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Perceptions of the implementation of credit rating agency regulation in South Africa

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Background: Credit rating agencies (CRA) played a key role in the global financial crises of 2007/2008 which led to the introduction of CRA regulation.

Aim: Using Giddens' theory of modernity as a framework, this article analyses experts' perceptions of the implementation of the CRA regulation in South Africa.

Setting: This article focussed on experts' perceptions of CRA regulation in South Africa.

Method: This qualitative article was conducted using detailed interviews with South African experts in the investing and credit rating industries. Interviews were conducted in 2013 and 2023. An interpretive approach was adopted to analyse the data into themes, providing insight into the perceptions relating to the introduction of CRA regulation in South Africa.

Results: While the introduction of CRA regulation in South Africa is a mechanism used to legitimise the capital system and encourage foreign investment, its applicability, considering the size of the country's CRA market, is contentious. Credit rating agencies' current business model is prone to conflicts of interest and no viable alternatives are available. Consequently, investors need to exercise judgement over their investment decisions instead of outsourcing their due diligence requirements to CRA without careful consideration.

Conclusion: Credit rating agencies' regulation in South Africa has further cemented CRA's position in financial markets in line with global trends in this industry.

Contribution: This article will allow policymakers, market participants and researchers to understand the perceptions of the CRA regulation in South Africa from a social constructivist perspective.

Keywords: credit rating agencies; *Credit Rating Services Act No. 24 of 2012*; legitimacy; regulation; theory of modernity; trust.

Introduction

This study explores investor perspectives on regulations concerning credit rating agencies (CRA) and the role of these ratings in contemporary markets. It is based on detailed interviews conducted with 21 experts based in South Africa, an important emerging economy, using Giddens' (1990, 1991) theory of modernity as a conceptual framework.

A study on CRA grounded in a social constructivist stance is timely. More than 10 years have passed since the Global Financial Crisis of 2008 (GFC), which was sparked by defaults on mortgage-backed securities in the United States of America's (USA) housing market (Scalet & Kelley 2012). The result was a withdrawal of trust in CRA's ability to rate securities accurately (Scalet & Kelly 2012) and calls for an enhancement of policy prescriptions for the sector (Bayar 2014; Rafailov 2011; Rhee 2015; Scalet & Kelley 2012; St. Charles 2010; White 2010b). Taking stock of investors' perceptions of these new prescriptions is useful for informing policy development and sheds light on how the regulatory project functions.

Much has been written on the role played by CRA in the GFC (Hill 2010a; Mutize 2019; O'Halloran & Groll 2019; Rafailov 2011; Scalet & Kelley 2012; White 2010a) and the steps taken by governments and regulators in response (Bayar 2014; Rhee 2015; Utzig 2010). Most notable is the USA's introduction of the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act)* (GovInfo n.d.; Scalet & Kelley 2012). How emerging economies managed the effects of the GFC has largely been overlooked, providing a basis for exploring how South Africa regulated CRA and how these efforts have been perceived by local investors.

The South African Government promulgated the *Credit Rating Services Act No. 24 of 2012 (CRS Act)* (Republic of South Africa [RSA] 2012; National Treasury 2011). Concerns were raised about the operability of regulations which, while resembling those of South Africa's major trade partners, had not been adjusted for the fact that South Africa's markets are not as deep, active and complex as those in the USA and the EU (Maake & Lefifi 2012). This has implications for the efficacy of the *CRS Act* and the legitimacy of the regulatory framework (Partnoy 2009a). The current article is one of the first to consider these possible limitations in more detail by capitalising on the fact that CRA and regulators have had time to implement the necessary systems and processes to give effect to the *CRS Act's* requirements. Similarly, investors have had the time to reflect on their engagement with CRA, the confidence vested in rating outcomes and the extent to which the *CRS Act* is contributing to more credible and reliable credit ratings in the local market.

Researchers have mainly focussed on international CRA. Comparatively little is known about Africa (Pillay & Sikochi 2022) and, more specifically, South African experiences with CRA and their regulation. The work conducted on South African and African CRA prioritises the development of macro-economic policy and broader financial implications (Bwowa, Mouton & De Wet 2024; Meyer & Mothibi 2021; Mokoaleli-Mokoteli 2019; Mugobo & Mutize 2016; Mutize 2019; Mutize & Nkhalamba 2021; Weyers & Elliot 2017). The idea that credit ratings are a product of social constructivism, in addition to rational economic imperatives, has not been adequately considered. This article aims to address this gap by drawing on primary data collected from individuals who engage directly with credit ratings. It explores how their perceptions of these ratings reveal the complex social and institutional factors that characterise periods of late modernity.

A qualitative analysis of CRA complements the predominantly positivist-inspired finance research. The current article responds directly to calls to widen the field of economic and financial analysis using an exploratory research design which prioritises meaning generation over quantitative assessments of the monetary impacts of recently enacted regulations (Brennan & Solomon 2008). At the same time, new regulations are often introduced in response to crises and examined in detail by academics (Conti-Brown & Ohlrogge 2022; Frankel 2002; Jackson 2004; Malsch & Gendron 2011; Maroun & Solomon 2013). Re-assessing regulatory changes long after their introduction provides a complementary perspective while adding to the current article's exploratory design and practical relevance.

As a developing economy, it is important for South African policymakers to examine not only the direct economic impact of regulatory changes but also how these are being internalised by citizens. Post-implementation reviews can contribute to more efficient policy development, especially when the applicable regulations deal with credit ratings and associated funding decisions (Mutize & Nkhalamba 2021; Naik, Bhoola & Roussow 2017; Weyers & Elliot 2017). Taking stock of regulations aimed at CRA is also an example of how academic research can be used as part of a broader accountability project. Organisations should be held accountable for adherence to laws and regulations, but governments must also be held to account for the impacts of its laws and regulations on organisations. Concluding on the efficiency or quality of South African regulation aimed at CRA is beyond the scope of this article but the research adds to the debate on how regulations function, something which can be used to guide further engagement with both policymakers and those subject to regulation.

