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I. INTRODUCTION

Concerns about the South African economy raised by credit ratings agencies are "not about numbers but about sentiment." This was how South Africa's Finance Minister Pravin Gordhan characterized the actions of credit rating agencies ("CRAs") in remarks made after delivering the country's Medium Term Budget Policy Statement in October 2013.[2] In various interviews, the Minister went on to provide a critique of the manner in which credit ratings agencies operate, touching on their perceived conflicts of interest and the quality of their analysis.

For emerging economies, the findings of credit rating agencies are crucial as they influence how the international investor community perceives a country's risk profile and its attractiveness as an investment destination. Credit rating agencies are relied upon to provide investors with information and guidance that serves as input into the analysis of securities and decision-making processes. For example, sovereign ratings provide an indication of the general business environment within a country and usually provide a ratings ceiling for the private sector. In playing this role, the views published by rating agencies have an impact on the cost of credit and access to capital markets, especially where local markets are small and opaque. The quality of CRA pronouncements and the cost of ratings also have a great impact on private sector companies that require ratings.

The dominance of the big three firms; Moody's, Fitch, and Standard and Poor's, is well-documented. The entrenchment of this dominance through regulation and legislation, starting with the endorsement of these three agencies by the United States as nationally recognized statistical ratings organizations, persists.

As the global financial crisis led to scrutiny of the ability of rating agencies to guide investors in assessing risk, key elements of their operating models have come to the fore as problematic. The dominant issuer-pays model, where the institutions issuing securities pay to be rated, distorts agencies' objectivity. The significance attached to the ratings issued by the big three is also being challenged, with governments across the G20, including South Africa, implementing measures to remove strict references to agency-issued ratings from legislation,

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[2] Financial Mail: *Gordhan slates rating agencies' sentiments on South Africa*. Troye Lund, (24 October 2013). www.financial mail.co.za. Accessed 20 January 2014.

regulations, and investment mandates. These measures also aim to encourage investors to form an independent assessment of credit risk beyond the assessments given by CRAs.[3]

In developing countries, the depth of analysis provided by these agencies, particularly in instances where they do not maintain a significant local presence but "parachute" analysts in and out of the country, has come into question. South Africa's Finance Minister, Pravin Gordhan, has argued that credit rating agencies have not given the country's policymakers enough credit for proper management of its economy. Since the dawn of democracy in 1994, South Africa received its first credit downgrade in 2012.

New entrants into the market for credit rating agencies have to contend with high barriers to entry. To be effective in the market, an agency needs to build a reputation for quality. However, quality is only observable *ex post* using a large sample of data. An agency also needs to produce ratings that are comparable across time and geography so as to create a standard that investors become comfortable with. Thus, the greater the coverage of an agency, the more valuable it becomes to investors. Investors also do not want to have to invest resources in understanding and interpreting many standards. Issuers also prefer to build trust with a few rating agencies; and prefer to receive ratings from agencies that are trusted by investors. All these factors tend to favor concentration.

As a response to the perceived challenges in this market, competition has been offered as a solution. Competition may improve the quality of ratings. However, competition has also been found to generate problems, as in the case of "ratings inflation" observed in the United States with the rise of rivals to the big three, due to the ability of issuers to play agencies off against one another to obtain favorable ratings.[4] This type of forum shopping, in the context of an issuer-pays model, highlights the ways in which other reforms are necessary to ensure that greater competition leads to desirable outcomes in the market.

II. INITIATIVES TO REGULATE CREDIT RATING AGENCIES IN SOUTH AFRICA

Five credit rating agencies operate in South Africa, commonly known as Moody's, Fitch, Standard and Poor's, Global Credit Rating Co., (GCR) and Ratings Africa.

In South Africa, credit ratings issued by CRAs are required by law in various contexts. For example, banks use credit ratings in calculating the prescribed minimum amount of required capital and reserve funds. Municipalities may only invest in instruments with an investment grade rating from a nationally or internationally recognized agency. In the private sphere, most fund managers have mandates that are determined with reference to credit ratings.

South Africa is implementing recommendations made by the G20 countries with regards to the regulation of agencies. These recommendations seek to create a globally consistent regulatory framework for agencies, which include the mandatory registration of CRAs.

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[3] Financial Stability Board: *Credit Rating Agencies – Reducing reliance and strengthening oversight. Progress report to the St Petersburg G20 Summit*. 29 August 2013. www.financialstabilityboard.org/publications Accessed on 20/01/2013.

[4] OECD: *Competition and credit ratings agencies*. Note from the Secretariat. DAF/COMP (2009) 39.

