAs have made several costly errors (White, 2006:1).

Like White (2010b), who believes that less regulation is the way forward, Richardson and White (2009) question whether regulation is the answer for the CRA industry. They allude to a system where the NRSRO category is abolished and investors and issuers are free to seek advice on creditworthiness from a variety of sources (Richardson & White, 2009). Others such as Hill (2004:95), however, believe that regulatory reform is needed and that eliminating the NRSRO category might be wise, provided that 'the process is carefully managed'.

Darbellay & Partnoy (2012) discuss how CRAs have been targeted by changes in regulation after the 2008 financial crisis. The authors look at how new regulation will solve problems, but at the same time introduce new problems into the CRA industry (Darbellay & Partnoy, 2012).

Partnoy (2009b) also introduces two important ideas about how CRA regulation can be reformed. His first idea is to make CRAs accountable for the ratings they give and to eliminate their exemption from liability (CRAs have enjoyed exemption from liability for their ratings and it has not been possible to take legal action against them). His second idea is to introduce competition into the oligopolistic CRA industry and to reduce reliance on credit ratings (Partnoy, 2009b).

The US regulatory response to the 2008 financial crisis was the introduction of The Dodd–Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The Dodd-Frank Act was signed into federal law in the US in July 2010. There are numerous sections of the Dodd-Frank Act that affect CRAs. The Dodd-Frank endeavours to increase accountability and oversight of the credit rating industry (Martin, 2011). Among other things, the Dodd-Frank Act also aims to reduce regulatory reliance on credit ratings, remove references of credit ratings from law, increase transparency in the credit rating industry and address conflicts of interest (Cane, Shamir & Jodar, 2011). White (2011) believes that eliminating regulatory reliance on CRAs will reduce the importance of the big three CRAs in the future (perhaps eliminating the NRSRO category) and allow market forces to prevail. Katz et al (2009) agree that reducing reliance on ratings might improve the CRA industry.

3. Research Objective

The aim of this paper is to provide an initial exploratory account of credit rating agencies grounded in a critical epistemology. The research is based exclusively on the South African context.

4. Scope and Limitations

This paper considers the US headquartered CRAs that also operate in South Africa. However, this paper provides a South African perspective on these CRAs only.

This paper does not deal with the different detailed methodologies used by the CRAs in order to compute their ratings.

The informational value of credit ratings may be mentioned, however, the central focus of this paper is to provide a South African perspective on CRAs. The central role that CRAs play in financial markets has been established above. An in-depth look at whether or not the ratings are unique or add value to the market is too broad for this paper.

Sovereign ratings and unsolicited ratings are not part of the scope of this paper.

Although the researcher made an effort to remain objective, the inherent biases of qualitative research must be acknowledged as a limitation of this paper.

5. Method

This research paper required a qualitative research methodology in order to obtain a South African perspective on CRAs. Seeing that numerous parties – some on opposite sides of the industry – utilise credit ratings, it seems that there are multiple views on this topic, and each of these perspectives potentially have equal validity or truth (Creswell, 1998).

To this end, this paper employs a detailed content analysis to illuminate perspectives on CRAs in South Africa. This research design was utilised to perform a 'detailed and systematic examination of the contents' of the interviews that were conducted in order to identify 'patterns, themes, or biases (Leedy & Ormrod, 2010:144).

5.1 Data Collection

Interviews were conducted with seven interviewees[36]. A small sample was selected since the aim of this paper was to explore perceptions. Although

[36] The terms experts, interviewees, participants and respondents are used inter-changeably throughout this paper.

the results show some agreement among the interviewees, the aim of this paper was not to reach a consensus or generalise findings as would be the case in a quantitative study. The sample of experts was carefully selected and each expert had an in-depth knowledge of world markets and CRAs.

