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The relevance of trust and legitimacy for the introduction of credit rating agency regulation in South Africa: an application of modernity theory

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The Relevance of Trust and Legitimacy for the Introduction of Credit Rating Agency Regulation in South Africa: An Application of Modernity Theory

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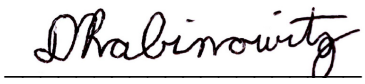
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2014

Declaration

I hereby declare that this research report is my own unaided work. It is submitted in partial fulfilment of the degree of Master of Commerce (by Coursework and Research Report) at the University of the Witwatersrand, Johannesburg, South Africa. It has not been submitted elsewhere for the purpose of being awarded another degree or for examination purposes at any other university.



David Michael Rabinowitz

29 April 2014

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I List of abbreviations and acronyms

Abbreviation/Acronyms	Description
CRA	Credit rating agency
DTI	Department of Trade and Industry
EU	European Union
Fitch	Fitch Ratings
FSB	Financial Services Board
G20	The Group of Twenty Finance Ministers and Central Bank Governors
GAO	United States Government Accountability Office
IFRS	International Financial Reporting Standards
IOSCO	International Organisation of Securities Commissions
Moody's	Moody's Investors Service
NRSRO	Nationally recognised statistical rating organisation
S&P	Standard & Poor's Financial Services
SAAA	Southern African Accounting Association
SARS	South African Revenue Service
SEC	United States Securities Exchange Commission
U.S.A	United States of America
Big Three	Refers to the 3 biggest credit rating agencies in the world namely: Fitch Ratings, Moody's Investors Service, Standard & Poor's Financial Services (in alphabetical order)

II List of Regulations

Companies Act No. 71 of 2008
Credit Rating Agency Reform Act of 2006
Credit Rating Services Act No. 24 of 2012
Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
National Credit Act No. 34 of 2005
Pensions Funds Act No. 24 of 1956
Sarbanes-Oxley Act of 2002

III Abstract

The 2007/2008 financial crisis and the role that credit rating agencies (CRA's) played leading up to the crisis precipitated the introduction of CRA regulation worldwide. By using Giddens's (1990. 1991) theory of modernity as a framework, this study explores the rationale for the introduction of CRA regulation in South Africa (the Credit Rating Services Act No. 24 of 2012), with a specific focus on trust and legitimacy. The findings in this study suggest that while the introduction of new regulation is a mechanism used to legitimise the capital system, it often has limitations and unforeseen consequences. This study used detailed interviews with some of South Africa's leading experts on the credit rating industry to explain the reasoning for South African CRA regulation. Lastly, this thesis adds to the scant body of interpretive (and normative) research on the use of arms-length regulation in modern governance discourse, and it is also the first research to explore CRA regulation in the South African context.

Keywords: Credit rating agencies, Credit Rating Services Act No. 24 of 2012, Legitimacy, Regulation, Theory of modernity, Trust.

1. Introduction

1.1 Purpose and context of the study

This research uses Giddens's (1990, 1991) theory of modernity to examine credit rating agencies (CRA's) and the regulation of these in South Africa, with a specific focus on the newly introduced Credit Rating Services Act No. 24 of 2012 (the Act). The thesis will be the first to examine this legislation and the issue of the regulation in an African setting. More generally, the research will add to the scant body of interpretive (and normative) research on the use of arms-length regulation in modern governance discourse[1].

There has been much debate about the causes of the 2007/2008 financial crisis (Coffee, 2009). CRA's have come under scrutiny for the role they played leading up to the crisis and, although not the only factor, most authors agree that CRA's contributed to the eventual meltdown of financial markets (Hill, 2010a; White, 2010a). Governments and regulators worldwide have, therefore, introduced arms-length CRA regulation to ensure that CRA's do not repeat past errors (St. Charles, 2010). Indeed, financial crisis often results in the introduction of new regulations (Hancher & Moran, 1989; Malsch & Gendron, 2011). The reasons for this are the central focus of this thesis. The introduction of arms-length CRA regulation in South Africa following the 2007/2008 crisis raises questions about the legitimacy of the capital system and the trust in it. It is for this reason that Giddens's (1990, 1991) modernity theory is used to provide an in-depth analysis of the new CRA regulation in South Africa.

1.2 Research objective

The objective of this study is to explore the rationale for the introduction of CRA regulation in South Africa, with particular focus on trust and legitimacy.[2]

[1] This thesis builds on the work of Rabinowitz and Nana (2013), which provides an overview of CRA's in South Africa.

[2] This study rejects the positivist need for a hypothesis or research question. This study is exploratory in nature and the social constructivist approach that is adopted justifies the use of a research objective (Creswell, 2009; Creswell & Clark, 2007; Maroun, 2012).

1.3 Significance of the study

This research utilises detailed interviews with some of South Africa's leading experts in the CRA industry to shed light on CRA's in South Africa, and on the recently introduced Credit Rating Services Act (2012). At present, international literature on CRA regulation is scant (Partnoy, 1999; White, 2010a). Similarly, no CRA research has been conducted in South Africa: this thesis will be the first to address South African regulation of local CRA's, something which is especially important, given the central role they play in debt capital markets (Hill, 2010a, 2010b; White, 2010a).

1.4 Assumptions

This study adopts a social constructivist approach, based on the assumption that modern society is not characterised by a single or unique 'truth'. The socially constructed 'truth' changes as society changes. This study also assumes that interviewees are honest and forthright (despite the number of safeguards put in place) (Hopwood, 2000; O'Dwyer, Owen, & Unerman, 2011).

1.5 Delimitations

This report uses Giddens's (1990, 1991) theory of modernity to explore CRA regulation in South Africa. This report also makes references to Suchman's (1995) legitimacy theory, but the aim of this research is not to examine the theory in detail[3]. Other perspectives or frameworks (models of economic rationality or alternate institutional theories) are not applied.

This report uses the regulatory environment in the United States of America (U.S.A) as a framework (seeing that the major CRA's have their headquarters in the U.S.A). The central focus of this paper is, however, on CRA's in South Africa and it must be stressed the objective of this study is not to provide a comprehensive history of the financial crisis commencing in 2007/2008.

[3] This is because modernity theory already caters for the relevance of institutional legitimacy (Unerman & O'Dwyer, 2004).

This research does not deal with the different methodologies used by the CRA's to compute their ratings. Furthermore, the informational value of credit ratings may be mentioned but the main aim of this paper is to provide a perspective on CRA's in South Africa. Lastly, sovereign ratings and unsolicited ratings are not part of the scope of this paper.

1.6 Structure of this thesis

Section 2 presents a review of prior literature on the given subject. Section 2.1 introduces Giddens's (1990; 1991) theory of modernity to provide a theoretical framework for analysing results, Section 2.2 examines the relevance of regulation and Section 2.3 gives a detailed background and explanation of CRA's.

Section 3 describes the research method, namely semi-structured interviews. Other issues such as purposive sampling, reliability and validity measures, ethical considerations and the design of the interview agenda are also addressed.

Section 4 presents a detailed discussion of the findings. It consists of two main subsections: Section 4.1 (Regulation legitimises the capital system) and Section 4.2 (The limitations and unforeseen consequences of regulation). Lastly, Section 5 concludes. Section 5.1 contains summarising comments and Section 5.2 discusses the contribution of this thesis. Section 5.3 concludes with the limitations of this research and areas for future research.

2. Literature review

2.1 Modernity Theory

Giddens (1990, p. 94) defines modernity as:

> '...a shorthand term for modern society, or industrial civilisation. Portrayed in more detail, it is associated with (1) a certain set of attitudes towards the world, the idea of the world as open to transformation, by human intervention; (2) a complex of economic institutions, especially industrial production and a market economy; and (3) a certain range of political institutions, including the nation-state and mass democracy'

Giddens (1990, 1991) asserts that past events significantly affect peoples' knowledge and understanding. The theory also states that modern financial and economic practices such as accounting, auditing and credit rating analysis have been socially constructed. They reflect the cumulative experiences of stakeholders and the prevailing social, political and economic context. The result is that global economic failures (such as Enron in 2001 and the global financial crisis, commencing in 2008) have far-reaching effects (Giddens, 1990; Partnoy, 2009c; Unerman & O'Dwyer, 2004). They alter the relevant jurisdiction's governance systems and can engender changes in other locations over time (Partnoy, 2009c).

Unerman and O'Dwyer (2004), for example, analyse the effects of the accounting scandals at the turn of the century, with specific reference to Giddens's (1990, 1991) theory regarding late modernity. The accounting scandals (a time distanciation), which rocked corporate America in the early 2000's, resulted in a loss of trust by non-experts (outsiders to the expert systems of auditing and accounting). They also culminated in the additional use of regulation to ensure minimum levels of audit quality (Maroun & Solomon, 2013). A predicted space distanciation (per modernity theory) also resulted in a proliferation of external regulation in other jurisdictions which were made reflexively aware of the limitations of existing systems of checks and balances (Unerman & O'Dwyer, 2004). The same may apply to a perceived need for additional regulation of financial systems. Just as financial scandals at Enron et al in accounting and auditing circles precipitates arms-length regulation of the respective professions (Malsch & Gendron, 2011), a crisis of confidence, sparked by the 2008 financial crisis, leads to a reflexive withdrawal of trust in rating systems and the need for additional regulation of the CRA's (Partnoy, 2009c).

2.2 On the relevance of regulation

Financial gatekeepers (auditors, investment bankers, CRA's, lawyers and regulators) form part of the system of checks and balances which ensures good corporate governance (Lessing, 2009). Several well-known corporate failures, such as those at Enron, have been attributed in part, to a breakdown, of corporate governance systems (Brennan & Solomon, 2008). Coffee (2002), however, asserts that the Enron scandal was a direct result of gatekeeper failure, rather than Board failure. He

defines gatekeepers as ‘reputational intermediaries who provide verification and certification services to investors’. These include auditors, securities analysts and credit rating agencies (Coffee, 2002, p. 15). The Enron scandal raises the question: why did gatekeepers allow management to perpetrate fraud?

The ‘bubble’ economy which characterised equity markets in the late 1990’s induced a euphoric atmosphere in which gatekeepers were rendered temporarily redundant. It seems that gatekeepers are only seen as necessary when investors are cautious and sceptical (Coffee, 2002). In terms of modernity theory, with outsiders to expert systems unable to understand fully the functioning of organisations, most are happy to assume that underlying expert systems function as they are intended, to safeguard the interests of stakeholders (Giddens, 1990). When, however, these systems fail, stakeholders become reflexively aware of the limitations of the capital market system (Unerman & O’Dwyer, 2004). This is followed by calls for independent audit committees, the use of non-executive directors; the development of codes of ethics; and the proliferation of regulatory bodies (Malsch & Gendron, 2011; Maroun & Solomon, 2013). In this way, the evolution of corporate governance systems, and institutionalisation of arms-length regulation, suggests that market forces alone are unable to regulate capital markets and that, after significant corporate failure, some form of intervention by the State is required (Malsch & Gendron, 2011).

> ‘The truth is most of the individual mistakes boil down to just one: a belief that markets are self-adjusting and that the role of government should be minimal. Looking back at that belief during hearings this fall on Capitol Hill, Alan Greenspan said out loud, "I have found a flaw." Congressman Henry Waxman pushed him, responding, "In other words, you found that your view of the world, your ideology, was not right; it was not working." "Absolutely, precisely," Greenspan said. The embrace by America - and much of the rest of the world - of this flawed economic philosophy made it inevitable that we would eventually arrive at the place we are today’. (Stiglitz, 2009, p. 1)

The cause of the 2007/2008 financial crisis cannot be blamed on one decision or event. Rather, ‘mistakes were made at every fork in the road’, with disastrous consequences (Stiglitz, 2009, p. 1). According to Stiglitz (2009), the philosophy of deregulation which was adopted by the U.S.A government in the 1980’s eventually culminated in the 2008 financial crisis. The repeal in 1999 of the Glass-Steagall Act

(an Act which had separated commercial and investment banks since the Great Depression) and the decision by the United States Securities Exchange Commission (SEC) in 2004, to allow investment banks to increase their debt-to-capital ratio (which allowed them to purchase more mortgage-backed securities, thus inflating the housing bubble), were two high profile errors. The refusal to regulate derivatives and the inability to deal with the problems caused by stock options and other incentives for company executives, are also cited as key failures. It seems that most of the decisions which led to the crisis were a direct result of the deregulatory philosophy adopted in the U.S.A at the time (Eichengreen, 2008; Stiglitz, 2009).

The result has been the proliferation of external regulation over capital market systems, including, for example, audit and corporate reporting regulation (Malsch & Gendron, 2011; Tremblay & Gendron, 2011). The rationale for introducing regulation is an important issue to consider. It seems that new regulation is often introduced in response to a specific crisis (Frankel, 2002; Jackson, 2004; Malsch & Gendron, 2011; Maroun & Solomon, 2013). Regulations and laws are often relaxed in prosperous economic times. When markets deflate or financial crises occur, there appears to be a proliferation of regulation (Malsch & Gendron, 2011; Maroun & Solomon, 2013). This can be described as a 'pendulum' effect (Litan, 2013; Minsky, 1978).

> 'There is much evidence that the government tightens regulation following market crashes and relaxes regulation as market prices rise. In the 1930's, there was no market to speak of, and the existing financial infrastructure did not work. Investors were gone. Yet, during those years, Congress passed regulation that was unheard of in strictness and intrusion, as compared to existing State regulation that governed the field until then. In 1970, after the market deflated from the bubble of the 1960's, Congress again amended the laws by tightening regulation, and in 1975 Congress restructured the markets at a higher cost to the financial system. Similarly, after the 1987 crash, there was a flurry of activity by Congress and State legislatures' (Frankel, 2002, p. 440).

The same lesson applies when considering the 2007/2008 financial crisis. Frankel (2002) asserts that regulation plays an important role in strengthening trust in the capital system. She compares the trustworthiness of the capital system to reputational concerns:

> 'Financial institutions and regulators respond to the weakening trust in the markets by assuring investors that their suspicions are unfounded. One can analogise the trustworthiness of the system to reputation. To reap future benefits from the financial markets, financial institutions and Congress invest in building up the markets' reputation for trustworthiness. But when times are good, Congress and the industry over-consume the fruit of a good reputation and deplete its value. When events lead investors to question the system's trustworthiness, Congress, the issuers and the industry start to repair the damage and invest in market reputation again. When investors' trust is restored, industry pressures increase to reduce the cost of capital formation. Investors do not seem to mind. Regulation is relaxed. And when prices fall, the cycle starts all over again.' (Frankel, 2002, p. 443)

According to Jackson (2004), there is a fine line between adequate regulation and over-regulation. Over-regulation can be just as dangerous as under-regulation, with the result that governments need to balance the prescription of rules and principles when developing new regulations with the need for a degree of self-regulation (Bratton, 2003; Burgemeestre, Hulstijn, & Tan, 2009; Coffee & Sale, 2009)[4]. Regulators also have to weigh the costs of law-making against the risk of reoccurrence of identified failures (Arjoon, 2006).

Irrespective of the extent to which regulatory environments rely on rules or principles, what is key is the power of new laws and regulations to reassure stakeholders that confidence in the capital market system is justified, particularly in the aftermath of a scandal (Unerman & O'Dwyer, 2004). As explained by Frankel (2002) and Brescia (2009), trust and trustworthiness are fundamental to the functioning of the capital system. Regulation or State law can have the effect of promoting behaviour that engenders trust and cooperation from market participants (Brescia, 2009).

With weaknesses in the expert system apparent to stakeholders, additional regulation becomes an important mechanism for introducing reform to prevent the reoccurrence of identified failures (Unerman & O'Dwyer, 2004). Modernity theory also suggests that, due to the social construction of capital institutions, the symbolic potential of regulation should not be overlooked (Giddens, 1991). Even if a new law is unable to produce a radical change in regulated practice, the mere fact that the

[4] This study focuses more on the body tasked with introducing, implementing and overseeing regulation. This leads to a debate about independent government regulation or self-regulation.

State is intervening at a time of perceived crisis is a powerful display which reassures non-experts of the credibility of the respective institution (Unerman & O'Dwyer, 2004).