The remainder of the article is structured as follows: The 'Literature review' section presents the theoretical framework and discusses prior literature. The 'Methods' section outlines the methods used in this study, while the results are presented in the 'Results' section. Lastly, the article concludes with the key insights and contributions of this study.

Literature review

Modernity theory

Giddens and Pierson (1998:94) define modernity theory as 'a shorthand term for modern society, or industrial civilisation'. Modernity theory can be extended to assess trust and legitimacy in expert systems such as auditing or accounting and finance systems (e.g., Unerman & O'Dwyer 2004). Doing so frames financial markets as a product of social constructivism in addition to just rational economic decision-making. Regulation of financial institutions within these markets promotes investor trust in the market (Frankel 2002). In his theory, Giddens (1990) refers to the notion of symbolic tokens and expert systems, both of which depend on trust. Symbolic tokens may be described as mechanisms by which people can be enriched with a certain value over time and space (Giddens 1990; Unerman & O'Dwyer 2004). Expert systems can be described as systems of technical or professional expertise upon which society largely relies (Gabbert 2007; Giddens 1990; Unerman & O'Dwyer 2004). Both symbolic tokens and expert systems are disembedding mechanisms (Giddens 1990). Disembedding mechanisms facilitate the abstract process of modernisation by transferring societal experiences from the time and place where the factors shaping those experiences occur to another time and place. This effectively recontextualises the social system among different people in various settings (Gabbert 2007; Giddens 1990; Unerman & O'Dwyer 2004).

Experts such as CRA gain greater relevance when investors are cautious and sceptical (Coffee 2001, 2003). Within the context of this study, when stakeholders become aware of the weaknesses in an expert system, additional regulation becomes an important mechanism for introducing reform to prevent the recurrence of identified failures. Although a new law may be unable to produce a radical change in

regulated practice, the State's intervention at a time of perceived crisis is a powerful display which reassures non-experts of the credibility of the respective institution. Additional regulation becomes a mechanism of reassurance ensuring the continuation of the taken-for-granted belief that the capital market system functions (Rabinowitz 2014; Unerman & O'Dwyer 2004).

Mechanisms such as regulation may restore the confidence of investors, but this is not to say that the regulations enforced are always the most efficient and appropriate for the time or jurisdiction in question (Giddens & Pierson 1998; Rabinowitz 2014). This logic can be extended to a South African setting. The proliferation of CRA regulation in South Africa necessitates a deeper exploration of its nuances, including its provisions, legitimacy within the capital system, limitations, and sometimes unforeseen consequences.

Role and significance of credit rating agencies

The CRA industry has many intricately related key players such as the issuers of securities, the CRA that rates those securities, the individual and institutional investors who purchase the securities and the regulators of those securities. Since its inception dating back to the 20th century, the importance of the CRA industry has grown (Scalet & Kelly 2012). The current system of credit ratings is dominated by three big CRA: Moody's, S&P and Fitch (the 'Big Three') (Miglionico 2023). Collectively, they hold at least 90% of the world's market share for ratings (Hung et al. 2022; Weyers & Elliot 2017).

The role of a CRA is to assess bonds and other securities and provide an opinion on the creditworthiness of the issuer of such financial instruments, which include major global organisations and governments worldwide (White 2018). This role involves evaluating the probability of repayment by the issuer or the ability to recover a loss in the event of default (Scalet & Kelly 2012).

The entire spectrum of information in the credit market is a function provided by CRA and this function contributes to the efficiency of the market (Rafailov 2011; Rhee 2015). Investors such as banks, pension funds, mutual funds, insurance companies and individuals rely on a CRA rating to manage risk and return (Rafailov 2011; Scalet and Kelly 2012; Sharma et al. 2022). Rhee (2015) analogised CRA to a library which does not create new information but rather codifies information and facilitates a better dissemination of that information.

In short, CRA have a market efficiency role strengthened by regulation (Miglionico 2023). Their ratings may be seen as a public good that serves those who are not able to assess the necessary information about the issuer (Scalet & Kelly 2012). As a gatekeeper, the CRA public persona is somewhat significant and regulatory attention and supervision should happen at a higher level (Rhee 2015).

Credit rating agencies role in the global financial crisis

The literature on the causes of the financial crisis is abundant with possibilities (Hill 2011). It is not the intention of the researchers to dissect or discuss any of these possibilities except in so far as they pertain to the role of CRA within the financial crisis, and more specifically those that policy prescription may address.

Partnoy (2009b) argues that one of the causes of the financial crisis in 2008 was market overdependence on credit ratings. This view seems to be mirrored by Mizen (2008) and Rafailov (2011), who state that the CRA failed to obtain enough information to provide accurate ratings and further failed to accurately assess the underlying risk of mortgage-backed securities. Compounding the issue was that it seemed that CRA took the view that it was not their responsibility to verify information and this led to them taking information at face value (Coffee 2009; Darcy 2009; LaFrance 2008; Rabinowitz 2014). As a result, the concealment of unfavourable information on the part of the issuer coupled with the inability of the CRA to compel further information, may have intensified the inaccuracy of the ratings provided (Rafailov 2011). Ospina and Uhlig (2018) challenged these initial narratives however and found evidence suggesting that improper ratings were not a major factor in the financial crises.

While Acharya and Richardson (2009) do not cite the CRA as the ultimate reason for the financial crisis, they do highlight that a conflict of interest might have arisen because of the CRA prioritising fees over accurate ratings (Rabinowitz 2014). The issuer-pays business model used by CRA (in which issuers of bonds and securities pay CRA for a rating) may create a self-interest threat of a rating agency 'selling' unwarranted high ratings (Acharya & Richardson 2009; Hill 2010b; Rafailov 2011). Credit rating agencies, however, appear reliable in so far as rating less complex debt instruments refuting, at least in one respect, the conflict of interest argument (Hill 2010b; White 2010a). Regarding more complex structured securities with greater returns, the issuer-pays model may have motivated CRA to alter the structure of transactions to achieve the issuer's desired rating (Hill 2010b).