The interviews were generally unstructured. The researcher gave an outline of the main topics discussed in the literature review, based on prior research. The interviews were unrestrictive and the interviewees were encouraged to expand on their thoughts and opinions as much as possible. The aim of the interviews was to facilitate an open forum for the expression of free flowing ideas, opinions and perspectives regarding CRAs. Questions were non-leading. Interviewees were allowed to speak freely with minimum interruption by the researcher.

5.2 Data Analysis

An inherent limitation of the findings from detailed interviews is that they are very subjective. It was essential for the researcher to suspend any preconceived notions or biases regarding CRAs, especially taking into account their notoriety after the 2008 financial crisis. However, the data was analysed in light of prior literature and this mitigated researcher bias to some extent. A further bias with such research is that respondents sometimes responded emotionally, based on their previous experiences with financial markets and CRAs.

The researcher interpreted the findings in light of the previous research on CRAs to mitigate research bias, while ensuring a thorough analysis of the data grounded in theoretical and practical frameworks as identified by the existing literature (for example Hill (2010a), Partnoy (1999 and 2009b) and White (2010a and 2010b)). This was inspired by Glaser and Strauss' (1967) 'grounded theory' approach. In some cases, especially regarding new South African CRA regulation, it was difficult to apply the grounded theory as previous research and data was not easily available. For this reason, it was impossible to ascertain whether these findings are anomalies or not. It seems that further South African research on CRAs is needed and this reiterates this paper's choice of an exploratory research method.

This paper does not endeavour to make recommendations, but rather, the objective was to present a South African perspective on CRAs. The conclusion makes several observations based on the data collected and previous research on the topic.

6. Results

This section presents the findings from the analysis of the interviews conducted.

6.1 Competition in the CRA Industry

A theme that emerged from the interviews with the respondents was the lack of competition amongst the three main CRAs. According to Mulligan (2009:1279), the 'big three' CRAs hold ninety-eight percent of the market share worldwide. There was general agreement among the respondents that the lack of competition is a problem that needs to be addressed. Several respondents pointed out that the Credit Rating Agency Reform Act of 2006 attempted to address the competition problem in the CRA industry, however, it proved 'ineffective'. This view is strengthened by White (2010a) and Mulligan (2009) who state that even though the number of NRSROs increased to ten by early 2010, the big three CRAs still hold ninety-eight percent of the market of ratings.

One respondent emphasised that it will be unlikely that new entrants would steal market share away from the big three CRAs. He stated that the big three CRAs are 'huge companies with huge intellectual property, expertise and massive networks'. Mulligan (2009) cites critics who agree with this respondent. Mulligan (2009:1296) states that some critics fear that new competitors will struggle to break the dominance of the big CRAs due to their 'large infrastructures, credibility and expertise'. However, this respondent was more hopeful that specialist CRAs can increase their market share, but even then, he felt this was unlikely (specialist CRAs specialise in servicing a specific sector such as insurance, as opposed to the whole debt market).

An expert stressed that regulators should take care not to 'extend the problem unwittingly by making it more difficult for new entrants'. She stated that 'every new piece of regulation is another barrier to entry'. White (2011) and Harper (2011) agree with this sentiment. White (2011) states that some of the sections in the Dodd-Frank Act may increase barriers to entry for new entrants and may make the incumbent CRAs more central to bond markets in the future. Harper (2011) doubts whether new entrants will be able to build good reputations to become NRSROs, seeing that such a status will expose them to increased liability, coupled with reduced reliance on NRSRO ratings.

Several interviewees were of the opinion that the dynamics in the CRA industry will not change unless governments take action and introduce public sector CRAs around the world. Coffee (2010) suggests a government-created CRA as a possible solution. Gillen (2009) suggests that the US government could create a government CRA or at least mediate the rating process. Two interviewees felt that this will almost certainly happen in Europe because European sovereigns are 'furious' because of 'constant downgrades' in the past few years.