Unerman and O'Dwyer (2004) provide an example of this process in their analysis of accounting scandals at the turn of the century. The accounting scandals that rocked corporate America in the early 2000's resulted in a loss of trust among non-experts (outsiders from the expert systems of auditing and accounting). The introduction of strong regulation to guard against failures in the future was seen by politicians and experts as the way to restore trust in accounting and auditing systems (Unerman & O'Dwyer, 2004). The loss of trust in professional accounting and auditing caused non-experts to change their 'acceptable levels of risk'. Non-experts also became aware of the pervasive nature of accounting and auditing in stock markets and individuals' everyday lives (such as pension funds and in some cases, continued employment). After some initial reluctance, politicians agreed to the introduction of regulation as a means to restore the trust of non-experts in the accounting and auditing systems (Giddens, 1991; Unerman & O'Dwyer, 2004, p. 972).

A paradox results in that regulation appears to bolster trust in the capital system. The only reason that regulation is, however, required is because trust itself is no longer adequate (Black, Hopper, & Band, 2007). As explained by Giddens (1990, 1991), the complexity of periods of late modernity means that the tension between regulation and trust is overlooked by most stakeholders. Instead, additional regulation becomes a substitute for trust ensuring the continuation in the taken-for-granted belief that the capital market system functions (Unerman & O'Dwyer, 2004).

Another key element with respect to regulation is the political agenda of powerful stakeholders. Black (2010) cites the United Kingdom's choice of principles-based regulation as a political tool used to attract foreign investment. Due to the Utopian image created by such a system, principles-based regulation was used as a 'weapon' in the battle for business between New York and London (Black, 2010, p. 12). This 'modus' was effective because the majority of large initial public offerings in 2005 took place in London and not New York (Ford, 2008). The use of a specific brand or a type of regulation as a tool to increase business and attract foreign

investment begs the question: do firms, politicians and regulators alike truly believe in the value of their regulatory systems or do they tactically choose regulation to maintain appearances, minimise costs and increase profits (Black, 2010)?

The use of regulation as a political tool to attract foreign investment mirrors DiMaggio and Powell (1983) model of mimetic isomorphism:

> 'Organisations tend to model themselves after similar organisations in their field that they perceive to be more legitimate or successful. The ubiquity of certain kinds of structural arrangements can more likely be credited to the universality of mimetic processes than to any concrete evidence that the adopted models enhance efficiency.' (DiMaggio & Powell, 1983, p. 152)

The same applies, *mutatis mutandis,* to the proliferation of State regulation of the capital market system over the last 20 years. With trust in the capital market shaken by Enron, Parmalat, WorldCom and – more recently – the 2007/2008 financial crisis, deregulation loses favour (Black, 2010; Black et al., 2007; Unerman & O'Dwyer, 2004). As predicted by modernity theory, politicians, regulators and firms align themselves with the regulatory reform movements in order to create the perception that their economy is successful and reputable. In doing so, they achieve market growth, gain economic credibility and secure their political power (Unerman & O'Dwyer, 2004). As discussed above, even if actual material changes to the capital system are not achieved, mimetic isomorphism allows regulators to create the appearance of reform and win continued support from constituents (DiMaggio & Powell, 1983).

Unerman and O'Dwyer (2004) reiterate this point, urging scepticism when evaluating the rationale for the introduction of recently enacted regulation. Although politicians and regulators may claim that new regulation is aimed at restoring trust, the introduction of regulation is in their best interests. If trust in the system were not restored, their positions in late-modernist society (in which they function successfully) would be threatened (Unerman & O'Dwyer, 2004). Frankel (2002) supports this view, arguing that government policies oscillate between the use of regulation and deregulation depending on market and political expediency. (Black, 2010) provides a recent example dealing with the 2007/2008 financial crisis:

She describes how accounting scandals at Enron and WorldCom, as discussed above, resulted in a shift away from self-regulatory models. This marked a period of increased state-intervention, an approach to regulation which was lauded by many and marketed as aiming to help markets to avoid regulatory failures in the future (Malsch & Gendron, 2011; Tremblay & Gendron, 2011). In the aftermath of the 2008 crisis, however, fundamental questions about the regulatory approach for the Financial Services sector arose. Pre-crisis, the new governance approach[5] was generally accepted as effective and responsive to firms and regulators. Post-crisis, the same approach has been criticised by many as one of the main causes of the crisis. It has been described as 'light touch' regulation for banks and rating agencies which placed too much responsibility on the respective firms to act responsibly (Black, 2010, p. 3; Coffee, 2009).

Through the lens of modernity theory, the financial crisis highlights inadequacies of regulation in the financial services sector. Reflexivity and disembedding mechanisms lead to parallels between current and prior regulatory failures being drawn by non-experts. The result is a flurry of criticism attributing the blame for the current crisis to a 'laissez-faire' attitude of regulators (Ford, 2010, p. 3). For governments to retain their credibility, introducing a new round of regulatory reform becomes paramount (DiMaggio & Powell, 1983; Suchman, 1995).

Of particular interest for the purpose of this research is the development of regulations for the credit rating industry. As discussed in Section 2.3.4 below, the sector has moved from a period of self-regulation to a current regulatory environment characterised by considerable monitoring by governments.

[5] According to Ford (2008), new governance refers to an innovative, pragmatic and flexible approach to regulation, as opposed to the rigid rules-based approach.

2.3 Credit rating agencies

2.3.1 History of CRA's

CRA's originated in the U.S.A. The first publicly available bond ratings were published by John Moody in 1909. Those initial ratings were focused on railroad activities, as the U.S.A had embarked on massive infrastructure projects at the time, and vast amounts of capital were needed to fund the projects. Moody's Investor Service (Moody's) was followed by Poor's Publishing Company in 1916, the Standards Statistics Company in 1922 and the Fitch Publishing Company (Fitch) in 1924. The Standards Statistics Company and the Poor's Publishing Company subsequently merged in 1941 to become what is still known today as Standard and Poor's (S&P). Presently, Moody's, S&P and Fitch are known as the 'Big Three' CRA's and they hold ninety eight percent of the world market share for ratings (Mulligan, 2009, p. 1279). Initially these CRA's published their ratings in 'thick rating manuals'. At that stage, the agencies adopted an 'investor-pays' business model[6] (White, 2012, p. 5). (Please refer to Section 2.3.2 for a more detailed discussion of the business models employed).

Following the Great Depression in 1929, bank regulators passed regulation whereby banking institutions were only allowed to invest in 'investment grade bonds' as determined by 'recognised ratings manuals' published by the CRA's. The insurance industry and federal pension regulators followed suit shortly thereafter. This meant that the largest investors in bonds had to rely on the ratings of the CRA's in order to invest in so-called 'safe bonds'. White (2012, p. 6) states that these 'delegations of safety judgements to the rating agencies meant that the latter's centrality for bond market information was further strengthened' (White, 2012).

The SEC cemented the importance of the CRA's in 1975 by imposing 'minimum capital requirements for broker-dealers', which included 'major investment banks and securities firms' (White, 2010a). The SEC also created a category called nationally recognised statistical rating organisation (NRSRO). The three CRA's were immediately admitted to this NRSRO category. The SEC stipulated that only NRSRO

[6] Under the investor-pays model, CRA's generate revenue by charging investors for access to their rating assessments. Under this model, ratings are only available to paying investors, as opposed to the whole market.

ratings were to be used in determining capital requirements for 'broker-dealers'. In addition, other financial regulators also adopted this new NRSRO category (White, 2010a, p. 213).

Sylla (2002) provides a detailed history of credit ratings. According to Sylla (2002, p. 23), the advent of huge infrastructural projects undertaken in the U.S.A in the late 1700's and 1800's led to the expansion of the American economy. The U.S.A 'economy was of continental proportions' and there was a great need for capital to fund the building of railroad infrastructure that would facilitate easy movement of goods throughout the country. Mercantile rating agencies originated in 1841 and they rated businesses' creditworthiness. In 1909 John Moody published the first publicly available bond ratings and these ratings related specifically to bonded railroad debts. The CRA's soon began rating all kinds of bonds and securitised debt (Cantor & Packer, 1994; Sylla, 2002).

More recent studies by White (2010a, 2012) offer a thorough history of modern CRA's. The history is vital to the understanding of how the CRA's became such integral players in the bond and debt markets. White (2010a) explains how the regulation that was introduced in the 1930's and subsequently the 1970's (i.e. the introduction of the NRSRO category by the SEC) cemented the role of CRA's in the market. White (2010a) also points out that the effective delegation of safety judgements to the CRA's by regulators (without a degree of control over their operations) would ultimately ensure that, when CRA's made mistakes, 'those mistakes would have serious consequences' for financial markets (White, 2010a, p. 212).

White (2012) also describes the role CRA's played in the subprime debacle that led to the 2008 financial crisis. He suggests that less regulation may be the answer for the credit rating industry, and he cites the failures of the Sarbanes-Oxley Act of 2002 and the Credit Rating Agency Reform Act of 2006 as examples of additional regulation that were ineffective.

Partnoy (1999) dismisses the reputational capital theory with regard to CRA's. The reputational capital theory refers to the view that CRA's rely on their good reputations in order to maintain and increase their customer base and revenue. He contends that CRA's do not rely on their reputations or the quality of their ratings to

solicit business, as would be the case in a free market. Rather, CRA's have been able to take advantage of regulation that has made them key players in debt markets. CRA's operate in an oligopolistic market and CRA's effectively sell 'regulatory licenses' (Partnoy, 1999, p. 682). Deb, Manning, Murphy, Penalver, and Toth (2011) agree that reputational concerns are not prioritised by CRA's.

Gatekeepers are unlikely to protect their reputational capital when their exposure to liability declines, coupled with incentives to acquiesce to increased client demand (Coffee, 2002). With specific reference to CRA's, Partnoy (1999) dismisses the reputational capital view, as a result of their minimal exposure to liability and their power to sell regulatory licenses. Coffee (2002) concludes that gatekeeper failure is to be expected in times of market euphoria because gatekeepers lose leverage over their clients:

> 'Popular commentary has instead used softer-edged concepts - such as "infectious greed" and a decline in morality - to explain the same phenomena. Yet, there is little evidence that "greed" has ever declined; nor is it clear that there are relevant policy options for addressing it. In contrast, focusing on gatekeepers tells us that there are special actors in a system of private corporate governance whose incentives must be regulated.' (Coffee, 2002, p. 1419)

Furthermore, CRA's are different from other 'financial gatekeepers'. Some of the main differences highlighted include: (1) despite the poor performance of CRA's, they have become more 'prominent and important', (2) they have been 'immune from civil and criminal liability for malfeasance' and (3) they are very profitable (Partnoy, 2006, p. 61).

Mählmann (2006, p. 21) states that CRA's (specifically, Moody's and S&P) have 'historically neither advocated nor encouraged the use of ratings in regulation'. Mählmann (2006) explains that one of the main concerns of CRA's was that making ratings mandatory would turn ratings into a commodity, thus forcing smaller rating firms to compete based on the price and level of the ratings issued, as opposed to their reputations and the quality of their ratings.

Partnoy (2002) perceives a paradox in the CRA industry. The paradox seems to be that credit ratings from approved NRSRO CRA's are vital in debt markets, yet their 'informational value' is limited, at best:

> ‘Paradoxically, the leading NRSRO’s became more profitable even as the quality of their ratings declined. Operating margins in recent years topped fifty percent; Moody’s profit margins were higher than any other company in the S&P 500 for five consecutive years during the early 2000’s. Moody’s market capitalization was nearly $20 billion at its peak; S&P was similarly profitable and large. The companies that owned NRSRO’s drew savvy investors, looking to profit from the reliable returns associated with the sale of regulatory licences.’ (Partnoy, 2009a, p. 6)

2.3.2 The change in business model

Prior to the 1970’s, CRA’s 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). In the 1970’s there was a shift in the business model adopted by the CRA’s. They moved from an ‘investor-pays’ model to an ‘issuer-pays’ model (White, 2010a, p. 214). This shift in business model enhanced the profitability of CRA’s and allowed them to expand the services they could offer (Cantor & Packer, 1994). A number of reasons for the shift in the business model were offered by the CRA’s.

First, the sales revenues from the ‘ratings manuals’ came under threat as a result of the introduction of the ‘high-speed photocopy machine’, which would have significantly affected the CRA’s revenue as investors could copy the manuals and share them freely (White, 2010a, p. 214). Second, Penn Central defaulted on $82 million of commercial paper in 1970. Cantor and Packer (1994, p. 4) see this as a ‘catalyst’ for the change in business model. As a result of this default, investors required reassurance from issuers. This reassurance came in the form of issuers ‘actively’ pursuing credit ratings and it seems this became the ‘established market practice’ from then on (Cantor & Packer, 1994, p. 13). Last, the CRA’s recognised their importance in the market after having been incorporated into legislation (as explained above). They felt that issuers should ‘pay for the privilege’ of having an official rating from one of the CRA’s (White, 2010a).

While the above reasons have been offered, they are contested and do not entirely justify the shift in the business model. At best, they are less than definitive (White, 2010a). Coffee (2010, p. 264) 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. Introducing a government rating agency has, however, a number of advantages and disadvantages (Coffee, 2010). In particular, Kudva (2010, p. 1) states:

> 'The investor-pays model creates an inherent bias towards credit rating agencies giving lower-than-warranted ratings, so that investors would get a higher yield. And pressures from investors to avoid rating downgrades would increase considerably, since downgrades result in mark-to-market losses on rated securities.'

The United States Government Accountability Office (GAO) (2012) seems to have identified alternative business models for NRSRO compensation. Some models seem more advanced than others, but none has been implemented. It seems that the creators of these alternative models have not pursued their models further because there is little or no incentive to continue developing these models due to the lack of attention to and interest in these from regulators in the U.S.A (United States Government Accountability Office, 2012). Kudva (2010, p. 1) states that every model has 'pro's and con's', but the key factor is how well conflicts of interest are managed.

2.3.3 Role in recent financial crises

Hill (2009) points out that CRA's 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, p. 291).

Partnoy (2009a) claims 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), who states that the CRA's failed to obtain enough information to provide accurate ratings. While Acharya and Richardson (2009) do not cite the CRA's as the ultimate reason for the financial crisis, they do highlight the fact that conflicts of interest might have arisen due to the CRA's prioritising fees over accurate ratings. This further contests the reasons offered by the CRA's attempting to justify their shift in business models.

According to Rafailov (2011), the CRAs' principal mistake was that they 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 CRA's to rate the credit risk of structured financial instruments accurately was a major factor in the financial crisis. Hill (2010a, p. 332) describes the CRA's as 'villains'. The CRA's rank second in her list of four main 'villains' who 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, p. 332) states that 'mortgage brokers and originators' committed blatantly illegal acts. The CRA's come second as they 'lied and/or exaggerated' when it came to rating complex repackaged securities.

In the U.S.A there were several issues which eventually led to the crisis. An emphasis was placed on increasing homeownership by the Clinton and Bush Administrations in the years before the crisis. The mortgage industry also changed dramatically – loans were sold off quickly and repackaged to sell to international investors. A plethora of new types of mortgage products emerged and the incentives of the multiple stakeholders (including mortgage brokers, lenders, and Wall Street firms) in these products became more focused on the quantity of products being bought and sold than on the underlying quality of those products. Securitisation also proliferated in the years before the 2007/2008 crisis and this resulted in subprime and other mortgage products being transformed into highly complex financial instruments that CRA's were contracted to rate (The Financial Crisis Inquiry Commission (FCIC), 2011; White, 2010a). The FCIC (2011) elaborate on the implications of this:

> 'Put simply and most pertinently, structured finance was the mechanism by which subprime and other mortgages were turned into complex investments often accorded triple-A ratings by credit rating agencies whose own motives were conflicted. This entire market depended on finely honed computer models—which turned out to be divorced from reality—and on ever-rising housing prices. When that bubble burst, the complexity bubble also burst: the securities almost no one understood, backed by mortgages no lender would have signed 20 years earlier, were the first dominoes to fall in the financial sector' (FCIC, 2011, p. 28).