Credit rating agencies regulation: *Dodd-Frank Act* and the *Credit Rating Services Act*

Regulation of CRA over their existence has been liberal. Since their establishment in the market, regulation existed in the form of self-regulation. Regulation was initially introduced in 1975 and thereafter in 2006 and 2010. Inadequate policy prescription for CRA allowed them to attain and maintain their big persona power but without the balancing acts of responsibility (Rafailov 2011).

From an overarching perspective, the *Dodd-Frank Act* endeavours to increase accountability and oversight of the

credit rating industry (Martin & Franker 2011). Dodd-Frank also aims to reduce regulatory reliance on credit ratings, remove references to credit ratings from the law, increase transparency in the credit rating industry and address conflicts of interest (Cane, Shamir & Jodar 2011).

South Africa's counterpart to the *Dodd-Frank Act* is the *CRS Act*. The *CRS Act* came into effect in April 2013 with the aim of enhancing the credibility of credit rating agencies and fostering confidence in the ratings provided (RSA 2012). Criticism was initially drawn for the introduction of the *CRS Act* in South Africa because of the relatively small size of the South African CRA landscape compared to that in developed markets (Maake & Lefifi 2012). Yet the stringency of the South African CRA regulation was found to be comparable to that of the European Union (EU), facilitating cross-border cooperation of certain South African CRA and allowing the EU to endorse the ratings of certain South African CRA (ESMA 2016).

Similar to the CRA regulation in the USA, the *CRS Act* focusses on the registration of CRA and imposes duties on CRA which manage aspects, such as internal controls, general efficiency and administration, the appointment of directors, the requirement to issue an annual report, accounting and auditing requirements and the need for an independent compliance unit. The *CRS Act* gives guidance on the implementation of rating models, methodologies and how issuing and publishing credit ratings should be performed (RSA 2012). The *CRS Act* also exposes CRA to delictual liability 'in respect of a credit rating issued or credit rating services performed in the ordinary course of business' (RSA 2012:30). Like the *Dodd-Frank Act* (GovInfo n.d.) in the USA, it seems that CRA will be subject to increased legal liability claims in South Africa. The new *CRS Act*, however, does not specify that CRA will be subject to liability for negligent or intentional misconduct (RSA 2012; Rabinowitz 2014).

Criticisms of credit rating agencies policy prescriptions

A review of the relevant literature reveals various propositions and oppositions of possible policy prescriptions concerning CRA and the CRA industry. The most relevant themes identified relevant to the research objective are discussed in this section.

Some commentators are strong proponents of a policy route that holds CRA liable as a deterrent to negligent or wilful malfeasant CRA behaviour (Cane et al. 2011; Harper 2011). Others, such as Richardson and White (2009) and White (2010b), question whether regulation is the answer for the CRA industry. Richardson and White (2009) refer to a system where the Security Exchange Commission (SEC) approved a nationally recognised statistical rating organisation (NRSRO) category for CRA to be abolished to allow investors and issuers to freely seek advice on creditworthiness from a variety of sources. According to White (2010b), the elimination of regulatory reliance on CRA will reduce the importance of the big three CRA in the future and allow market forces to prevail.

Goodhart (2010) expressed cynicism about attempts to hold CRA legally liable and analogised CRA liability to that stemming from the opinions and forecasts expressed by central banks, economists and governments. In their study, Dimitrov, Palia and Tang (2015) found no evidence that the provisions of the *Dodd-Frank Act* encouraged CRA to provide bond rating information that was more accurate and informative. Sharma et al. (2022) also found evidence to support the notion that the regulatory pressure created by the *Dodd-Frank Act* may have the unintended effect of negatively affecting the ratings process.

The introduction of new regulations may make it increasingly difficult for new entrants to effectively enter the CRA industry (Harper 2011; White 2010b). Some of the CRA provisions in the *Dodd-Frank Act* may increase barriers to entry for new entrants and may make the incumbent CRA more central to bond markets in the future (White 2010b). It is possible that new entrants may not be able to build good reputations to become NRSROs and face increased liability to comply with stringent requirements (Harper 2011).

Coffee (2010) argues that regulation is needed in order to induce the correct incentives in financial markets for CRA. A market where CRA are incentivised to compete for the favour of investors should mean that less regulation and oversight is needed. Conversely, where such incentives are absent, such as with CRA where there is an issuer-pays model, close regulatory oversight is required (Coffee 2010).

However, an extension of CRA policy prescriptions by reference to Giddens's (1990, 1991) modernity theory offers a unique social perspective on CRA' effect on modern society. The role of CRA seems cemented within financial markets (Coffee 2010), and the legitimacy and credibility of financial markets are of vital importance such that politicians and regulators may go to great lengths to maintain good images (Suchman 1995; Unerman & O'Dwyer 2004). While regulatory mechanisms may heighten investor confidence in such markets, their appropriateness regarding the time and jurisdiction of its enactment matters (Giddens & Pierson 1998; Unerman & O'Dwyer 2004). Studies have provided evidence of the influence of institutional factors on the adoption of regulated accounting practices in South Africa (Iredele, Tankiso & Adelowotan 2020; Mohamed, Yasseen & Omarjee 2019; Negash & Lemma 2020) and within this context, the use of CRA regulation to legitimise the role of CRA in South Africa is important. Credit rating agencies' research in South Africa also remains largely untouched, highlighting the importance of its exploration.

Methods

This study is qualitative and exploratory in nature. It follows a social constructivist view, given the complexity of CRA regulation. A qualitative design using semi-structured detailed interviews is appropriate given the exploratory nature of this study and the absence of direct prior research (Lauer & Asher 1988; Mouton & Marais 1988). A thematic approach was used to compare the responses of interview participants with reference to Giddens's modernity theory (1990). This enabled the researchers to explore and understand the extent to which the introduction of CRA regulation and the trust placed in institutions such as CRA has been shaped by modernity.

Research participants, sampling methods and data collection

Detailed in-depth interviews to explore and understand the perceptions of a sample of individuals operating in the investment and CRA sectors, on CRA regulation in South Africa, were carried out. Similar to other studies of this nature, each interview lasted between 45 and 120 min (Maroun & Solomon 2013; Mohamed et al. 2019; Rowley 2012). A sample size of 21 interviewees was used and is appropriate as other similar exploratory studies have utilised a similar sample size (Mohamed et al. 2019; Solomon et al. 2013).