The interview participants ultimately agreed that CRAs are in a stronger position now than they have ever been. This finding seems ironic. The participants cited the new regulation worldwide as a barrier to entry for new entrants. One participant concluded by stating that it is a 'difficult situation because regulators want more CRAs in the market, but at the same time they are trying to regulate them further'. This participant could not offer solutions to this dilemma.

6.2 Mandatory Use of Credit Ratings

The research findings showed that debt fund managers must use credit ratings where legislation or regulation requires such, or where the governance rules of the fund in question call for the use of credit ratings. For example, the internal rules of some funds require and/or limit the exposure to different classes of debt as determined by CRAs. Lannoo (2008:1) refers to the use of ratings to determine portfolio allocations as a 'quasi-formal role'. A respondent highlighted the fact that CRAs 'play a role beyond that of an ordinary business'. He stated that they operate in a 'protected environment' because of the high demand created for ratings by regulation and internal rules of investment companies. White (2010a:221) describes the CRAs as a 'protected oligopoly'.

Two respondents agreed that CRAs have never advocated the 'mandatory use of ratings'. Two possible reasons were offered by one of these respondents:

> *'One, rating agencies have confidence in their businesses and the way they rate instruments. Rating agencies believe that the 'market should decide' what importance to place on certain information. A more cynical reason would be that rating agencies did not want to be regulated themselves. If their ratings are not mandatory, there would be no justification for regulating the CRAs who issue these ratings.'*

The same respondents also stated that ratings should not be the only tool used by investment houses, banks or insurers. Rather, 'ratings should form part of a suite of tools' to help an investor make a decision.

6.3 Business Model and Conflicts of Interest

The experts all agreed that the issuer-pays business model will continue to be an issue of contention for the CRAs. There was general agreement among the experts that the business model that is currently utilised, whereby issuers pay the CRAs for ratings, introduces several conflicts of interest. The experts agree with Partnoy (2006) on some of the main conflicts of interest. The main conflicts of interest seem to arise when CRAs offer ancillary consulting services related to ratings they issue. Another conflict of interest that arose leading up to the financial crisis was that CRAs helped issuers to design complex mortgage-related securities, which the CRAs subsequently rated as AAA or equivalent, the highest possible credit rating. According to White (2010a), CRAs effectively rated securities that they had helped to construct, and issuers knew that their securities would receive good ratings.

A respondent stated:

> *'My experience with most investors is that they get information free. Generally they (investors) are in a position of power - people want to give them information. Therefore there was bound to be a rating agency or somebody who would come up with ratings that the investor wouldn't have to pay for. So if you're not going to have the investor paying for it, then the rating agencies have got little choice (other than to make issuers pay).'*

Kudva (2010) expands on the above respondent's opinion by stating that an effective rating agency business model ensures that ratings are available to all market participants. Kudva (2010) points out that utilising an investor-pays model would remove ratings from the public domain, as only investors who can afford it will be able to pay for ratings.

The above respondent offered an alternative model to that of the issuer-pays model. He stated further:

> *'You could get government to pay for ratings by issuing a government body. Would you trust a government body rating bonds? Frankly, I wouldn't. Governments don't always attract the right people, don't have the right methodology and governments are controlled by politicians who have different objectives from a free and fully informed market.'*

Despite this alternative being offered, none of the respondents seemed to favour a state-run CRA. Coffee (2010) also suggests a state-run CRA may be an alternative to the issuer-pays model, but not without its limitations.

Like White (2010a), one interviewee offered a possible defence that might be used by CRAs. This interviewee stated that CRAs may claim that they issue so many ratings (tens of thousands per year), that the revenue from one single rating is 'insignificant' and it would not be worth risking their reputations by subverting a single rating or a group of ratings. This interviewee stated that 'this argument makes sense on the surface, but it's not entirely true'. Partnoy (1999) seems to disagree with this potential defence of CRAs and he is of the opinion that CRAs do not rely on their reputation or the quality of their ratings in conducting their business affairs.