> 'While the vulnerabilities that created the potential for crisis were years in the making, it was the collapse of the housing bubble - fuelled by low interest rates, easy and available credit,

> scant regulation, and toxic mortgages - that was the spark that ignited a string of events, which led to a full-blown crisis in the fall of 2008. Trillions of dollars in risky mortgages had become embedded throughout the financial system, as mortgage-related securities were packaged, repackaged, and sold to investors around the world. When the bubble burst, hundreds of billions of dollars in losses in mortgages and mortgage-related securities shook markets as well as financial institutions that had significant exposures to those mortgages and had borrowed heavily against them. This happened not just in the United States but around the world. The losses were magnified by derivatives such as synthetic securities.' (FCIC, 2011, p. xvi).

Hill (2011a) states that self-deception played a big role in CRA's failures leading to the crisis. It does not suffice merely to blame CRA corruption, complacency or a lack of technical expertise. Despite mandated regulatory use of ratings, if CRA's had been obviously complacent or lacking in technical skills, the U.S. government and markets would have reacted accordingly and sought alternatives. CRA's have also proved that they are capable of being honest and reliable when rating plain-vanilla debt instruments (Hill, 2011a; White, 2010a). When it came to rating complex structured securities where the incentives and returns were far higher than vanilla instruments, there is evidence that both corruption and a lack of expertise played a part. It seems, however, that the over-arching reasons for CRA failures can be traced back to self-deception, as well as market euphoria and the illusion that risk had, in fact, been removed (Hill, 2010b, 2011a).

A further criticism of CRA's is that they failed to verify public information or information provided to them by issuers in the years leading up to the 2008 crisis.

> '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.' (Manns, 2009, p. 1022)

It seems that CRA's took the view that it was not their responsibility to verify information and this led to their taking information at face value (Coffee, 2009; Darcy, 2009), and LaFrance (2008)). Nevertheless, Manns (2009, p. 1022) argues that CRA's have 'responsibility without accountability'.

According to White (2010a), in the past, CRA's 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 U.S.A Constitution. Harper (2011) argues that CRA's should not enjoy First Amendment protection for the ratings of complex structured securities. What this disconnect between the reliance placed on ratings by stakeholders and current levels of accountability ultimately highlights is the need for effective regulation of the CRA's.

Hill (2009) is sceptical about the conventional reasons given for CRA failures leading up to the 2008 crisis. Although the argument of conflicts of interest in the CRA industry holds much appeal, Hill (2009) asserts that the reasons for CRA failures are far more complex. She dismisses possible solutions such as increased liability, the elimination of the NRSRO category and proposed measures to deal with conflicts of interest.

Hill (2009) argues that, although the failings of certain market players ultimately caused the crisis, there was a broader issue in the background – market participants convinced themselves that they had entered into a world where risk had been removed. Market participants 'drank the Kool Aid' (Hill, 2010b, p. 2) that demonstrated their belief that risk had essentially been managed and overcome:

> 'Rating agencies are indeed in the business of assessing credit quality, but many brilliant and sophisticated market participants with considerable amounts of money at stake and considerable access to information about the securities and about markets generally made the same mistake the rating agencies did. These instruments were not bought by widows and orphans who might more reasonably have unquestioningly relied on rating agency ratings.' (Hill, 2010b, p. 14)

2.3.4 The need for CRA regulation: Regulation in the U.S.A

As discussed in Section 2.2, 'crisis and regulation intertwine'. It also appears that regulation is often used in political power games (Malsch & Gendron, 2011, p. 2). While the aim of the SEC in establishing the NRSRO category was to force issuers to obtain ratings from reliable sources, the establishment of the NRSRO category has presented its own set of unforeseen consequences. 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 CRA's has also had its flaws - the CRA's have made several costly errors (White, 2006, p. 1). The SEC's decision to bestow the special NRSRO status on CRA's (thus handing them regulatory licenses (Partnoy, 1999) resulted in CRA's having immense power over debt capital markets (White, 2010a). The extent or the perception of the extent of this power is summarised by Friedman (1995):

> '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.'

In the past decade (as a result of Enron and the 2008 financial crisis) regulators have begun paying more attention to CRA's. CRA's were self-regulated entities until fairly recently. The recent scandals have prompted government regulation in many jurisdictions around the world (St. Charles, 2010). St. Charles (2010) compares European and American CRA regulation and she advocates bilateral dialogue between international regulators in order to avoid cross-border regulatory complications.

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 refer 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, p. 95), however, believe that regulatory reform is needed and that eliminating the NRSRO category might be wise, provided that 'the process is carefully managed'.

Coffee (2010) is of the opinion that regulation is needed in order to induce the correct incentives in financial markets for CRA's. A market where CRA's are incentivised to compete for the favour of investors should mean that less regulation and oversight are needed. Conversely, where such incentives are absent, close regulatory oversight is required. Coffee (2010, p. 276) is critical of CRA reform proposals that do not address the issuer-pays model. He refers to such reform

proposals as a re-arrangement of the 'deck chairs on the Titanic'. Hill (2011b) agrees that the issuer-pays business model must be abolished in order to increase competition and generate overall improvements in the CRA's industry.

Coffee (2010) insists that market participants must acknowledge the failings of CRA's leading up to the crisis and they must seek ways to align the incentives of CRA's and regulators to avoid such failings in the future:

> 'On both sides of the Atlantic, there should be a recognition that (1) the existing market for ratings failed, (2) voluntary self-regulation and reliance on the rating agency's desire to protect its "reputational capital" is inadequate, and (3) incentives must be aligned so that the watchdog is motivated to watch carefully...If we get the incentives right, relatively little regulation is needed. But if the incentives remain poorly aligned, it is unclear whether any level of regulation can ensure ratings accuracy.' (Coffee, 2010)

Partnoy (2009b) introduces two important ideas about how CRA regulation can be reformed. His first idea is to make CRA's accountable for the ratings they give and to eliminate their exemption from liability (CRA's 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). On the other hand, Katz, Munoz, and Stephanou (2009, p. 1) assess the policy responses to the 2008 crisis and offer some advice to improve the CRA industry while acknowledging that solutions to mend the system will not be 'easy'. (Katz et al., 2009) suggest that reducing reliance on CRA's and re-assessing the business model might improve the CRA industry.

Goodhart (2010) dismisses some of the suggestions for reform to make CRA's trustworthy in the eyes of all stakeholders. Holding CRA's legally liable for faulty ratings would render the CRA business unviable. CRA's provide an opinion of creditworthiness – Goodhart (2010) is cynical about attempts to hold CRA's legally liable – he asks what would happen if central banks, economists and governments were also held legally liable for their opinions or forecasts. Goodhart (2010) also rejects the idea of a change in business model to investor-pays. Lastly, 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 (Goodhart, 2010).

White (2011) and Harper (2011) agree that the introduction of new regulation makes it increasingly difficult for new entrants into the CRA industry. White (2011) states that some CRA sections in the Dodd–Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") (2010) may increase barriers to entry for new entrants and may make the incumbent CRA's more central to bond markets in the future. Harper (2011) doubts whether new entrants will be able to build good reputations to become NRSRO's, seeing that this attempt will expose them to increased liability, coupled with reduced reliance on NRSRO ratings. White (2010b) calls for less regulation of CRA's. His opinion is that the SEC should abolish the NRSRO category, thus opening up the market for information on debt instruments. White (2010a, p. 223) further argues that more regulation would likely raise barriers to entry and 'ironically' reinforce the position of the big three CRA's.

The U.S.A regulatory response to the 2008 financial crisis was the introduction of the Dodd-Frank Act (2010). The Dodd-Frank Act (2010) was signed into federal law in July 2010. There are several sections of the Dodd-Frank Act (2010) that affect CRA's. The Dodd-Frank Act (2010) endeavours to increase accountability and oversight of the credit rating industry (Martin & Franker, 2011). Among other things, the Dodd-Frank Act (2010) also aims to reduce regulatory reliance on credit ratings, remove references to 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 CRA's will reduce the importance of the big three CRA's 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.

The Dodd-Frank Act (2010) hints at the introduction of a CRA industry regulator – the SEC has commissioned a study to assess this possibility. In addition, Section 936 of Dodd-Frank (2010) states that a credit rating analyst must have the necessary knowledge and understanding in order to perform his job competently, but Section 936 stops short of introducing a professional oversight body (Dodd-Frank Act, 2010).

Dodd-Frank (2010, p. 497) explicitly acknowledges the 'systematic importance' of credit ratings and states further that the activities and performances of CRA's 'are matters of national public interest'. Dodd-Frank (2010) also cites the inaccurate rating of structured financial products by CRA's as a precursor for more regulation and accountability.

Dodd-Frank (2010) aims to reduce reliance on ratings and to improve the quality of ratings. It seems that regulators understand that investors will continue to rely on credit ratings (at least for the short to medium-term). It is for this reason that it makes sense for regulators to improve ratings as much as possible (Hill, 2011b).

Hill (2011b) asserts that removing regulatory references to ratings will not automatically solve the problem of over-reliance on ratings because there are no readily available substitutes. Darbellay and Partnoy (2012) agree that market participant behaviour will not change quickly because of the lack of alternatives to credit ratings. Flannery, Houston, and Partnoy (2010) find that credit default swap spreads are viable substitutes for credit ratings. On initial inspection, although they are not perfect, credit default spreads seem as though they are a viable substitute for credit ratings because they reflect information more accurately and quickly (Flannery et al., 2010).

Dodd-Frank (2010) aims to provide oversight for CRA's that is similar to other financial gatekeepers. Darbellay and Partnoy (2012, p. 15) highlight the fact that the Act provides regulators with 'significant room for interpretation and implementation'. It seems unclear how the SEC will utilise its increased regulatory powers. It also appears that CRA's will be open to legal liability claims and courts will have to interpret the new regulation. The impact of increased legal liability claims on CRA's is uncertain (Darbellay & Partnoy, 2012).

Darbellay and Partnoy (2012) assert that Dodd-Frank (2010) does not do enough to combat conflicts of interest which arise as a result of the issuer-pays model. It seems that forcing CRA's to revert to a subscriber-pays model would have been too drastic a step for the U.S.A Congress. (Hill, 2011b) is critical of Dodd-Frank (2010) – it seems that it has not done enough to prevent future CRA failures.

Altman, Oncü, Richardson, Schmeits, and White (2010) warn that oversight may increase barriers to entry into the CRA industry, and thus undermine increased competition. CRA reform that raises barriers to entry is counterproductive (Darbellay & Partnoy, 2012). Harper (2011) argues that Dodd-Frank (2010) and CRA regulation should have the goal of deterrence, rather than compensation. Exposing CRA's to 'crushing liability' could severely affect financial markets – CRA's play a central role in financial markets and they may stop rating complex structured securities to avoid liability. This would mean that investors will have access to less information for decision-making purposes. Harper (2011) further warns that CRA's may relinquish their NRSRO statuses in order to avoid liability - it seems that current and future U.S.A CRA regulation will only apply to NRSRO's. Dodd-Frank (2010) may lead to increased costs and decreased benefits for CRA's because it seeks to reduce regulatory reliance on ratings and increase liability simultaneously. For this reason increased CRA liability may be 'impractical' (Harper, 2011, p. 1967). Harper (2011) concludes that Dodd-Frank (2010) will increase CRA liability and accountability. He suggests a tier-based liability system, depending on the nature of CRA misconduct – this would have the dual effect of deterring future undesirable CRA behaviour, whilst also protecting CRA's from excessive liability claims.

The above discussion highlights the complexity of holding CRA's accountable for their ratings. Some strongly advocate liability as a deterrent to negligent or wilful malfeasant CRA behaviour (Cane et al., 2011; Harper, 2011). Harper (2011) believes that Dodd-Frank (2010) will expose CRA's to more liability claims than were lodged in the past, whilst Cane et al. (2011) call for CRA's to be subject to expert liability because they are so heavily relied upon by markets participants. An analysis of CRA accountability through the lens of Giddens's (1990; 1991) modernity theory potentially illustrates a different perspective on this issue. Financial markets are socially constructed (DiMaggio & Powell, 1983) and are based on trust (Frankel, 2002) and trustworthiness (Brescia, 2009). Following a financial crisis of the magnitude of 2008, regulations and liability clauses within regulations are often enforced to reassure non-experts that a system or industry (in this case CRA's) still works (Giddens, 1991). The legitimacy and credibility of financial markets is of vital importance and politicians and regulators go to great lengths to maintain good

images (Suchman, 1995; Unerman & O'Dwyer, 2004). Mechanisms such as regulation may, in fact, 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, 1990, 1991). The same logic applies in a South African context.

2.3.5 Regulation in South Africa: On the need for further research

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 CRA's. The CRA's 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 CRA's are opposed to this, as they insist that they (CRA's) merely offer a credit 'opinion'. The CRA's contend that investors should obtain further information before relying solely on one of their ratings to make investment decisions (Maake & Lefifi, 2012, p. 1).

The Credit Rating Services Act (2012) also exposes CRA's to civil liability. This seems to be an attempt to make CRA's accountable for negligent ratings. Some commentators have also called for 'individual accountability' – key personnel should be held personally responsible for negligence. The CRA's oppose these ideas (Donnelly, 2012, p. 1). Before the Credit Rating Services Bill was signed into law, it seemed that lawmakers were willing to make some compromises but, on the whole, they appeared to be determined to make CRA's more accountable for their actions (Donnelly, 2012). Section 2 of the Credit Rating Services Act (2012, p. 12) sets out five main objectives:

> '(a) Ensure responsible and accountable credit rating agencies;
> (b) Protect the integrity, transparency and reliability of the credit rating process and credit ratings;
> (c) Improve investor protection;
> (d) Improve fairness, efficiency and transparency of financial markets; and
> (e) Reduce systemic risk.'

Most of these objectives are similar to those of Dodd-Frank (2010). On the issue of CRA liability, Section 19 of the Credit Rating Services Act (2012, p. 30) states:

> '19 (1) A registered credit rating agency may be delictually[7] liable, in respect of a credit rating issued or credit rating services performed in the ordinary course of business in terms of this Act, for any loss, damages or costs sustained as a result of such credit rating or credit rating service.
>
> (2) Subsection (1) does not affect any additional or other liability of a registered credit rating agency to an investor or member of the public, arising from a contractual relationship or the application of any law.'

Like Dodd-Frank (2010) in the U.S.A, it seems that CRA's will be subject to increased legal liability claims in South Africa. The new South African Act, however, does not specify that CRA's will be subject to liability for negligent or intentional misconduct.

The Credit Rating Services Act (2012) also focuses on CRA registration (similar to that of NRSRO's in the U.S.A) and it imposes duties on CRA's. These deal with issues of internal controls, general efficiency and administration, the appointment of directors, the requirement to issue an annual report (to be made available to the public), accounting and auditing requirements and the need for an independent compliance unit (to be employed by the CRA's). The Act gives guidance on how CRA's should implement ratings models and methodologies. Guidance is also provided on how CRA's should go about issuing and publishing credit ratings.

Lastly, unlike Dodd-Frank (2010), the Credit Rating Services Act (2012) does not address the CRA business model. The issue of CRA business model ties in with Dodd-Frank's (2010) attempt to reduce conflicts of interest. Dodd-Frank (2010) seems to place an emphasis on resolving conflicts of interest in CRA's. On the other hand, the Credit Rating Services Act (2012) mentions conflicts of interest without specifying how to address them.

The similarities between South African and American CRA regulations, including the limitations of local regulations, raise a number of key issues. Is it possible that the

[7] Neethling and Potgieter (2010, p. 4) define 'delict' in South African law as 'the act of a person that in a wrongful and culpable way causes harm to another'.

development of the South African regulations are a reflexive response to the financial crisis commencing in the U.S.A in 2007/2008? In terms of modernity theory, experiences learned in the world's largest economy (a space distanciation) when dealing with the sub-prime mortgage crisis (a time distanciation) can impact the development of regulation of the South African credit rating agencies. At the same time, processes of mimetic isomorphism would suggest that replicating CRA regulation in the U.S.A becomes an important means of securing the legitimacy of the local capital market which is heavily dependent on international capital. Finally, just as the regulation of rating agencies in the U.S.A has given rise to unexpected consequences, the adoption of a similar regulatory framework in South Africa may also give rise to a host of difficulties when new laws and regulations are applied in a practical setting. Before dealing with each of these issues in Section 4, Section 3 outlines the chosen method.