Interviews were conducted in 2013 and 2023. This split time frame allowed the researchers to understand the perceived differences in data over different periods (Abdulai & Owusu-Ansah 2014). A total of 13 interviews were initially conducted in 2013 (R1–R13 in Appendix 1 [Table 1-A1]) to gain an understanding of interview participants' perceptions shortly after the initial implementation of the *CRS Act*. In 2023, a further eight interviews were conducted approximately 10 years after the implementation of the *CRS Act* (R14–R21 in Appendix 1 [Table 1-A1]) to understand if the perceptions of individuals within the investment and CRA sector's views on CRA regulation have changed since the implementation of the *CRS Act*.

Consistent access in 2023 to the same group of participants interviewed in 2013 was not possible but, for several reasons, did not compromise the ability of the researchers to evaluate how CRA perceptions have changed over time. Firstly, no changes to the *CRA Act* since its initial enactment in 2013 have occurred, allowing the eight interviews conducted in the latter part of the study to provide additional perspective on the appropriateness and effectiveness of CRA regulation. Secondly, all participants in both phases of the study were purposely selected and were experts in the CRA market thereby ensuring that they had the necessary expertise to answer the research questions (Rowley 2012). Lastly, the use of different interview participants in 2023 and 2013 allowed the researchers to recontextualise CRA regulation in a social system between different people in different settings in line with Giddens's (1990) theory in which value across time and space is recontextualised.

The sampling of interview participants was purposeful such that the researcher could concentrate on the views of only informed participants (Rowley 2012). Purposive sampling poses the risk of reporting biased results. However, because the selection of participants was well-considered and based on clear criteria (facilitating the collection of high-quality detailed results from informed and knowledgeable participants), it is considered appropriate (Sharma 2017). This is especially important, given the highly technical nature of CRA regulation. Participants were selected based on their experience and role in the investment and CRA sector. The roles assumed by participants included those pertaining to corporate governance, ratings, investment banking and equity investment. The selection of participants in this manner ensured that views on CRA regulation were solicited from a broad range of individuals who interact with the regulation within the sector. The researchers searched directories of individuals involved in this sector and reached out to potential participants to participate in the study. While experience and involvement in the sector were the main selection criteria of participants demographical factors such as age and gender were also considered to ensure an equitable spread of views. Table 1 presents a summary of the roles assumed by each participant included in the study.

The interview agenda (Appendix 2) was derived from the main themes and ideas which emerged from the literature review (Rowley 2012). Although the interviews were non-restrictive, non-leading and open-ended, a semi-structured approach was adopted to ensure that the same general topics were discussed and that the interviewees did not digress from the topic at hand. The interview agenda was initially piloted with two interviewees, followed by a detailed peer debriefing with two colleagues at the researchers' home university. The interview agenda was also presented at two accounting conferences in 2013 to test its applicability.

Data analysis

The researcher scrutinised all the data several times to gain a full understanding of what the data contained. During this stage, the data were categorised broadly, and preliminarily interpreted. During the classification stage, the data were formally grouped into categories or themes. This step also entailed finding the true meaning of the data. The last step of the process involved synthesising the data by creating the primary themes in the interview recordings and formulating the main arguments for and against the regulation of CRA in South Africa. This approach ensured that the researchers conducted a thorough analysis of the data collected. By the end of this

TABLE 1: Role of participants in the investment and credit rating agencies sector sampled.

Role of participant	Number of participants
Investment banking, corporate finance and credit analysis	4
Credit rating experts, credit analysts credit agency management	7
Corporate governance and law	7
Equity investment and analysis	3

process, the researchers were familiar with all the details contained in the data collected (Rabinowitz 2014).

Coding took place during the first step of the data analysis. The researcher highlighted the main themes that emerged from the interviews. Once the main themes were generated, each theme was then compared with prior literature and theories which either showed that the findings confirmed or challenged the main themes or concepts identified in the prior research (Rabinowitz 2014).

To ensure the validity of the study, several strategies were employed. Firstly, transcripts or sections of the written report were sent to the interviewees to verify the accuracy of the data captured. Secondly, a peer review to offer interpretations regarding the study was performed to enhance the accuracy of this study (Marshall & Rossman 2006). Thirdly, an independent party provided objective assessments of the project as a whole and was asked to review the research project in its entirety. The validity of this study was further enhanced through the use of purposive sampling (interviewing experienced and knowledgeable participants), piloting the interview agenda and grounding the interview findings in prior literature (Rowley 2012).

Several measures were adopted to ensure that ethical requirements were upheld. Interviewees who agreed to be recorded were assured that no one would have access to the recordings, besides the researcher. The anonymity of interviewees in terms of names, professions and positions was guaranteed and as such, is not mentioned in this article.

Results

Overall views of credit rating agencies regulation in South Africa

There was mixed sentiment regarding the decision to regulate CRA in South Africa. Proponents of the current South African CRA regulation believe that CRA must be regulated by the government as they play a vital public role, because of investors basing important decisions on credit ratings from CRA (R8; R9; R11; R12; R14; R15; R16). There is also the belief among those in favour of the new CRA regulation that it aims to engender more responsible behaviour from CRA, as opposed to restricting or hampering their activities (e.g. R3; R14; R15; R16; R19; R20; R21). These views can be likened to those of Partnoy (2009a) who suggested enhancing CRA accountability by eliminating their exemption from liability.

Positive sentiment was also expressed for South African regulators who are renowned for taking proactive steps to protect the economy, as opposed to those in the USA, who have been accused of introducing reactive regulations in response to certain crises (R8; R9; R11; R12). Some respondents claimed that South Africa was shielded from the impact of the 2008 crisis because of 'our world-class' government regulation from a financial services perspective (R9; R16). The fact that South Africa was only affected by 'the spillover of the crisis' proves that strong regulation can help a country avoid serious financial crises (R9). These perceptions are important from a modern social constructivist point of view as they offer evidence supporting the legitimacy of South African regulation.