One respondent pointed out that there may be a more complex problem than the issuer-pays model. He stated:

> *'It is not necessarily a question of who pays. It is far more complex than that. The key relationship is between the rating agencies and the investment/merchant banks that advise debt issuers – they usually influence which credit rating agency is used. Credit rating agencies never want to get on the wrong side of investment banks. They have a cosy relationship – that is the biggest problem. The issuer is severely or fundamentally influenced by the investment bank.'*

He further stated that this relationship requires investigation. White (2010a:221) shares the same concerns of the above respondent.

It seems that an investor-pays model would also have several difficulties. Two interviewees were of the opinion that if CRAs were to change back to an investor-pays model, this might induce issuers to choose 'lesser-qualified or less reputable CRAs to rate their instruments'. On this point, Coffee (2010:34) questions 'whether the rating agency so chosen will have credibility'. One interviewee was doubtful whether changing back to an investor-pays model would 'automatically make the relationship between issuers and CRAs appropriate'.

All the respondents agreed on the point that the issuer-pays model will not be eliminated in the foreseeable future. The respondents felt that a key reason for this is the current high levels of profitability achieved by the CRAs – it seems unlikely that CRAs would agree to such a change in business model. While the idea of a state-run CRA was suggested, the respondents were unable to recommend an alternative business model that they feel would be viable. One respondent compared the issuer paying for ratings to audit fees and he was unable to suggest a better option than issuer-pays. He stated that he 'cannot see the current model going anywhere'.

6.4 2008 Financial Crisis

There was agreement among the interviewees that there were several 'actors' to blame for the 2008 financial crisis. Hill (2010a:332) lists the 'actors' from most to least 'villainous' as follows: Originators, CRAs, investment banks and lawyers, and investors. The interviewees agreed with Hill (2010a), but some also regarded government regulators as another ‘actor’ who should shoulder some of the blame. Although the interviewees agreed on who the main ‘actors’ were, there was no agreement regarding who should shoulder most of the blame. The interviewees’ views differed on this point.

The role that originators or manufacturers of subprime mortgage loans played was clear in the eyes of the interviewees. The interviewees agreed that many originators were involved in illegal, dubious and/or unethical behaviour with the sole intention of deceiving borrowers and investors. The interviewees agreed that originators should bear a large responsibility for the crisis. Hill (2010a) concurs with this view. One respondent stated:

> *‘The subprime crisis was the trigger for the financial problems across the world, it wasn’t the cause. We had a long period of booming growth in low interest environments, which was not sustainable, and the massive debt accumulation at all levels – that was the cause of crisis.’*

All the respondents attributed a large portion of blame for the crisis to investors. Some respondents went so far as to claim that the investors who invested in AAA or similarly rated subprime mortgages were the ‘main actors' to blame for the financial meltdown. All respondents agreed that investors did not understand what they were investing in. Some respondents found it difficult to understand how investors invested in complex instruments without the requisite understanding of these investments. One respondent stated that 'investing in something that you do not understand is a recipe for disaster', Hill (2011) asserts that investors have admitted that they did not understand the securities that they purchased.

There was a call by several respondents for investors to be more responsible. One respondent highlighted the fact that ‘ultimately investors are responsible for whether or not they make sound investments, regardless of what opinions (CRAs or otherwise) they rely on’. Several respondents also seemed alarmed at the fact that investors still rely too heavily on CRAs for some of their investment decisions. This sense of alarm is also shared by Gillen (2009) and Partnoy (2009b).

One respondent defended the role investors played leading up to the crisis. This respondent stated:

> *'There is a big consumer education problem, I think. It's quite hard to blame the investors because really, it should be the responsibility of the whole financial community (including CRAs) to educate investors about what the risks of these products are and were, and they weren't really (educated properly).'*

This respondent stressed that the consumer education problem surrounding complex financial products needs to be addressed seriously.