3. Method

This chapter explains the chosen research method. Section 3.1 introduces the research paradigm. The difference between positivist and interpretive research is discussed and the decision to use the latter approach is explained. Section 3.2 provides a detailed description of the research method. Section 3.3 describes the data collection procedures. Section 3.4 outlines how the data was analysed and interpreted. Section 3.5 addresses validity and reliability issues. Section 3.6 outlines ethical considerations that were taken into account while conducting this study. Lastly, Section 3.7 lists the limitations of this research.

3.1 Research paradigm

There are several possible aims of an exploratory study. Firstly, it aids in gaining new insights into a set of phenomena. Secondly, it helps to determine future avenues for important research. Thirdly, it may clarify central concepts and theories. Lastly, it can possibly aid in developing new hypotheses about existing phenomena (Mouton & Marais, 1988). Creswell and Clark (2007) advocate the use of an exploratory qualitative study to explore a particular subject. Quantitative analysis can

then be used to explain and expand on the qualitative findings (Lauer & Asher, 1988; Leedy & Ormrod, 2010).

When using detailed semi-structured interviews to collect data, a researcher must recognise that his background affects the interpretation of the data collected. Constructivist researchers acknowledge that their interpretation of the data is affected by their personal, cultural and historical experiences. An important goal of this approach to research is to identify and interpret the views which other people have about the world. This approach also strives to develop a theory or pattern of meaning through inquiry (Creswell & Clark, 2007; Lauer & Asher, 1988; Maroun, 2012). This is very different from the positivist research.

The positivist approach places an emphasis on being able to quantify, predict, control and explain a particular set of phenomena. It seems that this approach is tailored for the study of the natural sciences (Lee, 1991). The positivist view is sometimes referred to as the scientific method. The positivist approach has evolved and some adopt a derivative of the positivist approach known as “post-positivism’”. Positivists place great emphasis on numeric measures. They believe that there are objective laws that govern the world, and these laws must be tested or validated so that we can understand the world we live in. A positivist research approach seems simple – the researcher identifies a theory, collects data that either verifies or refutes the theory, and the theory is then adjusted as is necessary. Positivists believe that there is an ultimate truth that can be uncovered. Finally, great importance is placed on the objectivity of the researcher and the results. A researcher is required to scrutinise research results for bias in order for the research to be considered competent (Phillips & Burbules, 2000; Smith, 1983).

Lee (1991, p. 343) summarises the positivist approach:

> ‘In a nutshell, the positivist approach involves the manipulation of theoretical propositions using the rules of formal logic and the rules of hypothetico-deductive logic, so that the theoretical propositions satisfy the four requirements of falsifiability, logical consistency, relative explanatory power, and survival.’

The social constructionist view has a different perspective of the world. It is generally regarded as an approach that is appropriate for qualitative research. A social constructivist seeks to understand the world in which he exists. Each individual develops subjective views of the world based on his experiences. Individuals' views differ widely. This means that a researcher who adopts this approach looks for a wide range of complex views as opposed to narrowing ideas into a small number of concise categories. The researcher's goal is to rely on the experiences of research participants (Berger & Luekmann, 1967; Creswell, 2009; Lincoln & Guba, 1985). Creswell (2009, p. 8) states:

> 'The questions become broad and general so that the participants can construct the meaning of a situation, typically forged in discussions or interactions with other persons. The more open-ended the questioning, the better, as the researcher listens carefully to what people say or do in their life settings.'

Positivist researchers strive for objectivity when doing research (Walsh & Stewart, 1993). These researchers believe that it is imperative to eliminate any preconceived notions, biases, prejudices and perceptions that they have. By eliminating subjectivity, these researchers hope to discover 'ultimate truth'. In contrast, many qualitative researchers contend that using such an objective approach to study human behaviour may not be desirable or possible (Creswell, 2009; Eisner, 1991). Qualitative research emphasises the role of the researcher. The researcher is an integral part in the qualitative research process. The researcher's ability in analysing and interpreting is imperative for understanding the social phenomena in question. A goal of qualitative research is to reveal multiple differing perspectives of the same phenomenon (Leedy & Ormrod, 2010).

Peshkin (1988, p. 418) further states:

> 'Those who turn to qualitative inquiry deny neither the utility nor the necessity of finding regularities and of making generalizations and predictions. However, they are attracted more to a form of investigation that, by considering the extraordinary variability of things, is replete with-and does not shrink from exploring-ambiguity. By taste, talent, and personality, they are disposed to use the means of qualitative inquiry. These means allow them to bring to bear all the potency for learning contained in the full range of human senses.'

As a result, qualitative studies do not define the phenomenon under investigation with an aim to testing a given set of hypotheses. Instead, a more exploratory approach is followed where the research uses a broader, less rigid means of collecting and analysing data. In particular, data collection and analysis take place continuously to allow for broader (and possibly less structured) research problems to be examined in detail (Leedy & Ormrod, 2010).

3.2 Research method

This research report adopts a social constructivist (or interpretive) worldview (Creswell, 2009). A qualitative design, using detailed interviews, is appropriate, given the exploratory nature of this study and the absence of direct prior research (Lauer & Asher, 1988; Mouton & Marais, 1988). The aim of this report is not to validate or refute a specific theory or objective state of reality. Instead, this report uses detailed interviews to explore and understand the differing perceptions and views of a sample of industry experts[8] on the regulation of CRA's in South Africa.

The researcher plays an important role in the qualitative research process. This type of research focuses on revealing complexities and places an emphasis on uncovering the deeper meanings perceived by individuals in particular issues (Creswell, 2009). Most qualitative approaches have two things in common: first, they focus on the "real world" – a set of phenomena is observed in their natural settings. Second, the phenomena are studied in their complexity. The aim of this qualitative research is not to simplify what has been examined. In this case, the researcher recognised that CRA regulation is complex. It is for this reason that this qualitative study endeavours to reveal the complexities of the issues surrounding CRA's and the regulation thereof in South Africa (Leedy & Ormrod, 2010).

It is imperative to acknowledge the role of the researcher in a qualitative study. The researcher was the interviewer and was exposed to the differing opinions of the participants. While an element of inherent bias exists in a qualitative approach, the total elimination of the researcher's influence on the study was impossible (Hammersley & Atkinson, 1989). The goal of qualitative research is, however, to gain

[8] The terms experts, interviewees, participants and respondents are used interchangeably throughout this research report.

an understanding of the researcher's role and to use it productively, as opposed to eliminating the researcher's influence (Maxwell, 1998).

With this in mind, the researcher had to decide on the best method of data collection. The use of a questionnaire or survey was considered. Questionnaires can be easily distributed to a large number of participants. The findings from questionnaires are often easy to quantify or generalise into rigid categories. The difficulty with using a questionnaire is gathering data in sufficient detail to shed light on the phenomenon under review (Creswell, 2009). Further, it is difficult to prove that the respondents have taken the questionnaire seriously and filled it out accurately (Rowley, 2012). It is for this reason that detailed interviews were used instead of a questionnaire.

Before having chosen to conduct interviews, the researcher was aware that interviews are time-consuming and time constraints can often affect the number of interviews to be conducted. A key advantage that an interview has over a questionnaire is that a purposeful sampling method can be applied. The researcher is able to choose an interviewee who has a good knowledge of the research topic (Creswell, 2009). In the case of a questionnaire, it is not always clear that the respondents have a high level of understanding of the research topic under review (Rowley, 2012).

Structured interviews seem similar to questionnaires, except that they guarantee a response. An unstructured interview can be used as an alternative. An unstructured interview often requires a researcher with experience and it often generates transcripts that are vastly different from one other and this makes them difficult to compare (Rowley, 2012).

A medium between structured and unstructured interviews is the semi-structured interview. This research study utilised a semi-structured interview approach. This was useful because the research objective focuses on gaining a deeper understanding of 'experiences, opinions, attitudes, values and processes' (Rowley, 2012, p. 262).

The interview agenda was derived after careful consideration of the main themes and ideas which emerged from the literature review (Creswell, 2009; Jacob &

Furgerson, 2012). These included the role and importance of regulation, key features of successful regulation, issues of trust, credibility and power, the regulator's role in the market, and the 2007/2008 financial crisis, with a specific focus on CRA's (Appendix 1).

The order of the interview questions was considered carefully – the questions led the interviews through a logical sequence which, in turn, led to a natural conclusion. The interview questions were non-leading and open-ended. Vague questions or questions which were too general were avoided. Lastly, invasive questions and questions that included two questions in one were also avoided (Rowley, 2012). The interview questions ensured that the same general topics and areas were discussed by each respondent. The interviews maintained a level of focus and also gave the respondents a level of flexibility to expand on ideas as they wished (Kvale, 1996, 2008; Turner, 2010). Lastly, the interview agenda was also piloted with two experts in Johannesburg. This was followed by a detailed peer debriefing with two lecturers at the University of Witwatersrand to make sure that the interview agenda was sound[9].

3.3 Data collection

Rowley (2012) suggests that it is appropriate to conduct between six and eight interviews of approximately an hour in length for such a study. Rowley (2012) further states that the sample of interview participants must include people with different backgrounds, roles, experience and other possible sources of variability to help gain a better understanding of the research problem and question.

The sample size for this study was thirteen[10]. Experts on CRA's, regulation and law were interviewed (Appendix 2 details the experience and background of the respondents). The researcher conducted in-depth interviews between September 2012 and December 2013, each of which lasted between 45 and 120 minutes (Maroun & Solomon, 2013; Rowley, 2012). The small sample size (compared with

[9] The interview agenda was also presented at the Southern African Accounting Association (SAAA) Biennial Conference in Somerset West in June 2013.

[10] Small sample sizes are an inherent characteristic of qualitative research (Leedy & Ormrod, 2010; Rowley, 2012). Examples of studies that have used small sample sizes include O'Dwyer et al. (2011), Maroun and Solomon (2013) and Hammond, Clayton, and Arnold (2012).

quantitative studies) is justified by the exploratory nature of this study. The main aim of such a study is to explore the differing perceptions and opinions of the interview participants (Creswell & Clark, 2007). The result of such an approach is a more extensive and insightful data collection process than a positive research study (Maroun, 2012). Consequently, this report utilised a sample size similar to studies by Maroun and Solomon (2013) and O'Dwyer et al. (2011).

The researcher contacted the interviewees (by phone or electronic mail) in order to find suitable times to conduct the interviews. Twelve interviews were conducted in Johannesburg, South Africa (either telephonically or in person), while one interview was conducted telephonically with a former South African citizen who now resides in Australia.

Purposeful selection of interviewees ensured that the researcher could concentrate on the views of only informed participants (Creswell, 2009; Patton, 1990). Purposive sampling poses the risk of reporting biased results. This method of sampling, however, also ensures high quality detailed findings that are collected from interviews with informed and knowledgeable participants. This was necessary due to the highly technical nature of this research (Creswell, 2009, 2012).[11]

The exploratory nature of this study dictated that the interviews conducted were as open as possible in order to elicit candid opinions from the interviewees. Although the interviews were unrestrictive, a semi-structured approach was adopted to ensure that the interviews did not veer off topic. The researcher gave a brief 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 provide an open forum for the expression of ideas, opinions and perspectives. Interviewees were encouraged to speak freely with minimum interruption by the researcher. Interviewees were asked to clarify points where there are possible ambiguities to ensure the quality of the findings. The interview questions (Appendix

[11] It should be noted that sampling decisions should not be made in isolation from the rest of the research design. Some of the things to take into account include the researcher's relationship with the interviewees, feasibility of data collection and analysis, as well as validity and reliability concerns (Maxwell, 1998).

1) were non-leading and the researcher avoided asking invasive questions (adapted from Creswell, 2009; Leedy & Ormrod, 2010; Maroun & Solomon, 2013).

The interviews were recorded using two digital recorders and one audiotape recorder. The digital recordings were backed up to a laptop and an external hard drive as soon as the interviews were completed. This was done to protect against the potential loss of data. The researcher also took basic notes during the interviews. Taking notes acted as a safeguard in the event that an interview recording was unclear or lost. The handwritten notes also aided in the process of analysing the interview contents. Creswell (2009) suggests that handwritten notes are taken in case recording equipment fails. The interviews were transcribed soon after the interviews were conducted and the transcriptions were then ready for analysis.

3.4 Data analysis and interpretation

The data analysis and data interpretation stages in a qualitative study are very closely linked and carried out by the researcher. The 'data analysis spiral' was used as a tool to analyse data in this study. The data analysis spiral can be used to analyse a wide range of qualitative studies (Leedy & Ormrod, 2010).

The spiral method consists of four main steps: organisation, perusal, classification and synthesis. Organising the data was done by creating a computer database. Once this was done, the large units of data were broken down into smaller units. This made the data analysis process more manageable. The perusal step was very time consuming. The researcher scrutinised all the data several times in order to gain a full understanding of what the data contained. It is during this step that the researcher began to categorise the data broadly, and where initial interpretation took place. The classification step of this process is where the data was formally grouped into categories or themes. This step also entailed finding the true meaning of the data. The last step in this process involved synthesising the data. The data was summarised and initial notes on the primary themes in the interview recordings - and main arguments for and against the regulation of CRA's in South Africa - were made. This approach ensured that the researcher conducted a thorough analysis of the data collected. By the end of this process the researcher was familiar with all the detail contained in the data collected (Leedy & Ormrod, 2010).

Coding the data took place at this of the qualitative research study. 'Coding' simply means that the researcher organised the data into manageable sections before interpretation took place. Coding took place during the first step of the data analysis spiral. The interview transcripts were coded according the themes that emerged from the interviews. Predetermined codes were not used. The researcher highlighted the main themes that emerged from the interviews and each theme was highlighted in a different colour. The coding process was completed using Microsoft Word. Once the main themes were generated, each theme was copied into a new Word document. The main themes that emerged from the coding process are the themes presented in the findings Section of this report (Creswell, 2009; Maroun & Solomon, 2013).

Prior literature on CRA's and CRA regulation was used to ground the interpretation and findings. The findings of this report were compared with prior literature and theories. This either showed that the findings confirmed or challenged the main themes or concepts identified in the prior research (Creswell, 2009).

Lastly, the interpretation of data in a qualitative study is influenced by the researcher's biases to some extent. This is unavoidable as the researcher is indeed an 'instrument' in this research approach. To ensure high quality findings, thirteen interviews were conducted to ensure that a wide range of varying perspectives were sought. Furthermore, the researcher made a concerted effort to find evidence to contradict the findings (Leedy & Ormrod, 2010). The researcher also guarded against excessive interpretation, as this poses a threat to the findings of a qualitative study (Elo & Kyngäs, 2008).

3.5 Validity and reliability

It should be noted that although the researcher was heavily involved in both data collection and analysis phases, this was not a threat to the validity or reliability of this qualitative study. Rather, this is an inherent characteristic of such research (Creswell & Clark, 2007).

Validity and reliability are key aspects of qualitative research that require attention (Creswell, 2009). Qualitative validity and reliability differ from their quantitative equivalents. In the qualitative research context, reliability is an indication that the

researcher's approach is consistent across different projects. Qualitative validity refers to the accuracy of a researcher's findings based on the procedures employed (Gibbs, 2008).

The researcher employed two main procedures to ensure reliability. First, the interview transcripts were thoroughly examined several times to ensure that no obvious mistakes were made during transcription. Second, the definitions and meanings of codes were constantly scrutinised by comparing the collected data with the assigned codes (Gibbs, 2008).

The researcher employed four main strategies to provide reasonable assurance with regard to the validity of this study. First, a 'member checking' technique was used to determine the accuracy of the qualitative findings. This was done by sending transcripts or sections of the written report to the interviewees to check that data was captured accurately (Creswell & Miller, 2000). Second, the researcher clarified the inherent bias that exists in a qualitative study (Creswell, 2009). Third, peer debriefing was used to enhance the accuracy of this study (Marshall & Rossman, 2006). The peer debriefing process involved locating a peer to review and offer interpretations regarding the study. Four, an independent reviewer was used to review this entire research project. This independent reviewer was not familiar with the research project and was able to provide objective assessments about the project as a whole (Creswell, 2009; Creswell & Miller, 2000).