Conversely, those more critical of the new *CRS Act* believe South African regulators have succumbed to international pressure by introducing the new regulation (R1; R2; R7; R10; R13). Consistent with some of the initial criticisms of the *CRS Act* (Maake & Lefifi 2012), many respondents felt that it was not immediately apparent that South Africa requires CRA regulation, especially because of the small size of the South African credit rating market and went on further to add that new CRA regulation is just a result of the 2008 GFC which caused a lack of confidence in capital markets (R1; R4; R6; R7; R8; R10; R15).

A key theme emerging from the detailed interviews was the need for South Africa to protect its international reputation to attract foreign investment. The principle of regulating CRA is important 'because it keeps up the perception of the South African economy' (R9). It seems that maintaining the perception of a stable and well-regulated economy is essential in this regard (R1; R4; R5; R7; R8; R9, R14; R15; R16; R18; R19; R20). In other words, these results suggest that forces of mimetic isomorphism (DiMaggio & Powell 1983) mean that South African regulators have largely replicated or aligned themselves with regulation from other jurisdictions to gain credibility and trust in the South African economy (Rabinowitz 2014). Trust, although formed by a complex array of factors, is needed for the healthy functioning of financial markets (Brescia 2009).

In analysing the responses from 2013 versus 2023, no apparent change in perception with respect to respondents' views on CRA regulation in South Africa was noted, with many respondents echoing the same sentiments on the regulation of CRA in South Africa. The social constructs reflective of the cumulative experiences of stakeholders within the prevailing social, political and economic landscape (Giddens 1990) do not seem to have altered from shortly after the enactment of CRA regulation in South Africa to a period of 10 years after enactment.

In short, two conflicting scenarios emerged from the interviews. On one hand, the regulation appears to have a functional role to play – it improves the operation of CRA. On the other hand, CRA regulation could be used to create the appearance of a rational expert system to maintain confidence in the capital markets on which governments are so heavily dependent (Unerman & O'Dwyer 2004; Rabinowitz 2014).

Table 2 provides a summary of the respondents generally in favour of increased CRA regulation versus those generally against it based on the interviews conducted. Table 3's sections regarding the role of respondents with respect to the

key themes identified provide further detail on respondents' views based on key themes that were identified across all interviews.

Regulatory model – Self-regulation or independent government regulation

The role of CRA, locally and internationally, and their implications in the GFC were seen as the primary drivers of the development and implementation of CRA regulation. In other words, respondents implied that had there not been an international crisis and criticism of the CRA industry globally, South Africa may not have thought it necessary to develop and implement CRA regulations.

The role CRA played, leading up to the crisis, inevitably led to regulation (R1; R2; R3; R6; R8; R9; R10; R14; R15; R16; R19; R20; R21). Historically, CRA were self-regulated to some degree or even unregulated (R2; R3; R4; R6; R14; R15; R19).

Self-regulation has been heavily criticised in recent years (R7; R8; R18). Self-regulation often resulted in the self-interest of the regulated entities being prioritised over the public interest (R7; R8; R18). The failure of self-regulation models in many industries is cited as the reason why government regulation is necessary (Rafailov 2011; Rabinowitz 2014; Stiglitz, 2009). Internationally, therefore, the trend in regulation has moved away from self-regulation towards independent government regulation (R12; R14; R20). 'Government regulation is there to protect the public' (R12; R14; R20).

TABLE 2: Summary of respondents generally in favour versus those generally against increased regulation of credit rating agencies.

Role of respondents	Number of respondents generally in favour of new CRA regulation	Number of respondents generally against new CRA regulation
Investment banking, corporate finance and credit analysis	2	2
Credit rating experts and credit analysts at credit agency management	4	3
Corporate governance and law	6	1
Equity investment and analysis	3	0
Total	15	6

CRA, credit rating agencies.

TABLE 3: Composition of respondents with respect to the key themes identified relating to the new credit rating agencies regulation.

Role of respondents with respect to the key themes identified	Active proponents of new regulation	Flexible adherents to new regulation	Dissidents of new regulation	Total
4.2 Regulatory model – Self-regulation or independent government regulation				
Investment banking, corporate finance and credit analysis	0	2	2	4
Credit rating experts and credit analysts at credit agency management	4	0	3	7
Corporate governance and law	4	3	0	7
Equity investment and analysis	1	2	0	3
Total	9	7	5	21
4.3 CRA accountability				
Investment banking, corporate finance and credit analysis	3	1	0	4
Credit rating experts and credit analysts at credit agency management	5	2	0	7
Corporate governance and law	5	2	0	7
Equity investment and analysis	3	0	0	3
Total	16	5	0	21
4.4 A paradox: Increasing the dependency on CRA				
Investment banking, corporate finance and credit analysis	0	4	0	4
Credit rating experts and credit analysts at credit agency management	0	4	3	7
Corporate governance and law	0	7	0	7
Equity investment and analysis	0	3	0	3
Total	0	18	3	21
4.5 Investor responsibility and the 2008 financial crisis				
Investment banking, corporate finance and credit analysis	0	0	4	4
Credit rating experts and credit analysts at credit agency management	0	6	1	7
Corporate governance and law	0	6	1	7
Equity investment and analysis	0	3	0	3
Total	0	15	6	21
4.6 The issuer-pays business model				
Investment banking, corporate finance and credit analysis	0	4	0	4
Credit rating experts and credit analysts at credit agency management	0	7	0	7
Corporate governance and law	0	7	0	7
Equity investment and analysis	0	3	0	3
Total	0	21	0	21
4.7 Regulator ability and enforcement power				
Investment banking, corporate finance and credit analysis	0	2	2	4
Credit rating experts and credit analysts at credit agency management	0	6	1	7
Corporate governance and law	2	3	2	7
Equity investment and analysis	0	2	1	3
Total	2	13	6	21

CRA, credit rating agencies.

Several respondents believed that CRA were scrupulous when it came to ratings, because of the reputational risk associated with issuing an incorrect rating (R1; R4; R5; R6; R8; R15; R17; R19). However, they went on to explain that the financial crisis highlighted potential weaknesses in the existing self-regulatory model (Rabinowitz 2014) (R1; R4; R5; R6; R8; R15; R17; R19).