According to one interviewee, the complexity that arose in the area of structured finance was a major cause of the crisis. 'Highly complex financial instruments were created as a result of structured finance' and these instruments were not easy to understand. This interviewee stated that these instruments were very mathematical and this in turn made 'the valuation of risk very technical and complex', requiring the expert knowledge of mathematicians and statisticians that needed to be familiar with financial markets. Traditional credit analysts did not possess such expertise. As a result, 'CRAs employed mathematicians in order to understand and value these risks'. Rafailov (2011) concurs with this interviewee in his view that some mathematical models that were employed by CRAs were inadequate. This interviewee highlighted the contrast between corporate and government bonds and complex financial instruments. He stated that when it comes to corporate and government bonds, 'any competent investor has always had his own opinion in addition to a credit rating'. When it came to structured finance, investors 'didn't have their own opinions and rather relied almost exclusively on CRAs' opinions'. This interviewee emphasised his view that a fundamental element for sound markets is 'diversity of opinion' – according to him, diversity of opinion was removed with structured finance. White (2010a) and Partnoy (2009b) agree with this respondent.

The theme of scepticism or professional scepticism was raised by several experts. One expert asked rhetorically: 'where was their scepticism?' – in reference to CRAs and investors. According to this expert, 'when the number of AAA rated instruments was increasing rapidly (all for the same type of instruments), something should have sounded a warning signal'. This expert again asked rhetorically in reference to the high volume of AAA rated instruments: 'how many people get 10 out of 10?'

It seems that all respondents agreed with Hill (2010b) on one of the root causes of the crisis. Hill (2010b:14) alludes to a failure by all market participants – they believed that they had 'conquered' risk. The respondents either alluded to the fact that risks were underestimated or misunderstood. One respondent stated further:

> *'The interplay between market risk and credit risk blew out. Traditionally they were seen as separate risks. There was a lack of understanding that the risk of lack of liquidity would become a credit event and this ultimately caused the problems.'*

6.5 Regulation

The first reaction of one interviewee on the topic of CRA regulation was that regulators, investors and other market players 'should not have placed such a large responsibility on the CRAs without requiring them to be liable if they did not adhere to standards (both government regulation and their private standards or methodologies)'. This view mirrors that of Manns (2009), who claims that CRAs have enjoyed responsibility without accountability. According to Manns (2009) CRAs should be accountable for their actions.

The majority of interviewees supported government regulation of CRAs. Two interviewees seemed unsure as to whether government regulation is the most effective remedy to the current situation. However, if they had to choose between no regulation, self-regulation or government regulation, it seems that they would prefer government regulation. One interviewee stated that it would be 'desirable to have a combination' of government regulation and self-regulation.

White (2010b) calls for less regulation of CRAs. His opinion is that the SEC should abolish the NRSRO category, thus opening up the market for information on debt instruments. White (2010a:223) further argues that more regulation would likely raise barriers to entry and 'ironically' reinforce the position of the big three CRAs. One respondent stated that regulators must not 'unwittingly extend the current situation by increasing the barriers to entry', but she believed that 'strong government regulation' is warranted. It seems difficult to reconcile the majority view of the respondents with White (2010b). While the majority of respondents advocated strong government regulation and supported many of the provisions of the Dodd-Frank Act of 2010, they also believed that barriers to entry should be lowered and market forces should prevail to provide a diversity of opinion in the debt securities markets.

It seems that White's (2011) concerns are valid, as three respondents agreed that as a result of the Dodd-Frank Act and other new regulation around the world, in the year 2013, the three big CRAs are in a stronger position than they have ever been.

Some interview participants did not feel that the introduction of regulation that focuses on rules is enough. Two participants stated that there should be a 'credit rating analyst profession'. These participants used the professions of accountants, actuaries, auditors and lawyers as examples that CRAs could learn from. According to one expert, 'regulation worldwide is trying to suppress over-reliance on ratings and in turn, it is also putting more responsibility on sophisticated investors'. This expert pointed out that this is an important factor when it comes to CRA liability. She stated:

> *'Investors might find it hard to hold CRAs liable if they (investors) have to shoulder more responsibility for their investment decisions and their use of ratings.'*

However, it seems that new regulation in the US has diminished some of the protection CRAs have previously enjoyed from liability (Harper, 2011).