Other steps that enhanced the validity of this study include the use of purposive sampling (interviewing experienced and knowledgeable participants), the piloting of the interview agenda[12] and the grounding of interview findings in prior literature (Creswell, 2009; Rowley, 2012). Lastly, the interviews were semi-structured. This was to ensure a detailed examination of the subject matter, while still retaining focus on the research objective. Research ethics (as discussed below), also formed part of the validity checks in this study (Holland, 2005; Maroun & Solomon, 2013; O'Dwyer et al., 2011).

[12] The interview agenda was piloted with two experts in Johannesburg and no issues were noted. Each pilot interview lasted forty five minutes on average.

3.6 Ethical considerations

A researcher has to anticipate ethical issues when embarking on a research project (Creswell, 2009). The highest level of research ethics was maintained throughout this study.

The purpose of this study was made clear to the interview participants from the outset, and in particular, that the research was carried out for academic purposes only. The researcher further clarified that the culmination of the findings in a research report would form part of the researcher's Master's degree (Creswell, 2009).

The researcher took several ethical considerations into account during the data collection process. Interviewees who agree to be recorded were assured that no-one would have access to the recordings, besides the researcher. It was also confirmed that their anonymity would be protected. No names, professions or positions of interviewees are mentioned in this report (Creswell, 2009).

The data collected from the interviews will be kept by the researcher and only the researcher has access to the recordings. The data will be discarded after a reasonable amount of time and will not be made publicly available. The interview agenda was piloted and ethical clearance was granted by the School of Accountancy for the interview agenda. The researcher did not suppress, falsify or invent findings to meet a specific agenda. The data collected was analysed and interpreted in line with accepted qualitative research procedures. All the findings were presented in a non-biased fashion (taking into account the inherent limitations of such a study, as explained above) (adapted from Creswell, 2009).

3.7 Limitations

Despite the safeguards that were put in place to ensure validity and reliability, a number of inherent limitations should be noted:

- There is a risk that interviewees provided rehearsed responses or responses that do not necessarily reflect their point of view. This may be due to pressure from employers. The interviewees may have felt compelled to give responses that are perceived as politically correct (see Creswell, 2009; Holland, 2005).

- As mentioned above, the researcher is an integral part of the data collection process when interviews are conducted. This may imply that the results from this study may not necessarily be conducive to generalisation or reproduction, as is the aim with positivist research studies (Alvesson, 2003).
- Interviews often provide highly exploratory results that are context-specific. This can produce results that are highly technical and some non-experts may find it difficult to interpret such findings.

3.8 Summary

In summary, the aim of this research is not to reveal an ultimate 'truth'. It is for this reason that a qualitative research design was utilised to provide perspective on CRA regulation in South Africa. Detailed semi-structured interviews allowed respondents the opportunity to express their views and opinions on the decision to regulate CRA's in South Africa. An element of bias may be apparent from the use of purposive sampling; however, this technique was used in order to ensure that well-informed and expert individuals participated, adding to the quality of the findings. As discussed above, the researcher employed many validity and reliability checks to ensure the quality of the findings. The data was also meticulously coded and the interpretation of interview findings was grounded in prior literature. The detailed findings are presented in Section 4 below.

4. Findings

4.1 Regulation legitimises the capital system

4.1.1 The role of CRA regulation in South Africa

South Africa is viewed by many market participants as a very restrictive country in which to do business due to its 'excessive regulation' (R10). Walmart's acquisition of Massmart is cited as an 'embarrassing' (R1) and 'scandalous' (R10) example of the growing perception abroad of the difficulties of doing business in South Africa due to government interference and regulation.

> 'South Africa has the reputation of being the most regulated country, not just in Africa, but in most of the world. It's difficult to do anything, despite what the DTI [Department of Trade and

> Industry] keeps telling you...Doing business for some investing in South Africa is a bit of a nightmare. Now there's lots of regulation and lots of it doesn't make any sense to people but it's there, it's part and parcel of it. So the South African view of life is if it moves regulate it, if it doesn't, regulate it' (R7).
>
> '...as you're probably aware, one of the things that we rated quite negatively on in the World Economic Forum's Global Competitiveness survey, is government intervention and fiddling around with regulations and how difficult it is to actually do business. (R1)'

On the decision to regulate CRA's, the Financial Services Board (FSB) (2013, p. 131) states:

> 'The Act gives effect to the G20 [The Group of Twenty Finance Ministers and Central Bank Governors] requirement of creating a globally consistent regulatory framework for CRA's, as well as complying with the IOSCO [International Organisation of Securities Commissions] principle that CRA's should be subject to adequate levels of oversight. The principle requires that this be done via a regulatory system that ensures that credit rating agencies...are subject to registration and ongoing supervision.'

There was a mixed reaction to the decision to regulate CRA's in South Africa. One school of thought supports the introduction of South African CRA regulation. Those that are in favour of the new South African CRA regulation believe that CRA's must be regulated by government because they perform a vital public interest role. Investors make important decisions based on credit ratings and, therefore, CRA's should be subject to a high level of scrutiny by a government regulator. There is also the belief that new CRA regulation aims to engender more responsible behaviour from CRA's, as opposed to restricting or hampering their activities (R3; R5; R9; R11; R12).

> 'There is third party reliance...they perform a public function. People make decisions based on them. They must be regulated and there shouldn't be a choice. The fact that people rely on them means that they can't just do what they want - there must be rules, standards, enforcement, regulation...at least the same type of regulation as auditors due to the reliance [placed on CRA's]' (R9).
>
> 'The new regulation is not telling them how to do their job. Regulators want CRA's to adhere to their own methodologies and to make sure that the methods that they use are robust enough to keep up with change' (R2).

Furthermore, introducing CRA regulation during a relatively stable economic period is a good sign – 'it seems like a proactive step...we now have the luxury of

introducing and implementing it slowly and seeing what works and what doesn't work' (R8). South Africa is often considered 'more visionary in terms of regulation'. Regulators in South Africa are renowned for taking proactive steps to protect the economy, as opposed to those in the U.S.A, who have been accused of introducing reactive regulations as a knee-jerk reaction to certain crises. The National Credit Act (2005)[13] and Section 90[14] of the Companies Act (2008)[15] are good examples of effective and forward-looking regulation in South Africa (R8; R9; R11; R12).

Those who are supportive of South Africa's regulatory environment also suggest that South Africa was shielded from the impact of the 2008 crisis as a result of 'our world class' (R9) government regulation. The fact that South Africa was only affected by 'the spill over of the crisis' proves that strong regulation can help a country to avoid serious financial crises (R9). Strong auditing, banking and credit (National Credit Act (2005)) regulation, as well as the Companies Act (2008), are cited as the main reasons for South Africa not being as harshly affected as many other countries by the 2008 global financial crisis. Exchange controls did play a role, but the situation would not have been very different had exchange controls not been in place (R9; R11; R12).

> 'Maybe it [the 2008 crisis] proves that a heavier hand with clear lines on rules and regulations helps when things go wrong. It protected them in bad times - that's the reason for regulation, to manage risk...They could argue that they missed out on the good times, making money, but that's not the point...it cuts the upside, but limits the downside when things go wrong' (R9).

The other school of thought is more cynical regarding the introduction of the new regulation. There is a claim that South African regulators have bowed to international pressure by introducing the new Act. It is not immediately apparent that South Africa requires CRA regulation, especially due to the small size of the South African credit rating market. It is also claimed that a proliferation of regulation is a natural result of the 2008 financial crisis (R1; R4; R6; R7; R8; R10). Similar to the arguments made

[13] The National Credit Act (2005) is outside the scope of this research.

[14] Section 90 deals with provisions relating to auditors who are engaged to perform a statutory audit for a company.

[15] The Companies "Companies Act No. 71" 2008) is outside the scope of this research.

by Hancher and Moran (1989) and Malsch and Gendron (2011), several of the respondents pointed out that:

> 'It is important to understand the driving force of CRA regulation at the moment...IOSCO is driving it. South Africa is an executive committee member of IOSCO, therefore, there is political pressure to abide by IOSCO recommendations. IOSCO is undoubtedly succeeding in their mission...the EU [European Union], Dodd-Frank, South Africa are all very similar or the same. The South African Act is very similar to the IOSCO code...the driving force and has been absolutely successful' (R4).

> 'Over-regulation always seems to result from an event, over-regulation in one direction or the other, so it's the pendulum of regulation...immediately after the crash the pendulum was swinging way out to over-regulation and then it's coming back and they don't know quite where it is at the moment, but it will inevitably come to under-regulation again and then something else will happen and so we go backwards and forwards. One thing that I believe would not have changed is if there was more regulation at the time, it wouldn't have made any difference' (R7).

The role of modernity theory is apparent here. The fallout from the 2008 financial crisis highlights a space and time distanciation. Lessons learned in other jurisdictions and emerging expectations (such as the IOSCO and other regulatory frameworks) have eventually led to new CRA regulation in South Africa (space distanciation). The 'pendulum of regulation' also underlines a time distanciation. In good economic times, we tend towards under-regulation, but in difficult economic conditions, markets become over-regulated in order to quell undesirable behaviour and restore confidence in the capital system (R1; R4; R7).

As discussed in Sections 2.1 and 2.2, periods of modernity are also characterised by the key role played by large institutions in capital markets. For these institutions to function, maintaining a sense of legitimacy or credibility is paramount, something which several interviewees confirmed when exploring the role of regulation of the CRA's.

A key theme emerging from the detailed interviews was the need for South Africa to protect its international reputation in order to attract foreign investment. The principle of regulating CRA's 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). In other

words, forces of mimetic isomorphism mean that South African regulators have, to a great degree, replicated or aligned themselves with regulation from other jurisdictions to gain credibility and trust in the South African economy. The FSB (2013, p. 131) states:

> 'As an important African economic powerhouse and a continuing participant in international debt capital markets, it is important for South Africa to be seen as leading the way in complying with these requirements.'

It appears that the onus is placed on regulators to ensure that a country is attractive to foreign investors. As explained by one respondent, it's the 'regulator's job to get foreign investment' (R8). Firstly, new regulation should be publicised in such a way that a jurisdiction's appearance is enhanced or maintained. Secondly, regulators should endeavour to introduce regulation that offers more advantages than rival jurisdictions' regulations, in order to compete for foreign investment (R1; R4; R5; R7; R8). These views highlight the important role which regulation plays in legitimising the capital system. Introducing regulation (especially in the aftermath of a severe financial crisis) seemingly adds credibility to governments and regulators, and creates the perception of an investor-friendly economy (albeit illusionary at times) (R1; R4; R5; R7; R8). Regulators often rationalise certain regulations or regulatory models by creating the impression that new regulation is necessary and adds value to the market, even if this is not always the case (Black, 2010; Unerman & O'Dwyer, 2004).

> 'Why are we regulating CRA's? We're competing with other developing countries. Nigeria is a big competitor, China too. We have to be first, the credibility of our market is really important to attract investment. We have to have the rules before others...otherwise we won't build confidence in our market....It's the same as adopting IFRS [International Financial Reporting Standards] a few years back, and the criticism that came with that' (R8).

The effect of the financial crisis on South Africa is also relevant. Some respondents claimed that the only reason that South Africa did not feel the full force of the crisis was strong exchange controls. South African banks were not allowed to 'gamble' and buy complex financial products that eventually triggered the crisis. South African banks with international arms operating abroad were 'burned' (R8). To claim that good banking and credit regulation was the reason for South Africa being shielded from the full force of the 2007/2008 crisis is 'rubbish' (R8).

> '...everybody was at risk, apart from the few of us in the Southern Hemisphere. We weren't at risk only because exchange controls didn't permit South African banks to get into this space...so for once, exchange control had a beneficial impact on the banks of the country - so they're now rated as the best in the world! It's bizarre!' (R7).

The importance of CRA regulation is not immediately apparent to this interviewee. Some experts thought that the new regulation will improve the way CRA's operate. The overriding view, however, is that the purpose of new regulation is to create the *appearance* of a strong and active regulator and government. Governments want to be seen as strongly reacting to financial crises in order to garner confidence in their respective markets (R1; R3; R4; R7; R8; R10). This finding echoes Giddens's (1990, 1991) views on periods of late modernity. The functioning of mechanisms of modernity, in this case the CRA's, relies heavily on trust, blind faith or simply the assumption that the system works. Regulation gives people the basis for making those assumptions rational. Ironically, however, the reason for the regulations being there in the first place is that trust itself is no longer adequate.

As discussed above, several respondents felt that replicating the move for more regulation of the CRA's was important for securing the confidence of non-expert users in the rating agencies (an example of an expert system, as discussed in Section 2.2). What some interviewees suggest is that it is more of a symbolic display than an example of substantive reform to the South African credit rating industry. In other words, what is equally relevant for the functioning of the expert system is the promotion of the myth that the system works and the ability of non-experts to overlook the tension between trust in the capital system and the need for CRA regulation (Giddens, 1991).

There is a resulting implication that the introduction of a new regulation is a mechanism that governments use for their self-interest. As discussed in Section 2.2, Unerman and O'Dwyer (2004) claim that governments go to great lengths to protect their respective economies because, in essence, a government's existence is inextricably tied to its capital system. In this light, regulation is often used as a political strategy, as highlighted by one interviewee:

> 'The credibility of our market is really important because we're really trying to attract investment. So, if we're not pro-active and the first [to introduce CRA regulation], and if we don't have the best rules, we can't build that confidence in our market, and, therefore,

> investors will go elsewhere. It [marketing our regulation well] is really important. That's one of the benefits, one of the upsides of South Africa - we are seen to have well regulated markets and good legislation. That [perception] helps us' (R8).

On one hand, the regulation has a functional role to play: it improves the operation of CRA's. On the other hand, the relevance of credibility and impression management lies at the heart of periods of late modernity (Giddens, 1990) and means that 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 (see Unerman & O'Dwyer, 2004). What needs to be examined in more detail is the nature of regulation itself – should we rely on a self-regulatory system or an arms-length independent one? This question is analysed in the subsection below.

4.1.2 Regulatory model – self-regulation or independent government regulation

The role CRA's played, leading up to the crisis inevitably led to regulation (R1; R2; R3; R6; R8; R9; R10). Historically, CRA's were self-regulated to some degree or even unregulated, as discussed in Section 2.3 (R2; R3; R4; R6).

Self-regulation has been heavily criticised in recent years. Self-regulation often resulted in the self-interest of the regulated entities being prioritised over the public interest (R7; R8). The failure of self-regulation models in many industries is cited as the reason why government regulation is necessary (Stiglitz, 2009). Internationally, therefore, the trend in regulation has moved away from self-regulation towards independent government regulation. 'Government regulation is there to protect the public' (R12). A recent World Bank report, for example, has called for accountants in South Africa to be regulated by a government or independent body (South Africa Report on the Observance of Standards and Codes Accounting and Auditing, 2013) and tax practitioners will now be regulated by the South African Revenue Service (SARS) (R8; R9; R11; R12). With self-regulation of these industries attracting considerable criticism due to self-interest threats, the continued functioning of the respective expert systems necessitates an increased use of external regulation (Unerman & O'Dwyer, 2004). The same is true for the CRA's (R1; R2; R8; R9; R11).

> 'Trust is a consideration, but for a long time businesses were free to do what they liked – there was a lot of self-regulation and now the pendulum has swung...Self-regulation can be scary. With the freedom of self-regulation there was a lot of abuse. The pendulum has swung

> past the point where we'll ever go back to self-regulation...Now regulators are trying to find a middle ground. Now there will always be some level of government regulation, because self-regulation was so disastrous' (R8).
>
> 'Self-regulation is not something we can go back to. It's proven not to work' (R9).

CRA's have traditionally been left to self-regulate. The notoriety they earned for their role in the 2008 financial crisis meant that they could no longer escape some degree of government scrutiny. Despite the fact that they were not regulated by governments in the past, there was a feeling that CRA's were scrupulous when it came to ratings, mainly due to the reputation risk associated with issuing an incorrect rating (R1; R4; R5; R6; R8). Respondents went on to explain, however, that the financial crisis highlighted potential weaknesses in the existing self-regulatory model and raised some concerns about the possibility of a similar rating scandal affecting South Africa. In response, there is a call for CRA's to be regulated by way of independent government regulation to ensure that errors of the past (and those in other jurisdictions) are not repeated locally (R2; R3; R4; R8; R9).