The *CRS Act* is the first CRA regulation in South Africa (RSA 2012). There is an inference that the decision to regulate CRA by way of government regulation was perhaps an impulsive reaction to the crisis and it is questionable whether there is a local market-driven need to regulate CRA because of the small size of the CRA market in South Africa (R7; R15; R20).

From a slightly different perspective, some respondents are sceptical about the government's involvement in regulating CRA. The government in South Africa was also accused of being inefficient, as opposed to its private sector counterparts, by some respondents (R1; R6; R7; R10). As a result, some respondents do not believe that government-backed CRA regulation is necessarily in the public's best interest (R1; R6; R7; R10). These sentiments are echoed by Goodhart (2010), as government involvement in the CRA industry by way of a government CRA or a government-promoted CRA is also dismissed because of concerns about trust and objectivity (Rabinowitz 2014).

In terms of modernity theory what is important is the ability of these mechanisms to reassure non-experts that these systems work (Giddens 1991; Unerman & O'Dwyer 2004). Consequently, concerns about the efficiency of regulatory measures and the ability of the State to enforce the regulations take second place to the symbolic value of laws (Unerman & O'Dwyer 2004). As predicted by modernity theory, with the financial crisis shaking confidence in the capital system, at least some response is needed to preserve the confidence of outsiders in the expert system (Giddens 1990). In this context, almost all respondents were willing to compromise by embracing a hybrid regulatory model which includes elements of both self- and government-backed regulation (R8; R14; R16; R17; R18; R19; R20). The industry should have its own rules and standards, and it should deal with issues as they arise (R1; R5), but an element of government regulation is imperative when there is non-compliance, as determined from these findings (Rabinowitz 2014).

Credit rating agencies accountability

A theme which emerged during the detailed interviews is the importance of CRA accountability. In the aftermath of the financial crisis, regulators have sought to enhance CRA accountability to ensure that they do not make the same errors (R2; R3; R4; R6; R8; R9; R14; R15; R18). The failures of gatekeepers, such as CRA, have shifted a degree of responsibility (unintentionally) onto investors (R4; R6; R10; R18). Investors must now be more cautious when assessing CRA opinions (R4; R6; R10; R18) (Rabinowitz 2014).

Possible effects of the *CRS Act* may be the need for investors to be more cautious upon whom they rely for information, and more ease for CRA to avoid responsibility for their errors (R4; R5; R6). The reason for this is that regulation has been introduced that should be a warning to investors that CRA should not be blindly relied on (R4; R5; R6). Notwithstanding the consequences of the new CRA regulation, all respondents agreed with Manns (2009): CRA must be accountable for their actions, and part of the discussion on accountability includes liability for CRA when they make errors (Rabinowitz 2014).

Despite the attention and notoriety that CRA has attracted following their errors leading up to the GFC, they are still largely misunderstood by many market participants (R4; R5; R6). Governments and regulators have attempted to restrict CRA by instituting stringent liability laws to protect the public in the event that these agencies make mistakes in the future (R1; R2; R6). This can be expected in terms of modernity theory, as this is part of the process of bolstering confidence and trust within an abstract system (Giddens 1990) such as the financial markets (Rabinowitz 2014).

A paradox: Increasing the dependency on credit rating agencies

Credit rating agencies' regulation worldwide has sought to reduce regulatory reliance on ratings, as well as encourage increased competition in the CRA industry (R1; R2; R4; R6; R8; R15). Moody's, S&P and Fitch hold the majority of the world market share for ratings (R2; R4; R6; R14; R15; R19) (Rabinowitz 2014).

The fact that CRA are being regulated means that they must contend with increased compliance costs, as well as increased exposure to liability (R1; R2; R4; R6; R8; R15). This makes it very difficult for new entrants into the CRA industry (R1; R2; R4; R6; R8; R15). White (2010b) and Harper (2011) echoed this sentiment. White (2010b), for example, argued that some of the sections in the *Dodd-Frank Act* may increase barriers to entry and may make the incumbent CRA more vital to bond markets, while Harper (2011) was not convinced that new entrants will be able to build good reputations to become NRSRO's, given that the status will expose them to increased liability, coupled with reduced reliance on NRSRO ratings (see also, Murphy 2009; Rabinowitz 2014).

Despite the reputational damage that CRA suffered because of the financial crisis, ironically, CRA are presently in a stronger position than they were before the crisis (R1; R8). This is a direct result of the regulatory response to the crisis. Despite the efforts to reduce reliance on CRA, greater reliance is being placed on the agencies than was the case before the crisis (R2; R4; R6; R8; R15) (Rabinowitz 2014).

When it comes to South Africa, few smaller CRA operate along with the big three (R7; R15). Some respondents took the position that regulation should not address competition

(or lack thereof) (R4; R6; R7; R15). Others, however, claim that growing the CRA industry is very important and that the new regulation will be a failure if there are no new CRA operating in South Africa soon (R8; R9; R11; R12, R15) (Rabinowitz 2014).

Ironically, the regulation introduced to preserve confidence in the expert system has the effect of strengthening the position of key industry players, making it difficult for alternatives to the current rating structures to take hold (R2; R6, R15). This can perhaps be explained via Suchman's 'sector leading paradox' (Suchman 1995:601). The proliferation of CRA regulation in response to the GFC has perhaps created a sense of isomorphism within a highly institutionalised CRA environment. In doing so, the results of the study suggest that this may have further embedded CRA within the market. This is an important consideration of the study, as the benefits of this type of outcome may be not realised by any of the players within the sector (Suchman 1995) (Rabinowitz 2014).

Investor responsibility and the 2008 financial crisis

All respondents concurred that investors relied too heavily on CRA leading up to the GFC, consistent with arguments by Mulligan (2009) and Partnoy (2009b). Blame for the GFC was, however, also attributed to investors. Some respondents went so far as to claim that the investors who invested in AAA, or similarly rated, sub-prime mortgages were primarily to blame for the financial crisis (R1; R3; R4; R10; R17; R20). Investors did not understand what they were investing in, and it is difficult to reconcile how investors could have invested in highly complex financial instruments without the requisite understanding (R2; R4; R5; R8; R10; R17). Investors have admitted that they did not understand the securities that they purchased (Hill 2011). Most respondents concurred with this view and concluded that placing the blame on rating agencies was an attempt by investors to abrogate their responsibility to carry out due diligence on their material investments.