6.6 Liability

Another theme that emerged from interviews with all the participants was the importance of CRA accountability. There was general agreement among the participants that CRAs should be accountable for their actions. Manns (2009) concurs with this view. Part of the discussion on accountability includes liability for CRAs when they make errors.

According to one respondent, new CRA regulation worldwide 'is trying to suppress overreliance on ratings and shift responsibility onto investors'. According to this respondent this is a key point to consider when considering liability. This respondent stated that 'factual causality is easy to prove, whereas legal causality is extremely difficult to prove'. This respondent referred to legal causality as the 'stumbling block' in such cases, because it is difficult to prove who 'the legally attributable cause of the loss is'. CRA liability was compared to auditor liability by this respondent – factual causality is easy to prove and usually involves 'negligence or gross negligence', whereas it is almost 'impossible to prove legal causality in most cases'. Another comparison made by this respondent between auditors and CRAs was that due to the reputational hazard of court cases, 'almost all cases are settled out of court'.

In the South African environment, one interviewee pointed out that CRAs are 'upset due to the horizontal application of the new regulation'. This respondent felt that 'this worry is misplaced because the liability clauses in the new regulation do not amend the current position'. The respondent explained that the current position is that a CRA can be held for delictual liability without the new Credit Rating Services Act. She stated that the problem of proving legal causality remains.

One respondent felt that the new Credit Rating Services Act in South Africa will make it 'more difficult for investors to hold CRAs liable for misrepresentation'. This respondent stated that investors seem to be happy with the new Act and CRAs seem to be unhappy. This respondent felt that 'the feelings on both sides are misplaced'. According to this respondent, the new regulation places more responsibility on investors to make informed investment decisions and this in turn will make it more difficult to hold CRAs liable.

On the topic of CRA liability, several respondents expressed certain concerns.

One respondent stated that he was 'alarmed' at the new Act because according to his reading of it, it seems that even if a CRA rates an instrument diligently and that rating seems appropriate, investors may still be able to bring a legal action against the CRA if they make a loss at a later time. He stated:

> *'I'm quite alarmed. The implication that if a CRA carries out a credit rating, even if it does its job diligently and that rating would seem to be appropriate. If an investor loses money later they will have an action that they will bring against the rating agency. If that's true, this is even worse than being an auditor. I know it's hard to conceive of anything worse than an auditor. In this case you can be presumed to be liable for damages even if you've done a good job, as opposed to compensating people where you've been negligent in the performance of your duties, which I think would be an acceptable penalty.'*

The above respondent warned that if his reading of the Act was correct, this would be a 'huge disincentive' to go into the CRA industry in South Africa and it would also discourage existing CRAs from operating in South Africa. This respondent stated that if CRAs add value (which according to Cavallo, Powell & Rigobón (2008), they do) and CRAs stop operating in South Africa due to the legal environment, it would 'generally reflect badly on our local economy and our ability to raise capital at an affordable level'.

One respondent concluded his thoughts on CRA liability by stating that CRAs should be 'accountable', but he feared that CRAs would be blamed for 'poor investment decisions'. He stated that CRAs should not be protected in a special manner from lawsuits, but 'it is not a solution to the problem to hold them liable'.

6.7 Investor Responsibility and Diversity of Opinion

The majority of respondents agreed with Mulligan (2009) and Partnoy (2009b) - that investors relied too heavily on CRAs leading up the financial crisis. Several respondents stressed the need for a 'diversity of opinion' and one respondent stated that 'good risk management comes with diversity of opinion'. Hill (2010b) proposes that investors should be encouraged to rely less on CRAs.