In other words, outsiders, or non-experts, operate on the good faith assumption that the expert system (the credit rating industry) is working as it ought to. The 2008 crisis shook confidence in the system and led to a realisation that self-regulation has discernible flaws. The way in which governments respond to preserve the functioning of the system is to introduce additional regulation (Giddens, 1990, 1991; Malsch & Gendron, 2011; Unerman & O'Dwyer, 2004).

> 'Historically, they did what they wanted, they self-regulated. We've learned from other professions, self-regulation doesn't work. I look at the legal profession, the accounting profession throughout, investment banking and commercial banking. We know self-regulation is a disaster. If you want to keep people on straight and narrows, you have to have a fear…a public body, a government appointed regulator to put fear in the organisation that if they don't do things right, they are going to lose their licence outright. I'm a big believer in it, but it needs proper administration' (R2).
>
> 'They [CRA's] should be regulated by the government. They should also have to be registered with a suitable body with a code of ethics and everything that surrounds a profession. Credit rating analysts at CRA's should have to pass exams like accountants, auditors, actuaries and lawyers. The reason I say this is because up until now, there has been no control over how they come to their ratings' (R3).

The above comments should not be construed as implying that interviewees unanimously agreed with the regulatory model for CRA's. The recent decision by governments and regulators around the world (including South Africa) to regulate CRA's by way of independent government regulation has been questioned on the grounds that:

> '...to introduce a statutory body, I think there needs to have been a progression beforehand which says that the industry or the profession has had self-regulation but it's now reached a level where its self-regulation is actually not in the public interest, it's more in the interest of those who are already in the inside...So regulation I think may be perceived as public policy but I don't think it's supportable unless there's been a market-driven need for it in the first place' (R7).

The Credit Rating Services Act (2012) is the first CRA regulation in South Africa. There is an implication that the decision to regulate CRA's by way of government regulation was perhaps a 'knee-jerk' (R7) reaction to the crisis (especially given the size of the CRA market in South Africa). It is questionable whether there is a local market-driven need to regulate CRA's (R7).

From a slightly different perspective, some experts are sceptical about government's involvement in regulating CRA's. One respondent went as far as to say that government's contribution should be 'microscopic' because 'there is much bureaucracy and red tape to contend with when government gets involved in the regulation process' (R7). Government was also accused of being inefficient, as opposed to its private sector counterparts (R1; R6; R7; R10). Lastly, there are some who do not believe that government-backed CRA regulation is necessarily in the public's best interest. Rather, the South African government is merely conforming to international trends and protecting itself and the South African economy (as discussed in Section 4.1.1) (R1; R6; R7; R10).

In terms of modernity theory, it does not matter if the relevant controls and regulations in place are the most efficient. What is most important is the ability of these mechanisms to reassure non-experts that these systems work. Consequently, those opposed to additional regulation, argue that concerns about the efficiency of regulatory measures – and the ability of the State actually to enforce the regulations – take second place to the symbolic value of the new CRA laws. 'Symbolic' should not, however, be read as 'less relevant' (Giddens, 1991; Unerman & O'Dwyer, 2004).

Interestingly, those who were critical or sceptical of government involvement in regulating CRA's accepted that it was an inevitable outcome of the financial crisis. In particular, they stopped short of concluding that government regulation was completely unnecessary. 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 (Section 2.1). In this context, almost all respondents were willing to compromise on a 'hybrid' (R8) regulatory model which includes elements of both self- and government-backed regulation. An 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. Government should be able to step in and deal with serious breaches of rules or standards (R1; R5; R6; R8; R10).

> 'A hybrid of self-regulation and government is best. The industries where regulation works best is where there is a good mix...a combination is ideal' (R8).

> 'I suppose inherently I'm a free marketeer, so government regulation is unwarranted inefficient bureaucratic interference, which is perhaps a little bit harsh, but it tends to come down that way very often. **But self-regulation is also a weakness**, because the people who are doing the regulation have a vested interest and are not necessarily seen to be acting neutrally, even if in their best endeavours they are doing. So if there's a possibility of a combination of the two, I think that would be desirable' (R1, emphasis added).

This Section has dealt with the nature or type of regulatory system that may be able to regulate CRA's effectively. A discussion of CRA accountability follows in the next subsection. Accountability is another key factor which contributes to stakeholders placing their confidence in the functioning of CRA's. In the institutionalised environment characterising modernity (Giddens, 1991), CRA's should be able to claim credit for their successes but, at the same time, should be held responsible for their errors. This discussion is expanded below.

4.1.3 CRA 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 in order to ensure that they do not make the same errors (R2; R3; R4; R6; R8; R9). As will be discussed below in Section 4.2.2, the

failures of gatekeepers, such as CRA's, has shifted a degree of responsibility (perhaps unintentionally) onto investors. Investors must now be more cautious when assessing gatekeeper opinions (R4; R6; R10).

The Credit Rating Services Act (2012) has had the following effect: Investors will have to be more cautious of whom they rely on for information and CRA's will be able to avoid responsibility for their errors more easily. The reason for this is that the fact that regulation has been introduced should be a warning to investors that CRA's should not be blindly relied on. The legal liability clauses in the South African regulation could be part of the process of replicating CRA regulation in the U.S.A and other jurisdictions around the world (Section 4.1.1). The fact that investors will carry an increased burden is possibly an unforeseen consequence of regulation (R4; R5; R6). Notwithstanding the consequences of the new CRA regulation, all interviewees agreed with Manns (2009): CRA's must be accountable for their actions, and part of the discussion on accountability includes liability for CRA's when they make errors.

As discussed in Section 2.3.5, Section 19 of the Credit Rating Services Act (2012), CRA's in South Africa may be held delictually liable in certain instances. One of the respondents stated that new CRA regulation, worldwide, 'is trying to suppress overreliance on ratings and shift more responsibility onto investors'. This is a key point to consider with regard to CRA liability (R2). In fact, investors might find it hard to hold CRA's liable if they (investors) have to shoulder more responsibility for their investment decisions and their use of ratings (R2; R4; R7).

The legal position in South Africa before the new Act was introduced was that a CRA could be held delictually liable for damages. In order to be successful in such a case, factual and legal causality needs to be proved. Factual causality is easier to prove because it often involves negligence or gross negligence. Legal causality is 'extremely difficult to prove (almost impossible to prove in most cases)' because it is very difficult to prove who 'the legally attributable cause of this loss is'. The same principles apply to auditors, and this is the reason why lawsuits against auditors in South Africa are seldom successful' (R4). The end result is that:

> 'Regulation is actually easing liability on CRA's. Before [the new Act was introduced] they could be held delictually liable anyway. The new regulation exacerbates the problem – it's much harder to prove them liable now...the problem of proving legal causality remains' (R4).

It seems that even factual causality is also not always easy to prove – 'it is difficult to prove a negligent rating, unless obvious mistakes have been made' (R2). An Australian court recently ruled that S&P was guilty of misleading investors and has ordered them to pay damages (Kelly, 2012). This case is an 'obvious example where a CRA was negligent and made errors in its calculations'. It is important to point out that most legal actions against CRA's post-2008 have not been successful, despite the mistakes that were made (R3).

> 'It's a very, very hard thing to prove…If they've made an error in a calculation on one of their models, arguably they're negligent, but a rating is no protection against fraud, that is clearly understood...my fear is that there is huge amount of ignorance about details of what rating agencies do. Rating agencies are complex institutions and they issue complex opinions. Now it's newsworthy when someone's downgraded. But, how many people that have an opinion on it, bothered to read the reasons for that downgrade? Take, for example, the recent sovereign downgrade in South Africa. How many people have bothered to read that piece? Yet everyone's got an opinion on it. It makes very interesting reading. (R2)'

Despite the attention and notoriety that CRA's have attracted following their errors leading up to the 2008 crisis, they are still largely misunderstood by many market participants. Governments and regulators alike have tried to restrict CRA's by instituting stringent liability laws to protect the public in the future, should these agencies err (R1; R2; R6). Through the lens of modernity theory, this is part of the process of reacting to prior failures and reassuring stakeholders that the expert system remains sound.

Initially, the comment that new South African regulations are: 'trying to suppress overreliance on ratings and shift more responsibility onto investors' (R2) seems in conflict with the functioning of modernity mechanisms. A key point to remember, however, is that CRA's are firmly entrenched in world financial markets and at present there are no readily available alternatives (Flannery et al., 2010). As one interviewee explained:

> 'Institutions and politicians react defensively to downgrades – 'it's like insulting a family member...something you can't do...even if it's completely plausible to downgrade, it's very rare that they accept a downgrade and understand it properly' (R6).

Nevertheless, CRA's continue to operate, even after the introduction of new regulation and increased liability clauses. In South Africa, the Act, therefore,

attempts to regulate the rating agencies while simultaneously requiring market players to understand CRA's better, rather than attacking and blaming them for past failures (R1; R2; R5; R6).

It appears that regulators must perform a delicate balancing act when it comes to CRA liability. CRA's perform a function which financial markets value (despite their recent failings) and their credit opinions are very valuable. In fact, whether or not CRA's are willing to acknowledge it, the role they play in financial markets is a public interest role (R2; R8; R9; R11; R12). Legal liability must, therefore, be reasonable. On the one hand, it must be substantial enough to deter negligent or fraudulent behaviour if the relevant regulations are to have the intended effect of bolstering confidence in the expert system. On the other hand, it should not be so excessive that it makes the industry undesirable for new and incumbent players, leading to functional problems which can be just as damaging as a crisis of trust. In other words, care must be taken to balance the need to reassure non-experts about the ability of the CRA's to function. Lastly, there must be some form of accountability for the CRA's, especially in light of their considerable power[16].

Some concern was raised about the liability clauses in the Credit Rating Services Act (2012). It seems that even if a CRA rates an instrument diligently, and the 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. If a rating proves to be incorrect due to market conditions changing, or unforeseen events, CRA's should not be subject to liability. It may be appropriate to provide further guidance on the liability clauses in the new Act (R1; R2; R4; R8).

> 'If I've read one aspect of it [the Act] correctly, I'm quite alarmed, which is the implication that if a credit rating agency carries out a credit rating, even if it does it diligently, and that rating would seem to be appropriate, that if an investor loses money later, that they will have an action that they can bring against the rating agency. Now if that's true, then this is even worse than being an auditor! I know it's hard to conceive of anything worse than an auditor but there you can be presumed to be liable for damages even if you've done a good job, as opposed to

[16] CRA power is highlighted by many authors. Partnoy (1999) and White (2010a) underline the rating agencies' exemption from liability and the regulatory reliance placed on ratings (discussed in more detail in Section 2.3). Mulligan (2009) draws attention to the fact that Moody's, S&P and Fitch hold 98% of the world market share for ratings. Lastly, Friedman (1995) and Sinclair (2005) also emphasize CRA power over debt capital markets and they show the serious consequences of upgrades or downgrades by a CRA.

> compensating people where you've been negligent in the performance of your duties, which I think would be an acceptable penalty' (R1).

The above respondent warned that if this 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 CRA's from operating in South Africa. If CRA's add value (Cavallo, Powell, & Rigobón, 2008) and stop operating in South Africa due to a burdensome legal environment, it would 'generally reflect badly on our local economy and our ability to raise capital at an affordable level' (R1).

As a result, there also may be a need to limit claims against CRA's. Harper (2011, p. 1969) states that unlimited liability for CRA's is not a viable option at this stage, as there are no alternatives to CRA's. The same is true in South Africa where it was pointed out that a CRA profession would have to develop in order to institute a limit on liability. To put this in context, a cap on auditor liability was only introduced after an auditing profession was well-established. Essentially, auditors were required to register with a professional body that regulates their activities and stipulates certain procedures, allowing for a relaxation of the extent to which auditors are held liable (R7; R9). It is very unlikely, however, that a CRA profession will be developed in South Africa in the near future because of the costs involved and the small market for credit ratings (R1; R2; R8; R9).

> 'Absolutely...I don't think that rating agencies should be protected in some special manner from lawsuits, but I don't think it's a solution to the problem to hold them liable. I mean it's an interesting one. There was a time when auditors were being blamed for everything and, in fact, ultimately there was a need for legislation to protect auditors to limit the size of damages claims because the auditor profession couldn't operate. Otherwise, it was a choice of whether you want auditors or not, which is a whole different debate...there is a danger that the rating agencies are going to be blamed for poor investment decisions, but, yes, I do believe they should be held accountable' (R2).

Several interviews noted that there is a risk that CRA's may be above the law, in certain instances, due to the their immense power in debt capital markets (R1; R2; R4; R6; R8; R9; R12). Consequently, most respondents agreed that some measure of legal liability was necessary:

> 'You cannot place the amount of responsibility that was placed on CRA's [prior to the 2008 crisis] without requiring them to be liable if they don't adhere to the standards - both government and the ones they've put there for themselves' (R4).

> 'I think it's proper for regulation to say: We are giving this responsibility to the CRA's, if they don't fulfil their duties in terms of this regulation, they can be held liable by third parties who have suffered a loss' (R4).

As noted above, however, a balance is needed between holding the CRA's *bona fide* liable for damages and protecting the industry against frivolous claims:

> 'On the one hand, it doesn't help if you have regulation but can't take action against them. On the other hand, if the liability is so heavy, nobody will want to enter that market. The concept of liability must be there, but the regulation must be very clear on liability...the test cannot be that we never make mistakes and that you get killed for making mistakes. The reasonable person test should be used – would a reasonable person have come to a similar decision?' (R8)

> 'If liability is too burdensome, it makes it difficult to attract people to that profession...it must be reasonable and it needs to be balanced. Liability can't be too much, but it can't be too little either, otherwise auditors and CRA's might think they can get away with anything. Auditors and CRA's are powerful and can sweep things under the carpet – we must not allow that' (R9).

In summary, the new Act will possibly make it more difficult for investors to hold CRA's liable for misrepresentation. The new regulation places more responsibility on investors to make informed investment decisions and this, in turn, will make it more difficult to hold CRA's liable. The new regulation does not amend the current position – one can hold a CRA delictually liable but the problem of proving legal causality remains (R4). On the one hand, this reflects the desire to regulate the industry (Section 4.1.1) without imposing undue legal liability risk on the CRA's. On the other hand, the limitation of legal liability could be an example of an unforeseen consequence of regulation. As highlighted by Unerman and O'Dwyer (2004) and Black (2010), modernity is characterised by a high degree of institutional complexity leading to the possibility of new regulatory measures – introduced to restore confidence in the expert system – operating contrary to the expectations of policy-makers.

4.2 The limitations and unforeseen consequences of regulation

4.2.1 A paradox: Increasing the dependency on rating agencies

CRA 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). Moody's, S&P and Fitch hold 98% of the world market share for ratings (R2; R4; R6).

> 'Regulators must be careful with new regulation, not to extend the problem unwittingly by making it more difficult for new entrants...every new piece of regulation is another barrier to entry' (R4).

The fact that CRA's are being regulated means that they have to contend with increased compliance costs, as well as increased exposure to liability (Section 4.1.3) This makes it very difficult for new entrants into the CRA industry (R1; R2; R4; R6; R8). White (2011) and Harper (2011) agree with this sentiment. White (2011) states that some of the sections in the Dodd-Frank Act (2010) may increase barriers to entry and may make the incumbent CRA's more vital to bond markets. In the U.S.A, Harper (2011) doubts whether or not new entrants will be able to build good reputations to become NRSRO's, seeing that such a status will expose them to increased liability, coupled with reduced reliance on NRSRO ratings.

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

> 'Ironically their role has been strengthened. Everything that has happened, the whole response to 2008, has been to place greater reliance on the rating agencies. So, has their reputation been destroyed - maybe. Has it been a terrible thing for rating agencies? I don't think so. They endured a tough year or so, but their financial performance is not entirely bad at the moment. You just have to track their share prices...You've seen them! (R2)'

When it comes to South Africa, several smaller CRA's operate along with the big three. Some interviewees took the position that regulation should not address competition (or lack thereof) (R4; R6; R7). Others, however, claim that growing the

CRA industry is very important and that the new Act will be a failure if there are not more CRA's operating in South Africa in the near future (R8; R9; R11; R12).