The 'outsourcing of risk assessments to CRA' by all market participants, including regulators and investors was 'one of the single biggest causes of the crisis' (R4). The over-reliance on credit ratings highlights two key issues: firstly, because of the mandatory or quasi-mandatory use of credit ratings, investors became complacent and did not conduct adequate research before making investment decisions (R1; R2; R3; R5; R6; R8; R17; R19). Secondly, there was a general lack of questioning which led to a 'herd mentality' among investors, especially when it came to mortgage-backed securities and other complex financial instruments (R1; R2; R3; R5; R6; R8; R17; R19) (Rabinowitz 2014).

Credit rating agencies were also heavily criticised for rating instruments which they did not fully understand (R2; R5; R6; R10; R11, R15, R17, R19, R20). Lewis (2010) describes the situation pre-2008, where the benefit of hindsight reveals that CRA did not understand the risk attached to sub-prime securities. While this criticism was widely shared, several respondents were sceptical about whether the regulation would be able to address shortcomings in the acumen of analysts and executives at CRA. Without necessarily changing the way analysts operate or their attitude towards the rating process, it seems unlikely that regulation will be able to change dramatically the processes used by CRA to perform their rating services (R1; R7; R8; R10; R19) (Rabinowitz 2014).

The issuer-pays business model

Credit rating agencies' regulation in South Africa, and other jurisdictions, does not directly address the CRA issuer-pays business model (R4; R5; R6). The fact that globally, new regulation does not address this controversial issue highlights the limitation of some regulation (R4; R5; R6) (Rabinowitz 2014).

Credit rating agencies have become very powerful as a result, and they would not agree to be dictated to by regulators with respect to what business model they should use (R2; R4; R5; R20). Although it was never explicitly stated, respondents alluded to a CRA ability to hold governments ransom, especially with respect to how they earn their keep. In particular, the power of the CRA has allowed the issuer-pays model to become firmly entrenched (R4).

A common argument in the literature is the conflict of interests experienced by CRA (Partnoy 2006; Pillay & Sikochi 2022; White 2010a). Leading up to the financial crisis in 2008, issuers who were paying for the ratings of complex financial instruments were able to secure favourable ratings from CRA (R1). There was general agreement among respondents that the issuer-pays business model introduces several conflicts of interest (R1; R2; R3; R4; R6; R8; R15; R18; R19; R20; R21). Consistent with Partnoy (2006) in the USA, respondents confirmed that CRA earn a substantial amount of their revenue from issuers who pay them for ratings in South Africa (R1; R2; R3; R4; R6; R8; R15; R18; R19; R20; R21). Credit rating agencies also sell additional research to investors who request further information but the revenues from the sale of this additional research are minimal in comparison (R2; R6). Despite the criticism of the issuer-pays model, respondents were unable to suggest practical alternatives. An investor-pays model was mentioned but CRA would not agree to such a change at present (R1; R2; R4; R5; R6; R7; R17; R19). Although most respondents would support the pursuit of an alternate business model, they all accepted that the issuer-pays model will continue for the foreseeable future. The current high levels of profitability achieved by the current CRA business model which is likely to create resistance to change is one reason. Another reason may be grounded in the fact that CRA issue so many ratings (tens of thousands per year) and that the revenue from one single rating is insignificant making it senseless to risk their reputations by subverting a single rating or a group of ratings (R14; R18; R21) (Rabinowitz 2014).

The possible introduction of a government rating agency was discussed but this possibility was summarily dismissed by most respondents. All respondents supported the preservation of the status quo, relying on privately owned CRA. Coffee (2010) supports the idea of a state-run CRA as an alternative to the issuer-pays model, but not without its limitations. Despite the errors that CRA made in the past, it seems that many of the respondents would still rely on the incumbent privately owned CRA over a government rating agency CRA (R1; R2; R4; R5; R6; R7; R14; R16; R18; R21) (Rabinowitz 2014). It would appear that CRA have become so institutionalised that a significant reform seems unimaginable.

Regulator ability and enforcement power

In South Africa, the Financial Services Board (FSB) is tasked with the implementation and enforcement of the *CRS Act* (Financial Services Board 2013). Respondents expressed differing views regarding the FSB. Some claimed that the FSB is more than capable of enforcing CRA regulation in South Africa (R8; R9; R11; R14), while others questioned the sufficiency of the skills and resources of the FSB to understand CRA and regulate them adequately (R2; R10).

The FSB was criticised for its ability to enforce the relevant regulations which is frustrated by a lack of resources and by the country's legal system (R2; R7; R8; R18). There is a growing public perception that regulators are incapable of carrying out their responsibilities efficiently and effectively, when, in fact, many matters are out of the regulators' hands when the judiciary is involved (R14). Even though this perception might be false, the legitimacy and reputation of regulators in South Africa suffer and trust in the capital system is eroded (R1; R7; R8; R10; R14) (Rabinowitz 2014).

Many respondents called for regulators to be granted the power to enforce regulation effectively without having to rely on the courts, which will aid in repairing their reputation (R7; R8; R9; R11: R12). This can be expected in terms of modernity theory in which it becomes important, through the implementation of safeguards, to rebuild trust and confidence placed by non-experts in highly institutionalised environments such as financial markets (Giddens 1990).

Supplementary analysis

The researchers considered if respondents' views varied with years of experience, their demographics or places of employment. This was found not to be the case. The current article's aim was not to test for the possibility of certain characteristics driving the type of responses on CRA and associated regulations, but the sensitivity analysis (Table 3) provides some confirmation that the interview findings were not driven by these additional facts and circumstances. Future research will be required to reach firmer conclusions on the relevance of age, experience, demographics and work history on how CRA and associated regulations are perceived. Appendix 1 (Table 1-A1) details the demographics and experience with respect to each respondent.