The experts seemed to agree that new regulation worldwide places more responsibility on investors. CRAs have published their methodologies and further information about their ratings and the regulatory reliance on ratings seems to have eased somewhat. Mulligan (2009) concurs with these experts. One expert commented on the South African regulation by stating that 'there seems to be a non-verbal devolution away from reliance on CRAs' towards independent and critical inquiry by investors.

All the respondents advocated that investors should 'do their own homework'. The respondents did not find it satisfactory that large investors placed such a large reliance on CRA ratings leading up to the financial crisis. Darbellay and Partnoy (2012:23) state that 'behavioural reliance on ratings has deeply been anchored in the financial markets' and it will take time to find alternatives that can be used instead of, or in conjunction with CRA ratings. Five respondents agreed that credit ratings should be used as a tool that forms part of a suite of tools in order to make an informed investment decision. One respondent even stated that 'any banker or investment house that only uses credit ratings is making lazy investment decisions'. However, Cane et al (2011:37) state that new securitised instruments have become too complex for average institutional investors and 'this increasingly means that investors are essentially forced to rely on CRAs as the information concerning these investments is simply too difficult to understand'.

One respondent delved deeper into the issue of how investment decisions are made:

> *'The difficulty seems to be that we seem to have lost the ability, apart from some fund managers and individuals with time on their*

> *hands, to make judgements about what we think we should invest in. Some people take bets. It seems to be a general malaise. People are not making informed judgements.'*

6.8 CRA Regulation in South Africa

The respondents seemed to agree that the introduction of CRA regulation in South Africa was inevitable as a result of the financial crisis. The respondents also agreed that it is better for CRAs to be regulated than not. However, all respondents criticised the Draft Amendment of Regulation 28 of the Pension Funds Act 24 of 1956 ("Regulation 28") because it makes the use of certain credit ratings mandatory.

Besides the liability clauses in the Credit Rating Services Act that have been discussed above, the respondents did not raise any other major concerns regarding the Act. However, a respondent asserted that original versions of the Bill were 'poorly worded and missed large amounts of subtleties'. He stated that later versions of the Bill showed great improvements.

Regulation 28 invoked strong reactions from most interviewees. Regulation 28 mandates the use of ratings. An interviewee pointed out that 'the FSB's stated aim was to bring South Africa in line with international best practice – and Regulation 28 seems to be doing the exact opposite'. Regulation 28 seems to entrench (and mandate) the use of ratings and this step seems similar to the SEC's introduction of the NRSRO category and the mandatory use of ratings in US regulation that has been reviewed by Dodd-Frank.

Some interviewees criticised Regulation 28 heavily. They could not understand why the FSB has 'gone against international best practice' – trying to lessen official reliance on CRAs. The only explanation one interviewee could offer was that someone 'must have paid a bribe'.

Another respondent stated that the reason for the introduction of Regulation 28 can be traced to 'a lack of understanding of subtleties and complexities'. He stated further:

> *'Regulation 28 is a document of less than five pages, whereas the United States equivalent of this law is a thirty volume encyclopaedia. I acknowledge that the United States is potentially over-regulated, but people in the industry on all sides find it (Regulation 28) is a disaster because there is not enough detail and it does not deal with the complexities of reality'.*

In concluding, several respondents either questioned the ability of the FSB or declined to comment on the FSB's ability to administer and enforce the Credit Rating Services Act properly. The general feeling among respondents was that new CRA regulation in South Africa is good, but it does have some 'flaws'.

7. Conclusion

CRAs are firmly entrenched in world markets. Moody's, S&P and Fitch hold ninety eight percent of the world market share of credit ratings and it is difficult to see their stranglehold being broken in the near future. Despite attempts by regulators to lower barriers to entry and encourage new entrants, it appears that it is almost impossible to compete with the big three rating agencies because they possess exceptional expertise and they have made themselves indispensable to debt capital markets.