> '...if regulation is done to restrict new entrants into the market, then I think that would be counter-productive to a market-based economy. If the regulation is there to protect and enforce what serves the market best, then that's something that I think I could live with and support' (R1).
>
> 'It's very scary actually...we're trying to open up the market by regulating them more! It's a very interesting point, but it's the only way we're going to get there' (R8).
>
> 'The position of the Big Three[17] right now is stronger than it has ever been. There is regulation risk now. Regulators want more CRA's but they're trying to control them more also, so it's a difficult situation' (R6).

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). Modernity mechanisms mean that assumed confidence placed in external regulation of expert systems (Unerman & O'Dwyer, 2004) aids in legitimising the existing industry practices and players to the extent that alternatives become unimaginable (Suchman, 1995). As discussed in Section 4.1, regulation has become an inextricable part of the modern capital system, and a financial world without regulation of the CRA's is inconceivable. Despite the fact that regulation entrenches the very CRA's that played an infamous role in the 2008 crisis, regulators want to be seen as acting strongly in response to a crisis. They, therefore, regulate the industry and, in doing so, entrench the existing rating agencies rather than decrease the regulatory burden on CRA's in order to open up the industry for new entrants (see Section 4.1).

As discussed in Section 2.3.4, White (2010b) also warns that the introduction of more regulation will further entrench CRA's, as opposed to making entrance into the CRA industry easier. With regulation and the self-interest of governments closely linked (Section 4.1.1), it is likely that regulators fear being perceived as failing to respond to a crisis of confidence with added regulation more than the unforeseen consequences of those new laws.

[17] Moody's, S&P and Fitch – as referred to in Section 2.3.1 above.

The next subsection highlights both the limitations and the unforeseen consequences of CRA regulation with respect to investor responsibility. One of the main limitations seems to be that investors still rely heavily on CRA's, despite CRAs' failings. Furthermore, the fact that CRA regulation has been introduced has seemingly lessened the burden of responsibility on CRA's, whilst increasing the burden on investors for their investment decisions. This discussion follows below.

4.2.2 Investor responsibility and the 2008 financial crisis

New South African and other international CRA regulation places more responsibility on investors (R2; R4; R5; R10; R11). As explained by one interviewee:

> 'There seems to be a non-verbal devolution away from reliance on CRA's towards independent and critical inquiry by investors' (R4).

CRA's have published their methodologies and further information about their ratings and the regulatory reliance on ratings seems to have eased somewhat. As explained by Mulligan (2009), the fact that CRA's have come under intense scrutiny since 2008 is a sign to investors that more caution and thought must be exercised when utilising credit ratings to make investment decisions. The same applies in South Africa (R2; R4; R10; R12).

> 'We are definitely seeing a concerted effort to take reliance away from ratings towards the investors taking more responsibility for their own decisions. CRA regulation is implying that investors must first assess the relationship between issuers and CRA's and the reliability of the CRA itself...before you begin to look at the rating itself' (R10).

> 'Investors must now form their own opinions on the ratings, CRA's and rated products' (R12).

All respondents concurred that investors relied too heavily on CRA's leading up the financial crisis (see also Mulligan, 2009; Partnoy, 2009b). Blame for the 2008 financial crisis was, however, also attributed to investors. Some interviewees went so far as to claim that the investors who invested in AAA, or similarly rated, subprime mortgages were primarily to blame for the financial meltdown (R1; R3; R4; R10). 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). As explained by one respondent, 'investing in something that you do not understand is a recipe for

disaster' (R5). Hill (2011a) asserts that investors have admitted that they did not understand the securities that they purchased. Most interviewees 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 a due diligence on their material investments.

The 'outsourcing of risk assessments to CRA's' (by all market participants, including regulators and investors) was 'one of the single biggest causes of the crisis' (R4). Financial markets placed a considerable amount of confidence in credit ratings before 2008 because of mandatory or quasi-mandatory use of these ratings being required by regulation or in terms of investment fund rules. The over-reliance on credit ratings (as described in detail by Partnoy, 2009b) highlights two key issues: first, due to the mandatory or quasi-mandatory use of credit ratings, investors became complacent and did not conduct adequate research before making investment decisions. Second, 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). The fact that a large number of instruments were receiving AAA ratings did not arouse suspicion from the majority of market participants. As explained by one interviewee: 'nobody listens to a naysayer in a bull market' (R2) (see also Hill, 2010a). Consequently, there was an appeal by respondents for investors to be more responsible with regard to their reliance on credit ratings:

> 'Yes, you can blame the rating agencies, however investors make their choice. Ultimately the investors made bad investment decisions. Yes, there were some of those investments that were of dubious morality, I accept that. I accept that they over-sold...but ultimately investors bought things and they didn't understand what they had bought' (R2).

> 'CRA's don't add value. The problem is that the market wants ratings from CRA's, therefore, issuers have to get them. The market places a value on credit ratings from CRA's. You have to do your own research to judge creditworthiness. Investors must do their own research – the same as banks. This is a very important point...however, it will also cost money to do your own research' (R3).

This may be especially true when it comes to the valuation of complex financial instruments. CRA's were heavily criticised for rating instruments which they did not fully understand (R2; R5; R6; R10; R11). Lewis (2010) describes the situation pre-

2008, where the benefit of hindsight reveals that CRA's did not understand the risk attached to subprime securities - while professionally and morally problematic, investors should still take full responsibility for the losses on complex instruments, which they did not properly understand (R2; R5; R11; R12).

> 'Now what I think happened was that in the late nineties securitisation started growing. Rating agencies started beefing up their capacity to deal with it. They employed some very, very smart mathematicians, who worked together with traditional credit analysts and lawyers...You need all those skills to understand the risk of securitisation and they started developing some very clever methodologies to assess the risk of securitisation...The problem, initially, was that they [CRA's] developed a separate model for each transaction. Now each transaction is unique. The problem is, as volume transactions started growing in the early 2000's, they didn't have enough people to create these models and they thought they could employ any old idiot with a PhD in physics who was going to be able to rate this accurately. The reality is they started just using the same model over and over again, even though the circumstances were different' (R2).

Factors which resulted in CRA errors included a lack of capacity to deal with the volume of securitised transactions coupled with an incomplete understanding of those transactions. Another significant factor was that there was a 'loss of scepticism' (R1).The approach used to rate complex financial instruments was too mechanical and quantitative in nature. As important as quantitative statistical analysis is, rating analysts should have taken a broader view of market conditions (R1; R2; R7):

> 'Perhaps they weren't asking enough questions...in looking at a bond issue, then they have to look at all of the economics underlying that – the business purpose for it, and to understand all of the risks, and what the response is to those risks. AAA is the best rating you give to anything. How many people get ten out of ten? So something should have sounded a warning signal to them when the number of AAA-rated debt instruments was increasing rapidly and all for the same type of instrument. Something's going on' (R1).

While this criticism was widely shared, several interviewees were sceptical about whether or not regulation would be able to address shortcomings in acumen of analysts and executives at CRA's. The same is true of well-entrenched methodologies for rating instruments. It is not clear if new regulation is internalised as predicted by policy-makers. Without necessarily changing the manner in which 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's to perform their rating services[18] (R1; R7; R8; R10).

Credit 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 (R6). There is a need for diversity of opinion when making investment decisions. 'Good risk-management comes with diversity of opinion' (R2; R7). Hill (2010b) proposes that investors should be encouraged to rely less on CRA's. Furthermore, Darbellay and Partnoy (2012, p. 23) state that 'behavioural reliance on ratings has been deeply 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.

Several respondents were, however, concerned that, almost 7 years after the start of the 2007/2008 financial crisis, investors remain heavily reliant on CRA's for key investment decisions (R1; R3; R5; R9). These interviewees felt that the regulation has not resulted in more investor awareness. Paradoxically, the power of external regulation to secure confidence of outsiders in the functioning of expert systems has perpetuated a misconception that CRA's operate efficiently and effectively and that their ratings can be automatically relied upon. The result is that some investors have 'barely reacted' to the 2007/2008 financial crisis and 'astonishingly' still place their trust in CRA's (Hill, 2010b, p. 16). Cane et al. (2011, p. 37) argue that new securitised instruments have become too complex for average institutional investors and 'this increasingly means that investors are essentially forced to rely on CRA's as the information concerning these investments is simply too difficult to understand'. Arguably, however, the complexity of an investment does not negate the need for a prudential financial analysis.

This is not to say that CRA's should not be accountable for their ratings (see also Section 4.1.3). Interviewees unanimously agreed that those in positions of trust ought to be subject to monitoring and regulation. For several respondents, this meant that, despite the investor's responsibility to perform his own due diligence, regulations should entrench the principle of accountability for CRA's.

[18] The researcher would like to thank one of the external examiners for pointing this out.

> ‘CRA’s will claim that investors must do their own homework. I don’t buy that. If they [investors] must do homework themselves, why do we need CRA’s at all? The fact is that people rely on them and they must give some level of assurance! People must be able to rely on what they say...there must be a certain level of comfort. If they can’t do that, then why do we need them at all? They claim that it’s just an opinion [that they offer], but it’s the only opinion in the market! (R8)’

> ‘There is a big consumer education problem, I think. It’s quite hard to blame the investors [for the 2008 crisis] because really, it should be the responsibility of the whole financial community [including CRA’s] to educate investors about what the risks of these products are and were, and they weren’t really [educated properly]’ (R6).

> ‘CRA’s are independent private sector bodies. Irrespective of what happened, the reality is that they’re just giving their opinion on something. Yes, they could have been wrong and should have been stricter on ratings, but they didn’t seem to understand what was going on. Not only them, everyone didn’t seem to know what was going on...You do rely on the CRA’s in some sense, but the ultimate responsibility lies with the person who invests. If you don’t understand instruments you are buying, ultimately it’s your responsibility’ (R5).

Those who claim that CRA’s must act in the best interests of the public are reluctant to blame investors, especially in relation to the consumer education problems when it comes to complex financial instruments (R2, R5, R10). The findings seem to suggest that if CRA ratings cannot be relied on (with a reasonable amount of assurance), then CRA’s seemingly do not add value to financial markets and are perhaps obsolete (R3; R8; R9). On the other hand, CRA’s operate as private entities with an objective of making profits. CRA’s offer creditworthiness opinions which must be taken into account, along with other credit opinions (R2; R5; R10).

The topic of how investors make their investment decisions is a complex one. It is unclear from the findings who should bear the ultimate responsibility of educating investors. The views of who should be responsible for educating investors range from financial gatekeepers, to regulators, to investors themselves (R1; R2; R6; R7; R8; R10):

> ‘I think the difficulty at the end of the day is that we seem to have lost the ability, apart from a few fund managers and a few individuals who’ve got time on their hands, to make judgements about what we think we should invest in. Some people just take bets...people are not making informed judgements. It’s a whole separate research paper as to why they’re doing that, but it seems to be a general malaise. It’s apparent, not only in South Africa, but it’s around the

> world that people now don't want to do the work that enables them to make the judgement and it's easier to take the view of somebody else and go with the rest of the herd' (R1).

In summary, there are conflicting views with regard to investor responsibility. In its simplest form, the issue is: how much reliance should investors place on credit ratings? Those who argue that CRA's perform a public interest role in financial markets are of the opinion that investors must be able to place great reliance on CRA's. On the other hand, perhaps investors need to be more cautious with credit ratings due to CRA failures leading up to 2008. The introduction of CRA regulation seems to infer that there has been a loss of 'trust' in CRA's (R7; R8). This, in turn, means that investors will bear the brunt of criticism for bad investment decisions in the future, even if they still choose to rely solely on credit ratings.

One of the biggest areas of contention with respect to CRA's is the issuer-pays business model and the potential conflicts of interest that it introduces. A discussion about CRA regulation would be incomplete without addressing the issuer-pays business model. The next subsection looks into this area and highlights certain limitations of regulators when it comes to regulating privately owned entities such as CRA's (despite the public-interest role that they purportedly play).

4.2.3 The issuer-pays business model

CRA regulation in South Africa, and in other jurisdictions, does not directly address the CRA issuer-pays business model. The fact that new regulation worldwide does not address this controversial issue highlights the limitation of some regulation (R4; R5; R6). CRA's are privately owned businesses which focus on revenues and profit. As discussed, the mandatory or quasi-mandatory use of ratings entrenched the need for CRA's and they became very powerful as a result (R2; R4; R5). Despite the public interest role which CRA's play in financial markets, regulators worldwide have deemed it a step too far to legislate how they should earn their keep. This may be due to that fact that there are no obvious viable alternate business models. The more likely reason is that CRA's are powerful and they would not agree to be dictated to by regulators with respect to what business model they should use. Several respondents referred to CRA power throughout their interviews (R2; R4; R5; R6; R7; R8; R10).. Although it was never explicitly stated, interviewees intimated that CRA's

have the power to hold governments to ransom, especially with respect to how they earn their keep (Section 2.3). In particular, the power of the CRA's has allowed the issuer-pays model to become firmly entrenched.

> 'CRA's went largely unregulated until relatively recently – it was thought that their reputation was of such importance that they could not afford not to put checks on themselves. It seems that the reputational hazard was not enough' (R4).

The above respondent confirms Partnoy (1999) and White's (2010a) belief that the reputational hazard of publishing inaccurate ratings was not enough to curb greedy or negligent CRA behaviour. The main concern with an issuer-pays model is that CRA's will rate favourably (and often inaccurately) in order to preserve their client base. One respondent asked: 'Why get a rating if it's going to be bad news, especially if you've got to pay for it? (R1)' For example, 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's.

There was general agreement among interviewees that the business model introduces several conflicts of interest (R1; R2; R3; R4; R6; R8).

> '...the issuer pays for the rating. This is an important point. You can put checks and balances in place but does it help? Especially before the financial crisis, did CRA's really stick their necks out? No, because the issuer was paying them for the rating' (R8).

The topic of business model, and how CRA's earn their revenues, led to a discussion on whether or not CRA's see themselves as a profession serving the public interest or as businesses operating with the primary intention of earning a profit[19]. With respect to CRA's, there was almost unanimous agreement that they are first and foremost a business, focused on 'money-making' (R3) and the 'bottom line' (R2) (see also Partnoy, 2006).

> 'They [CRA's] are a business. Regulators want to try to make sure they are a profession...CRA's, lawyers and auditors, they're all businesses. You will never totally get them to have that mind-set [of acting like a profession which serves the public interest]. Those days are gone realistically. I think everyone is in it to make money...The whole thing of a profession is inherently flawed' (R8).

[19] Similarly, there has been ongoing debate among auditors as to whether auditing is a profession or a business (although this is beyond the scope of this research).

As in the U.S.A (Partnoy, 2006), respondents confirmed that CRA's make the vast majority of their revenue from issuers who pay them for ratings. CRA's 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).

Notwithstanding the criticism of the issuer-pays model, respondents were unable to suggest practical alternatives. An investor-pays model was mentioned but CRA's would not agree to such a change at present (R1; R2; R4; R5; R6; R7). Furthermore, an investor-pays model could potentially introduce other problems and conflicts of interest:

> 'With the investor-pays model, it would take the opposite approach, but there would still be the same problems. Whilst ratings could be inflated under an issuer-pays model, they would be deflated under the investor-pays. Ratings are used for credit default swaps, effectively the yield on debt. Investors want the highest possible yield and issuers want the lowest possible yield, so you've got problems on either side' (R6).

If investors were to pay for ratings, this may tempt issuers to use less qualified or less reputable CRA's to produce their preferred rating (R2). On this point, Coffee (2010) also questions 'whether the rating agency so chosen will have credibility'.

> 'Is that ethical [The investor-pays business model]? I don't know. Don't ask me, I'm sure there's some wiser person than me who could answer that question. I don't know, to be perfectly honest. But I'm not sure if I have a better suggestion, than issuer-pays. It's a bit like auditors, it's probably a less than perfect solution. If the investor pays the company being rated, how are they going to choose the rating agency? Are they going to choose [a CRA] that is a reputable one and not go for the one who is least qualified to give them the right rating?...Will they automatically have an appropriate relationship if they are not paying them to do it? I don't know if it does it' (R2).