South Africa passed the Credit Rating Services Act No 24 of 2012, whose provisions became fully operative on December 17, 2013. This legislation provides for the registration of credit rating agencies, the regulation of their activities, the conditions for the issuing of credit ratings, and the organization and conduct of CRAs. In terms of this act, credit ratings can only be issued by a registered credit rating agency. Agencies must ensure that they have the capacity to issue sound ratings and must review the quality of their methodologies and ratings regularly.

The Act also provides for various disclosures that agencies must make to the public (such as its methodologies and assumptions, code of conduct, nature of compensation arrangements, and default rates of its rating categories) and to the registrar (such as its top clients and how revenue is split among them). The act also calls for the registrar to have regard to the "principle that competition between regulated persons should not be impeded or distorted." The act also sets out some elements that may be included in memoranda of understanding with regulatory authorities in other jurisdictions.

The competition authorities have jurisdiction over CRAs in the conventional areas of merger control, exemptions, and also anticompetitive conduct (unilateral conduct and horizontal restraints such as collusion). However, these powers are exercised in response to conduct by CRAs. Like in most areas of the economy, effective competition also requires policies that shape the rules of the game in a pro-competitive manner. The Credit Rating Services Act features elements that support competition.

It has been argued that measures to increase transparency in CRAs enhance competition as they allow users to compare the processes and performance of CRAs. As mentioned above, CRAs registered in South Africa will be required to disclose their methodologies and the default rates of the categories that they rate. This should also enable new entrants or non-big three players to be able to demonstrate their competitive advantage to issuers and users of ratings.

In December 2013, Fitch South Africa and Global Credit Rating Company were registered under the new legislation. The applications for Moody's and Standard and Poor's are still under consideration and these agencies are operating under time-bound exemptions.

III. CHALLENGERS FROM EMERGING MARKETS

The creation of Arc Ratings through the combination of CARE Rating (India), Global Credit Rating Co. (GCR, South Africa), MARC (Malaysia), SaeR (Portugal), and SR Rating Group (Brazil) occurs against the backdrop of regulatory changes meant to enhance competition. This follows the emergence of another challenger to the big three—Universal Credit Rating Group, a joint venture among Dagong Global Credit of China, Egan-Jones Ratings of the United States, and RusRating of Russia, with headquarters in Hong Kong.

South African-based GCR began its life as a subsidiary of U.S.-listed CRA Duff and Phelps. According to the company, it accounts for the majority of ratings in Africa. The company rates all security classes. Over the years, GCR has attracted investment from development finance institution DEG/KFW group (stake acquired December 2007) and French government-owned Proparco (stake acquired 2009).

The rationale provided by Proparco for its investment in GCR was to improve the provision of financial information in the West and Central African Economic and Monetary

Unions as a way to improve the efficiency of financial markets in this region and to act as a catalyst for foreign investment into the region.[5] This rationale, couched in terms of encouraging private investment into the region, suggests that the big three were not particularly active in this part of the world, whereas GCR had experience in "difficult" emerging markets.[6]

GCR sees its value proposition as its insight into the unique characteristics of emerging markets—giving it what is considers the largest subscriber base in that market. It estimates that in Africa, it accounts for 60 percent of ratings. Arc Ratings has introduced new methodologies to its product range, including a systemic risk rating and a financial stability ceiling. These methodologies aim to give clients insight into general risks across an economy and a different approach to determining a country's ratings ceiling.

It remains to be seen whether Arc Ratings and/or Universal Credit Rating will act as effective constraints on the big three agencies. In press statements, these emerging markets challengers have sometimes portrayed themselves as offering a "complementary" service to the big three, especially given the industry practice of seeking ratings from two agencies. The entrants seem to envisage a world where issuers would seek a rating from one of the big three CRAs and an emerging markets player.

IV. CONCLUSION

Global developments in policy towards CRAs favor adding constraints to their influence by reducing the weight placed on ratings in risk assessments and regulations and also through the introduction of competition. South Africa conforms to this trend, with new legislation passed to enhance transparency and competition between CRAs.

In line with G20 policy reforms, financial regulators have also embarked on measures to remove hard references to agency-issued ratings in legislation and regulation. The emergence of Arc, which includes the leading ratings agency in Africa, GCR, occurs against the backdrop of these pro-competitive reforms. These reforms suggest the need for closer co-operation between competition authorities and financial regulators with oversight over CRAs.

[5] Proparco/GCR press release: *Proparco acquires stake in global credit ratings* (16 November 2009).

[6] Proparco Note: *Contributing to the development of capital markets in Africa*. www.proparco.fr. Accessed 20 January 2014.