It seems that White (2010a) and Partnoy (1999) are correct in their assertions that the NRSRO category helped to entrench CRAs' power in the markets. The NRSRO has been the biggest barrier to entry into the CRA industry. White's (2011) fears about new regulation acting as added barriers to entry are justified. New regulation such as the Dodd-Frank Act makes it more difficult for small firms to enter the market. This is due to the added compliance rules that must be met.

Regulators had an opportunity to take a bold decision. They could have removed regulatory reliance on ratings, while at the same time lessening the burden of compliance-based regulation (instead of increasing it). This in turn would have lowered the barriers to entry into the CRA industry, rather than increase them. White (2011) advocated such a move. It seems that such a move was never likely because regulators wanted to be seen as acting strongly in the aftermath of the 2008 crisis in order to quell the venomous criticism. It seems that every financial crisis garners a strong response from regulators. Regulators seem to worry more about their appearances after a financial crisis and less about the long-term consequences of new regulation.

The debate on the business model adopted by CRAs will likely continue for the foreseeable future. Abolishing the issuer-pays model would cause as many problems as it solves. None of the proposed business models are perfect. In fact, some have bigger problems than the issuer-pays model. Moreover, as any free market allows, CRAs are entitled to use any model that they desire. There is no easy solution to the business model problem and the inherent conflicts of interest thereof.

The potential introduction of government CRAs worldwide seems like a "kneejerk reaction" to the financial crisis. It also seems like a political move by sovereigns in order to achieve better ratings following the mass downgrades after the crisis. Government CRAs would introduce a plethora of new problems into an already troubled industry and it does not seem advisable.

CRAs' role in the financial crisis is clear. They made many large errors in the area of structured finance. They rated instruments as AAA when they were in fact junk instruments. However, CRAs have become scapegoats for regulators, and especially investors. Investors must shoulder the majority of blame for their own reckless behaviour. There can be no excuse for investors who invest in investments that they do not understand, even on a basic level. Investing in complex financial instruments without the requisite knowledge is tantamount to gambling. Investors should not have been allowed to blame others for their bets. CRAs made blatant errors, but they merely offer their opinions. Investors must do extensive research on complex instruments before they invest in them. If they choose not to, they (the investors) must take full responsibility for their investment decisions. A question remains: Does the institutional investor (who is merely investing money collected from its clients) or the end investor (the salaried "man on the street" who has entrusted his money with the institutional investor, a so-called professional) shoulder this blame?

CRAs should be regulated by governments worldwide. Regulation should ensure that CRAs fulfil their role diligently and it should also ensure that CRAs maintain the correct focus of providing reliable information to markets. However, regulation should not act as a barrier to entry into the industry. The introduction of a professional credit rating analyst body seems like a viable idea that should be explored further.

CRAs should be accountable for their actions. Increased liability and damages are not the answer to the CRA problem. CRAs should be accountable for negligent behaviour, but ratings should not act as a protection against losses.

The new Credit Rating Services Act in South Africa changes little by way of holding CRAs liable. Ironically, it makes it more difficult to hold CRAs liable for damages. A problem with the new Act is that CRAs may be held liable, even if they perform their duties properly. The introduction of Regulation 28 does not make sense in the current regulatory climate. Perhaps the FSB does indeed lack an understanding of the subtleties of CRAs.

In conclusion, the central theme that emerges from this paper is the power commanded by the CRAs. It seems that they are in a stronger position now (in 2013), than ever before. This quote by Friedman (1996) still seems appropriate:

> *'There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful.'*

This paper opens the debate from a South African perspective about the role CRAs play in world financial markets and the immense power they wield. Perhaps future research can focus on providing a better understanding of CRAs to all market participants. The impact and implementation of new CRA regulation worldwide are also pertinent avenues for future research. Lastly, it seems imperative for future research to provide detailed insight on investors' decision-making processes.

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