The possible introduction of a government rating agency was discussed but this possibility was summarily dismissed. All respondents supported the preservation of the status quo, relying on privately-owned CRA's. In terms of modernity theory, CRA's have become so entrenched that a significant reform to the system is unimaginable. Coffee (2010) also suggests a state-run CRA may be an alternative to the issuer-pays model, but not without its limitations. Despite the errors that CRA's made in the past, it seems that all the respondents would still rely on the incumbent

privately-owned CRA's over a government rating agency CRA (R1; R2; R4; R5; R6; R7).

> '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 objectives different from a free and fully informed market' (R1).

Respondents agreed that existing regulation, including South Africa's Act, does very little to address conflicts of interest arising from the issuer-pays model. The result is the rating process, including the relationship between the rated and the CRA's, remains a black box which regulators dare not open. CRA's are so powerful and firmly entrenched in the capital market that governments are either unable to regulate them, or unwilling to confront them on issues where they will be met with fierce resistance (R1; R4; R6; R8).

According to some respondents, CRA's have little choice other than to make issuers pay for ratings. The free access to information on the Internet would severely damage rating agencies' profitability if an investor-pays model were to be used (R1; R4; R6). In addition, markets try to supply investors with as much information as possible in order to generate investment, so it seems that an issuer-pays model ensures that important information is available to all market participants, most importantly investors (R1; R4; R6).

> '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]' (R1).

If CRA's are going to continue to employ an issuer-pays model, 'they must be able to demonstrate that they can add value to the instruments being rated' (R1). This potential problem could be seen as the beginning of an 'unfortunate moral hazard' (R7). CRA's might find themselves in the same position as auditors. There is an implication that, because the issuer is paying for the rating, it will be able to generate a good rating from the CRA. This implies that a CRA may deviate from the guidelines and rules as set down in its established rating methodology in order to issue a more favourable rating. The alternative is to issue a fair rating but risk losing a potentially

lucrative deal. This problem can be compared to an auditor who threatens to qualify a report, and is subsequently threatened with the loss of that client as a result (R1; R7; R8).

> 'Part of the issue is whether or not they're dealing in a commodity, which is the rating, or if they're dealing in a service, which is how a company can improve its appearance, to get a better rating. Nobody's quite sure, because there are no standards that are understood, communicated to people as to how the rating agencies come up with their ratings' (R1).

If an issuer-pays model is to be successful, there must be "Chinese Walls" in place (R5; R6). In theory, such mechanisms are meant to separate credit analysts from the commercial negotiations surrounding a rating. Most respondents rejected the idea of Chinese Walls stating: 'they don't work' (R4), 'they are see-through' (R10), 'Chinese Walls are useless and they are not fine at all (R9)'. Regardless of the fact that CRA's endeavour to separate their credit analysts from commercial dealings with their clients, it appears that the analysts are almost always aware when they are issuing ratings for important clients (R2; R4; R6; R8; R9; R10) - 'the issuer-pays model still places a bias on the credit analysts' (R4).

Like White (2010a), one interviewee offered a possible defence that might be used by CRA's. This interviewee stated that CRA's 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' (R2).

There may, however, be a more complex problem than the issuer-pays model – the relationship between investment banks and CRA's (White, 2010a). This relationship seemingly requires intense scrutiny and investigation (R2).

> 'Right, that the revenue from any single rating is so insignificant that it is not worth putting their reputation at stake, that on the surface that makes a lot of sense. But that's not entirely true...that glosses over a vital fact, and this is why I am not sure if the question is about who pays. It's a more complex issue - a key relationship is with the merchant bank, the investment bank advising the debt issuer, because they usually influence which rating agency is used. So, as a result, Moody's, S&P and Fitch never want to get on the wrong side of Goldman Sacks, Morgan Stanley...Absolutely, there are a dozen major banking institutions that are advising on the vast majority of material debt issues in the world. Now there's a cosy

> relationship between those guys and the rating agencies. That is the problem, not the bank that the issuer pays...ultimately the issuer chooses the rating agency, but they are severely influenced, they are fundamentally influenced by their adviser [investment bank] on the debt issue' (R2).

Although all the interviewees would support the pursuit of an alternate business model, they all accepted that the issuer-pays model will continue for the foreseeable future. A key reason for this is the current high levels of profitability achieved by the CRA's. It seems unlikely that CRA's would agree to a change in business model – one respondent in particular was adamant that this is due to rating agency power: 'you cannot tell them what to do' (R5). It should also be noted that, despite all the flaws that were identified regarding the issuer paying for ratings, no feasible alternatives were offered as a solution.

> 'If a bright spark can come up with a way that CRA's are happy with the way they are paid, and regulators and markets are as well...Until such a time, I don't see the issuer-pays model going anywhere, because fundamentally, that's where the money is' (R6).

As discussed in Section 4.1, governments place importance on maintaining a perception of an attractive economy. There may also be no real incentive to reform the CRA business model in this case. CRA's are very powerful institutions and it may suffice for government to create the impression of good regulation and a sound economy. Malsch and Gendron (2011) analyse the drastic change in the regulatory landscape for auditors over the past two decades. It was once considered unthinkable to regulate the way auditors conducted their business (Malsch & Gendron, 2011). It should be noted that auditors are also powerful institutions (Levitt, 2002). At present, almost all aspects of the auditing profession are thoroughly regulated, and that begs the question: Why should gatekeepers such as CRA's be any different Malsch and Gendron (2011)?

The fact that far-reaching CRA regulation worldwide has not directly tackled the issuer-pays business model, to a large degree highlights the limitations of this regulation. CRA's are supposedly gatekeepers of financial markets and a responsibility is placed on them to keep markets fully informed and to hold market participants accountable. The great monetary incentives that CRA's have are a real threat to their objectivity and independence. This has been made clear in the aftermath of the financial crisis. The public's trust in CRA's was shaken, in large part

due to their skewed incentive structures. The fact that regulators either cannot, or feel that they cannot, dictate a viable substitute business model would support the school of thought that perceives regulation as a façade. This in turn begs the question: are the relevant regulators able to enforce the relevant regulations?

4.2.4 Regulator ability and enforcement power

The FSB is tasked with implementing and enforcing the Credit Rating Services Act (2012) in South Africa. There were differing views with regard to the FSB. Some claimed that the FSB is more than capable of enforcing CRA regulation in South Africa (R8; R9; R11), whilst others questioned whether the FSB had the skills and resources to understand CRA's and regulate them adequately (R2; R10).

> 'I think the FSB has a very good track record...I think they have the mindset of a good regulator – that's not too draconian and that wants to work with companies...it's not as if they haven't made mistakes. I think with some things they were too soft...but I think they've got good experience now, which counts for a lot...And I think that the other thing they do well is they look at best practice, they go elsewhere and see what are the lessons learned there and they try to come up with a South African solution...so they don't necessarily try to completely reinvent the wheel, which is not always the right mindset...The FSB as a regulator has a good enough track record to deal with it [CRA's]...as regulators go, they're definitely in South Africa, the better one' (R8).

Some respondents, however, criticised the FSB, claiming that the South African CRA regulation is 'boilerplate' (R9) or simply a 'copy and paste exercise' (R8) from other jurisdictions (Section 4.1.1). Furthermore, the FSB was heavily criticised for the introduction of Regulation 28 (issued in terms of Section 36 of the Pension Funds Act (1956)). Regulation 28 mandates the use of ratings, and this goes against current international best practice. Currently, international best practice has moved toward reducing reliance on credit ratings by removing the mention or mandate for ratings (as discussed in Sections 2.3.4 and 4.2.1). Regulation 28 goes against this trend and 'people in the industry on all sides find it a disaster' (R2). As discussed above (Section 4.1), the replication of international best practice is key for securing the credibility of the capital market - it is unclear what the FSB's intentions were with the introduction of Regulation 28, although it seems that the long term goal is to remove the mandatory use of credit ratings from regulations in South Africa (R4; R6; R13). On one hand, Regulation 28 is an example of an unforeseen consequence of

a regulation. On the other hand, respondents suggested that this showed a lack of clear direction on the part of the regulation and the regulator (R3).

> 'I fear in South Africa, that the FSB may not have the capability to do its job. So, I fear that the FSB does not have the ability to deal with the complexity of it...Their stated aim was to bring South Africa in line with international best practice but, in fact, a lot of what they were doing is in the opposite direction...International best practice at the moment is to try and lessen the official role of rating agencies...Regulation twenty-eight is moving in the exact opposite direction' (R2).

The ability of the FSB to enforce the relevant regulations is frustrated by a lack of resources and by the country's legal system (R2; R7; R8).

> '...the structure itself I think is a good structure. They've got some very competent people who were in there, they don't have enough manpower to deal with all the issues that come up, so inevitably it takes a long time...it can take two or three years for the FSB to get it right, to actually come to a decision on what should happen...they often try to negotiate some sort of settlement which then compensates people that have suffered...it takes a long time to bring the thing to a conclusion, but that's typical of the justice system in South Africa anyway. But what is concerning is that some of the judgements have been overturned subsequently or reduced and that indicates perhaps that there is a lack of impartiality in the way that they proceed against some people as compared to others. Is that a good thing or a bad thing? I don't know.' (R7)

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. Despite the fact that this perception might be false, the legitimacy and reputation of regulators in South Africa suffers and trust in the capital system is eroded (R1; R7; R8; R10).

Many respondents called for regulators to be granted power to enforce regulation without having to rely on the Courts. The advantages of this would be that issues would be dealt with far more quickly and public funds would no longer be wasted on drawn-out legal battles. The fact that so many cases in the past have been drawn out has further exacerbated the perception that regulators are inept and incapable (R7; R8). Trust in regulators and regulatory models has suffered as a result. If regulators were allowed to enforce regulation more effectively without relying on the judicial system, it might aid them in repairing their reputations and restoring some trust in the system (R7; R8; R9; R11: R12;).

> ‘If you got a regulator that simply has to say in the public interest the only thing I can do is to take you to court, I don’t know if that’s always in the public interest because it drags it out. Besides I’d hate to think how much money they’ve spent on legal fees, it’s very good for the legal profession, and so guess who writes the laws, but no! The regulators should be permitted to come to a decision and a judgement that is specific to the facts in the case that is not going to be used as you would typically see in other cases to set a precedent for others to follow or to argue constitutionality or otherwise. If you can reach an agreement with somebody, to me that’s a market-based solution even if it’s only between two people and, therefore, it’s done, let it lie and move on’ (R1).

5. Conclusion

5.1 Summarising comments

This thesis confirms that regulation plays an important role in capital markets. The question is whether regulation is introduced, based on its merits or whether it merely acts a smokescreen to serve self-interests. The introduction of CRA regulation worldwide was a predictable and inevitable response to a financial crisis (Giddens, 1991; Unerman & O’Dwyer, 2004). The Credit Rating Services Act (2012) is South Africa’s attempt to conform to so-called international best practice. CRA regulation in South Africa should not, however, be taken at face value – it should be met with inquisitiveness.

The issues of trust, power and credibility are clearly illustrated in this research. Governments flex their muscles by regulating the perceived culprits of the 2007/2008 crisis (in this case CRA’s) through increased control and monitoring. On the one hand, governments try to restore trust and credibility in their respective economies to secure foreign investment and to achieve economic growth. Based on the experiences of foreign jurisdictions (a space distanciation) dealing with the 2007/2008 financial crisis (a time distanciation), the South African government introduced new CRA regulation to restore confidence in capital systems. This is especially important, given the highly institutionalised environment characterising periods of late modernity, coupled with the country’s dependence on foreign capital as a developing economy. On the other hand, a paradox results - despite the involvement of the CRA’s in the financial crisis, their services and expertise are in

high demand and the CRA's continue 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. Recently enacted regulations provide important reassurances, even if these are more symbolic than substantive.

What this suggests is that regulation alone is not a solution to the problems posed by the dominance of the CRA's. 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's must be accountable. The lack of practical alternatives or substitutes for ratings means that possible onerous liability referred to in the Credit Rating Services Act (2012) 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 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. Lastly, it is questionable whether CRA regulation will be able to address possible shortcomings in analytical acumen of rating analysts, improve their professional judgment or lead to more holistic rating models which take quantitative and qualitative factors into account.

Paradoxically, CRA regulation has further cemented the rating agencies' position in financial markets. CRA's 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 capital markets are social constructions swayed by past events and experiences. As reputations and world markets recover from the 2007/2008 crisis, the pendulum of regulation will probably swing back towards less oversight and looser controls.

5.2 Contribution of this thesis

This thesis makes an important contribution to the corporate governance literature. There are very few examples of interpretive and critical corporate governance research in South Africa and, in particular, research dealing with the importance of

understanding *how* regulations function in a practical setting. This study may also have practical applications for the CRA industry in South Africa.

The findings will be of interest to regulators, politicians, CRA's, investors and other industry players - CRA's play a prominent role in international financial markets and it is, therefore, of importance that the regulation of these institutions is examined and understood. The introduction of CRA regulation has inevitably followed the 2007/2008 crisis. The proliferation of CRA regulation necessitates that the nuances of regulation are discussed and understood. This includes the workings of regulation, how regulation legitimises the capital system, its limitations and the sometimes unforeseen consequences. The qualitative nature of this research and small sample size means that the findings should not be broadly generalised, however, this thesis lays the basis for future research and it should lead to more in-depth CRA research being conducted in South Africa.

5.3 Limitations and areas for future research

This thesis used Giddens's (1990; 1991) modernity theory as a theoretical framework to examine the introduction of new CRA regulation in South Africa. Suchman's (1995) legitimacy theory is incorporated into this research but it was not used as the primary theoretical framework. Future CRA regulation research could, therefore, concentrate specifically on the regulations which confer a sense of pragmatic, moral or cognitive legitimacy. Similarly, the issue of institutional power has only been touched on. How power dynamics between regulators, institutional investors and CRA's lead to the development and application of relevant laws and regulations could be an interesting area for future research. In addition, Malsch and Gendron (2011) examine the dynamics of power in the auditing regulatory space. It appears that a similar in-depth analysis of power in the rating agency regulatory arena is an important area for future research.

The exploratory nature of this research, based on a small group of informed participants, means that the findings should not be generalised (as would be the case in a positivist study). As a result, future researchers should examine whether the concepts introduced in this thesis are applicable in other developing economies and whether or not perceptions of CRA regulations vary among stakeholders. (To

this end, it should be noted that there were no significant differences in the responses of the different types (or groups) of respondents in this study, although this was not the focal point of the research).

Finally, at the time of completion of this study, the Credit Rating Services Act (2012) is still in its early stages of implementation. It will be interesting to observe how South African regulators implement and internalise this new regulation. Follow-up studies ought to be conducted to assess the respective strengths, weaknesses, successes and failures of this new Act. In particular, it would be interesting to explore the actual processes followed by the CRA's to grade instruments and how, if at all, this has changed following the financial crisis and promulgation of recent regulation. To this end, future research should focus on whether the new Act adds tangible value or whether its introduction has been a "smoke and mirrors" exercise as suggested by most of the respondents participating in this research.

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VI Appendix 1 – 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's 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?

VII Appendix 2 – Experience/background of respondents

Respondent	Experience/Background
R1	Retired Investment banker.
R2	Over 20 years of rating, risk management and credit risk management.
R3	Over 40 year so of corporate experience. Multiple direct dealings with CRA's.
R4	Commercial Law expert.
R5	Rating expert.
R6	Approximately 10 years of rating experience.
R7	Financial Analyst.
R8	Approximately 25 years of corporate experience including auditing, corporate governance and regulatory work.
R9	Over 20 years corporate experience and over 10 years of regulatory experience.
R10	Investment banking and regulatory background.
R11	Approximately 35 years of regulatory, academic and corporate governance experience.
R12	Approximately 10 years of corporate governance and regulatory experience.
R13	Ratings, regulatory and investment banking experience.

VIII Appendix 3 – Ethics clearance

Ethics Clearance was granted by the University of the Witwatersrand. The following is the Ethics Clearance reference: CACCN/1057.