Conclusion

The objective of this article is to understand the perceptions of experts in the investment and CRA sector in South Africa on the relatively new CRA regulation, and, to draw conclusions using a modernity theory-inspired analysis. This study adopted a social constructivist approach, based on the assumption that knowledge is a social construction (Monahan & Fisher 2010). Semi-structured, detailed interviews were carried out with a sample of 21 interviewees in 2013 and 2023 and their responses were then analysed and coded to identify the main themes that emerged. No key differences were noted by respondents in the period shortly after the enactment of the regulation and 10 years later.

The intricacies of trust, power and credibility are highlighted in this article. On the one hand, governments try to restore trust and credibility in their respective economies to secure foreign investment and achieve economic growth. The South African government introduced new CRA regulations to restore confidence in capital systems (National Treasury 2011). This is especially important, given the highly institutionalised environment characterising periods of late modernity Giddens (1990, 1991), coupled with the stimulation of South Africa's economy via foreign direct investment (Sunde 2017). Despite the involvement of the CRA in the financial crisis, the results of this study indicate that their services and expertise are in high demand and the CRA continues to have significant influence over financial markets. Once again, modernity theory sheds light on this apparent contradiction. With non-experts unable to understand fully the functioning of the rating systems, they rely on the good-faith assumption that underlying technical properties are sound (Giddens 1990). Recently, CRA enacted regulation provides important reassurances, even if these are more symbolic than substantive (Rabinowitz 2014).

It would appear that regulation alone is not a solution to the problems posed by the dominance of the CRA. It is up to investors to decide if credit ratings are credible, and investors should complement credit ratings with their own due diligence assessments. Good corporate governance also dictates that CRA must be accountable. The lack of practical alternatives or substitutes for ratings means that possible onerous liability referred to in the *CRS Act* is not a workable solution at this stage. Regulators and other industry players have not found viable solutions to CRA accountability, and it is up to all market participants to decide if and how this issue should be addressed. It is also concerning that the new *CRS Act* does not address the issuer-pays business model and its inherent conflicts of interest. It is likely that this is a subject that regulators will need to address in the future (Rabinowitz 2014).

Paradoxically, CRA regulation has further cemented the rating agencies' position in financial markets. Credit rating agencies are here to stay, and it is up to all market participants to create a way to improve them and the system at large. Modernity theory dictates that expert systems (in this case financial markets) are social constructions swayed by past events and experiences (Giddens 1990; Unerman & O'Dwyer 2004). As reputations and world markets recover from the GFC, the pendulum of regulation may swing back towards less oversight and looser controls (Rabinowitz 2014).

A limitation of this article is that it is exploratory in nature and does not seek to address the *CRS Act* in detail or its effectiveness. An area of future research includes analysing the effectiveness of CRA regulation in detail to increase CRA accountability and behaviour, based on FASB reports on complainants, fines and other regulatory powers at its disposal.

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Competing interests

The authors declare that they have no financial or personal relationships that may have inappropriately influenced them in writing this article.

Authors' contributions

D.R. was responsible for the original write-up. M.I.S. conducted further analysis and interviews, and collaborated with W.M. on the write-up. Lastly, W.M. was responsible for supervision, review and editing.

Ethical considerations

All interviews were recorded and backed up soon after the interviews were completed with the interviewees' consent. Ethics clearance was obtained from the University of the Witwatersrand, in accordance with the ethical requirements for the use of human participants for interviews with credit rating agencies (ethics clearance number: CACCN/1057 and ethics certificate: H22/05/20).

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Data availability

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Disclaimer

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Appendix 1

TABLE 1-A1: Experience and background of respondents.

Respondent	Experience and background	Period in which interview was conducted	Gender	Age group (in years)
R1	Retired investment banker	2013	M	55–60
R2	Over 20 years of rating, risk management and credit risk management	2013	M	55–60
R3	Over 40 years of corporate experience. Multiple direct dealings with CRA	2013	M	55–60
R4	Commercial law expert	2013	M	30–35
R5	Rating expert	2013	M	30–35
R6	Approximately 10 years of rating experience	2013	M	40–45
R7	Financial analyst.	2013	F	30–35
R8	Approximately 25 years of corporate experience including auditing, corporate governance and regulatory work	2013	F	40–45
R9	Over 20 years of corporate experience and over 10 years of regulatory experience	2013	M	40–45
R10	Investment banking and regulatory background	2013	M	55–60
R11	Approximately 35 years of regulatory, academic and corporate governance experience	2013	F	40–45
R12	Approximately 10 years of corporate governance and regulatory experience	2013	F	55–60
R13	Ratings, regulatory and investment banking experience	2013	M	40–45
R14	Equity trader and portfolio manager with over 30 years of experience	2023	M	55–60
R15	Credit ratings specialist consultant with over 15 years of experience	2023	M	40–45
R16	Equity analyst with approximately 13 years of experience	2023	F	45–50
R17	Financial services focussed external auditor at a large firm	2023	M	30–35
R18	Corporate governance expert, academic and former audit firm partner with over 20 years of experience	2023	M	45-50
R19	Corporate finance and investment banker	2023	M	30-35
R20	Corporate finance expert dealing with credit risk	2023	M	30–35
R21	Professional retail investor in local and international markets	2023	F	35–40

M, Male; F, Female.

Appendix 2

Interview agenda

Interview agenda:

1. What is the rationale for regulation?
2. What role does regulation play? (With specific reference to South Africa)
3. Was the financial crisis the result of a lack of regulation or a lack of enforcement? In addition, what role did CRA play, if any?
4. What are the key features of good regulation, and why? (Including a discussion of independent government versus self-regulation)
5. With reference to regulation, please share your views on matters of trust, credibility and legitimacy.
6. If trust existed between stakeholders, would we need regulation?
7. What should regulation address and what should be left to market forces?
8. What is the role of regulators in the market?
9. Does regulation play a role with respect to a country's reputation and foreign investment?
10. Why did South African regulators introduce the Credit Rating Services Act (2012)?
11. Does South Africa need the same kind of CRA regulation as the United States?
12. What are your views on the new South African CRA regulation?
13. What are your views with respect to the rating agencies' business model?